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Informal Workouts, Restructuring and the Future of Asian Insolvency Reform

**Proceedings from the Second Forum for
Asian Insolvency Reform - December 2002**



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FOREWORD

An effective insolvency system represents a critical part of every well-functioning market economy. The 1997 Asian financial crisis exposed the lack of such systems in many Asian countries. Weak secured-creditors rights and liquidation procedures often enabled insolvent debtors to block or delay meaningful debt and operational re-structuring. Reallocation of resources from failed businesses to productive ones was slow and inefficient. Creditors shunned markets that failed to protect their rights. In the six years since the onset of the crisis, most Asian countries have reformed their insolvency laws and procedures. In large part, the focus has been on: (i) establishing limited life, specialised bodies to deal with non-performing loans; (ii) replacing generally outdated insolvency regimes with new rescue procedures; and (iii) developing informal workout practices.

Progress to date has been substantial. At the same time, a significant gap has opened up between theory and practice, between rules and their implementation. This gap arises partly from the inescapable growing pains of assimilating in a few short years rules, practices and attitudes that took decades to evolve in developed markets. In addition, by focusing on and adopting some of the more advanced aspects of developed-market insolvency regimes, many Asian economies have failed to put in place the fundamentals that make these advanced aspects work.

The present volume provides a regional overview and in-depth country profiles on the form and substance of Asian insolvency reform, focusing on (i) general bankruptcy-reform developments; (ii) cross-border insolvency issues and informal workouts; and (iii) experience with non-performing loans (“NPLs”) and bulk sales. Contributions were prepared for and presented at the second Forum on Asian Insolvency Reform, 16-17 December 2002, in Bangkok, Thailand (“FAIR II”), which was organised by the Corporate Affairs Division of the OECD, within the framework of the Asia Regional Programme of the OECD Centre for Co-operation with Non-Members (CCNM). FAIR II was hosted by the Ministry of Justice of the Kingdom of Thailand and sponsored by AusAID and the ADB, in partnership with the Government of Japan and the World Bank.

The opinions expressed are those of the individual authors and do not necessarily reflect those of the OECD, the governments of its members or non-OECD countries. Lampros Vassiliou, OECD Consultant for Asian Insolvency, and Angela Jepson of the OECD Corporate Affairs Division edited this publication. This report is published on the responsibility of the Secretary-General.

Eric Burgeat
Director
Centre for Co-operation with Non-Members

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POLICY IMPLICATIONS FROM THE SECOND FORUM ON ASIAN INSOLVENCY REFORM

by

Robert Zafft¹ and Lampros Vassiliou

An estimated US\$ 2 trillion of bad debt hanging over Asian economies lends seriousness and urgency to insolvency-reform efforts in the region.

Since the economic crisis hit in 1997, most Asian countries have reformed their insolvency laws and procedures. In large part, the focus has been on: (i) establishing limited life, specialised bodies to deal with non-performing loans; (ii) introducing new rescue procedures to generally out-dated, insolvency regimes; and (iii) developing informal-workout practices.

Progress to date has been real and has been substantial. The effort, ingenuity and, in some cases, personal bravery of the many people responsible for this progress deserve recognition. At the same time, a significant gap has opened up between theory and practice, between rules and their implementation. In part, this gap arises from the inescapable growing pains of assimilating in a few short years, rules, practices and attitudes that took decades to evolve in developed markets. On the other hand, by focusing on and adopting some of the more advanced aspects of developed-market insolvency regimes, many Asian economies have failed to put in place the fundamentals that make these advanced aspects work.

In effect, these economies have tried to run before they have learned to walk. Their crisis-induced haste was understandable. But, now, nearly six years later, many such economies still have not adequately addressed the basic problems that gave rise to the crisis. As a result, they may be setting themselves up for another fall.

Emergency measures

In the immediate aftermath of the crisis, Asian countries moved swiftly to establish specialised bodies to handle non-performing loans (NPLs) and restructuring. Specific initiatives included:

1. Creation of asset-management companies (AMCs), including: China's four AMCs, national AMCs (such as Danaharta in Malaysia, the Indonesian Banking Restructuring Agency (*IBRA*), the Korean Asset Management Company (*KAMCO*), the Thai Asset Management Company (*TAMC*)), and collective AMCs (such as the Taiwan Asset Management Company formed by a collective of financial institutions);

1 . Senior Corporate Governance Specialist, OECD (e-mail Robert.Zafft@oecd.org).

2. Creation of rapid disposition agencies, such as the Financial Sector Restructuring Authority in Thailand (*FRA*), which was responsible for disposing of the assets of 58 suspended finance companies in Thailand;
3. Creation of restructuring funds, such as the Financial Restructuring Fund in Chinese Taipei, which is funded by tax receipts and is used to acquire NPLs from closed financial institutions (although there are proposals to extend the fund at present to enable acquisition of NPLs from other operating financial institutions);
4. Establishment of independent facilitating bodies, such as the Jakarta Initiative Taskforce (*JTIF*) in Indonesia aimed at encouraging restructuring;
5. Creation of restructuring committees, such as the Corporate Debt Restructuring Committee (the *CDRC*) in Malaysia and the Corporate Debt Restructuring Advisory Committee (the *CDRAC*) in Thailand, which have administered frameworks, binding and non-binding, for out-of-court, informal debt restructuring;
6. Creation of special legislative environments and vehicles to promote investment in distressed debts and assets such as the mutual funds created by the Securities Exchange Commission in Thailand, numerous vehicles in Korea (such as Corporate Restructuring Vehicles, Corporate Restructuring Companies and Real Estate Investment Trusts), and the proposed special purpose asset vehicles (*SPAVs*) in the Philippines. Restrictions on foreign ownership were put aside and tax waivers and incentives offered to encourage investment.

These measures enjoyed varying degrees of success. Some very successfully promoted the pace of restructuring, while less successfully promoting quality in restructuring. In addition, the above measures also engendered some inappropriate practices, even moral hazards. For example, the shuffling of debts without resolution from bank to AMC to national AMC, etc., has fostered a culture of non-payment by debtors. An equally if not more serious hazard has arisen from the bulk purchase of non-performing loans by state-run AMCs. In many cases, although the loans acquired were practically worthless, state-run AMCs bought them at or near face value using long-term, zero-coupon, sovereign debt. In this manner, state-run AMCs successfully re-capitalised the banks, but also permitted banks and bank managers to avoid accountability for past mistakes. Nor have banks or bankers been forced to put in place proper risk-analysis and credit-quality management systems to prevent these mistakes from recurring. As a result, banks and bankers are free to continue their old ways, with the ultimate burden being transferred (through the AMC sovereign debt) to the taxpayers, or perhaps more accurately, their children.

Most of the specialised bodies mentioned above had a limited life and some have already ceased operations. In all cases, the focus had been on providing a temporary opportunity or vehicle to promote recovery. None were intended to be long-lasting reforms. Going forward, it is essential that Asian economies remain committed to cleaning up bad debt and that the knowledge, and experience built up within these specialised organisations not be lost.

Rescues and Informal Workouts

The situation concerning rescue laws and informal workouts is more complex. Asian governments have, in several cases, introduced new rescue laws by essentially lifting and transplanting (with some local tailoring) concepts from developed-economy insolvency regimes such as Chapter 11 of the U.S. Bankruptcy Code. Informal-workout procedures have, at the same time, been developed largely as evolutions of the so-called London Approach.

As noted above, it would have been unrealistic to expect that emerging-market insolvency regimes could have both smoothly and effectively incorporated legislative, regulatory, institutional and judicial practices that took decades to evolve in developed economies. Such practices require time to be understood by policy makers, business leaders and practitioners, to be assimilated into the overall legal system, to be implemented and enforced by entirely new or radically re-designed agencies and courts, and to be accepted by the general business and governmental culture.

There is another side to the “restructuring revolution” taking place in Asia, however. By focusing on rescue laws and informal workouts without first putting into place credible liquidation procedures, as well as systems that effectively protect creditors’ rights and reform managerial and lending practices, many Asian regimes have postponed rather than confronted the problems that caused the 1997 financial crisis. When these problems manifest themselves again, regional governments and financial systems may prove inadequate to the task.

In coming to grips with restructuring issues, it is important to remember that the purpose of restructuring, whether formal (court or agency led) or informal (led by debtors and creditors negotiating on their own), is to preserve the value of the debtor’s business as a going concern: (i) if it is viable; and (ii) where the return to creditors can be maximized. While cutting up and selling off pieces of the business might fully satisfy secured creditors’ claims, it is wasteful to the economy – and unfair to unsecured creditors, shareholders and employees – to do so where the claims of creditors can be satisfied in some other manner.

Real restructuring involves several pre-requisites. First, the trigger for insolvency proceedings must come early enough in the debtor’s decline for the debtor and the creditors to find common ground. Where a debtor can go, or be pushed, into a rescue procedure when liquidity problems first arise, the chances of saving the business as a going concern are much greater than if rescue can only be triggered by debtor’s balance-sheet insolvency. Second, the debtor must face a real and credible threat of liquidation or creditors’-rights enforcement, or he has no incentive to restructure in a timely fashion. Third, restructuring accomplishes little if it does not change the underlying corporate, operational and managerial practices that led to the initial insolvency; i.e., restructuring has to “fix the business.” Fourth, there must be some method of binding dissenting creditors who unreasonably seek to hold up an agreement.

In the absence of these and other pre-requisites, “restructuring” can degenerate at best into debt re-scheduling, and, at worst, into a charade wherein insolvent debtors frustrate the legitimate claims of creditors while keeping hold of assets that could be placed into more productive use.

In surveying the practice, rather than the theory, of restructuring in Asia, it is the worst-case scenario that all too frequently plays out. Fraudsters have been allowed to walk away from companies after gutting their assets. In Indonesia, Thailand and the Philippines, specialised courts and judges charged with expedited consideration of cases have been plagued by constitutional and jurisdictional challenges and uncertainties. More generally in the region, indiscriminate issuance of injunctions or temporary restraining orders against creditors, inconsistent interpretations of the law, build-up of caseload, rotation of judges, and delaying tactics by debtors – not to mention outright corruption of judges and regulators – demonstrate that changes in the legal and institutional frameworks have not consistently gained purchase on the ground.

A similar tale unfolds with regard to informal workouts. Many workout plans represent a fictive rescheduling of debts, with the creditors extracting additional security and fees, but having no real expectation that the debtor will be able to comply with rescheduled payment plan. Particularly suspect are plans that: (i) rely upon rosy multi-year projections; (ii) defer interest for several years; (iii) or that

contain a significant balloon (or bullet) payment at the end of the term. In such case, the debtor may have avoided liquidation, but the insolvency process has failed to rehabilitate the business or to give it a fresh start, free and clear of unsustainable debt. As one regional banker has said, “we will do the rescheduling now and then do the restructuring next time they default”.

Creditors have a reason to be patient, since substantive restructuring might require them to write-off or to write down substantial amounts of their portfolio. This patience also takes the form of specious debt-to-equity swaps. Here, the lender surrenders its loans in exchange for shares in the debtor. These shares have no hope of ever generating returns but permit the lender to keep the investment on its books at an inflated value.

The above fictional reschedulings would more appropriately be viewed as an extension or adaptation of a moratorium (or standstill). Such moratoria are imposed by rescue laws, or at the beginning of a restructuring. The purpose in either case is to give the debtor breathing space whilst the rescue/restructuring is formulated. Of course, a realist might ask whether it matters what these arrangements are called, so long as debtors and creditors have agreed to them. Taking a step back, if policy makers’ macro objective since 1997 has been to achieve stability, at least in the short term, as well as to satisfy stated requirements of international agencies that assisted Asian countries following the crisis, haven’t the fictional reschedulings been a success?

The fact is, the difference between a real restructuring and a disguised moratorium does matter. A logical, and inevitable, consequence of the above practices is that many “restructurings” effected in the first few years after the crisis would fail. This is already occurring. The ability of a number of Asian economies to handle another major economic crisis or downturn must be questioned. If events force these economies to acknowledge the real losses hiding in their financial systems, it is unclear whether these systems – or the governments that stand behind them – will have sufficient liquidity to effect a bailout. The US\$ 2 trillion bad-debt overhang mentioned at the beginning of this article begins to look ominous.

Necessary first steps

To deal meaningfully with bad debt now and in the future, Asian insolvency regimes need to master the basics. A few of the most important are:

1. Putting in place credible liquidation procedures and efficient secured-transaction processes. These procedures and processes form the backbone of an insolvency regime. They permit prompt disposal of moribund businesses and force the managers of potentially viable businesses to negotiate real and rapid restructuring. Failed attempts to restructure in a timely fashion should lead to automatic and efficient liquidation, so as to protect creditors and to reallocate resources to more productive uses;
2. Creating the right dynamics for restructuring. The “trigger” for insolvency should be early enough that the debtor still has the prospect of being restructured into a viable business. In this regard, cash-flow tests for insolvency (rather than balance-sheet tests) should become the norm. In addition, restructuring procedures, even where the debtor remains in possession, must provide creditors an independent review by qualified experts of the debtor’s business, its prospects and options for restructuring. Restructuring works best when the debtor is co-operative and independent, expert advisers are engaged to review the business and to devise restructuring plans. Triggers and incentives are also needed to push or entice parties into restructuring – often these take the form of insolvent trading laws that hold

directors personally liable when an insolvent continues to trade, or central bank provisioning and loan-classification rules;

3. Requiring that re-structuring “fix the business.” Many distressed Asian businesses need substantial operational and managerial restructuring to become viable. Because of the large number of family owner-managed businesses in Asia, replacing management can be particularly difficult. But it must be possible. The *threat* of replacement is often sufficient to produce an informal workout; but, the *fact* of replacement is sometimes necessary to save the business.
4. Reforming lending practices. Bulk sale of non-performing loans to AMCs has retarded the development within banks of expertise in handling distressed debt. Nor have many banks, with notable exceptions, sufficiently improved risk analysis and credit-quality control so that the mistakes of the past will not recur. From a long-term perspective, failure to reform lending practices may prove to be the greatest missed opportunity of the emergency steps taken to deal with the crisis.
5. Strengthening institutional capabilities and, at its most basic, the rule of law. Much of this effort requires training, knowledge transfer, and leadership to eradicate corruption. The public must develop confidence that the skill and resolve exist within the government to improve judicial and regulatory enforcement.

Conclusion

Asian economies have come far in reforming their insolvency regimes, but much of the basic work remains: creditors’ rights must be enforced. Moribund businesses must be liquidated. Failed management must be replaced or put under very watchful eye. Lending practices and debt-portfolio management have to improve. Court systems must offer predictability and the rule of law.

These tasks are not complicated, but they are hard. Some of the most wealthy, powerful and politically connected interests in society must be forced to change how they do business. Still, for all the problems described in this article, there are examples of Asian regimes that either have, or are in the process of, taking these steps. Ultimately, it is not a question of culture, but of will. The prospect of a second Asian financial crisis should convince policy makers, business leaders and the public that it is time to put first things first.

PART I

GENERAL INSOLVENCY REFORM

Regional Overview

REGIONAL OVERVIEW

by

Lampros Vassiliou²

I. Background

The objective of this report is to facilitate discussions at FAIR II³. The author conducted missions in Thailand, Malaysia, Indonesia, the Philippines, Chinese Taipei and China in connection with FAIR II and to assist in preparation of this report. The comments below will generally focus on these countries although references to other countries in the region will also be made.

This report will seek to provide the following.

6. A review of the progress of and dynamics affecting restructuring and insolvency law reform in the Asian region.
7. A review, on a country-by-country basis, of recent developments in restructuring and insolvency law reform in the Asian region.

II. Descriptive labels

The developments, dynamics and pitfalls associated with the Asian recovery identified in this report are best summarised in the descriptive labels or phrases used as headings in this report.

2 . The author, Lampros Vassiliou, is the OECD Lead Consultant for FAIR. He is a Partner and Head of Corporate Restructuring & Insolvency — Asia for Allens Arthur Robinson (in association with Siam Premier International Law Office). He can be contacted at Lampros.Vassiliou@aar.com.au. As the OECD's Lead Consultant on Asian Insolvency he organised FAIR II, for which he conducted missions in Thailand, Malaysia, Indonesia, China, Chinese Taipei and the Philippines. Mr. Vassiliou is also a consultant for the World Bank and is involved in conducting assessments for the World Bank in Thailand, the Philippines and India in the insolvency and creditor rights area under the joint IMF-World Bank ROSC (Review of the Observance of Standards and Codes) programme. He is also a consultant for the Asian Development Bank and has been involved in technical assistance programme programmes in Thailand, the Philippines and Pakistan, including in relation to insolvency law reform, training of bankers, judges and official receivers and other capacity building projects. Parts of this report have also appeared in other published works of the author including in an article co-written by the author together with Robert Zafft, Senior Corporate Governance Specialist with the OECD, published in *International Financial Law Review* and the *Allens Arthur Robinson Annual Insolvency Review 2002*.

³ FAIR II is the Second Forum for Asian Insolvency Reform. The Organisation for Economic Co-operation and Development (OECD), in partnership with AusAID, the Government of Japan, the World Bank and the Asian Development Bank, held FAIR II in Bangkok, Thailand on 16, 17 December 2002. FAIR II was hosted by the Ministry of Justice of the Kingdom of Thailand.

III. The Restructuring Revolution

The author has in a number of presentations described developments in insolvency law reform and practice over the last few years as an insolvency revolution. Certainly, insolvency laws have had a prominence that has not previously been witnessed in many countries. Insolvency law developments and corporate rescue models adopted by some countries following the recessions in the late 1980s have been proved to be useful precedents in assisting economies in Latin America, Eastern Europe and Asia to deal with insolvency in the 1990s and at the beginning of this century. Countries throughout the world, particularly in Asia, have revised their insolvency laws and developed out of court workout approaches. A number of multilateral agencies have led significant endeavours aimed at developing cross-border insolvency laws, increasing the efficiency of systems, and most recently, achieving uniformity in insolvency laws and practices where possible. Progress in debt restructuring has varied from country to country as has the landscape for investors in distressed assets in the Asian region.

However, the period of significant change in the last six years in Asia is perhaps better described as a “restructuring revolution” rather than an “insolvency revolution” for most of the progress and focus has centred on development of corporate rescue regimes and informal workout practices. Following the Asian financial crisis which began in 1997, many countries in Asia began to reform their corporate insolvency, restructuring and debt recovery laws and procedures as part of a strategy to remedy legislative and institutional weaknesses and strengthen their financial and corporate sectors. In large part, the focus has been on: (i) establishing limited-life, specialised bodies such as asset management companies (AMCs) together with the creation of special legislative environments to facilitate investment in distressed assets and bulk sales of non-performing loans (NPLs) by financial institutions; (ii) introducing new rescue procedures to generally outdated, insolvency regimes; and (iii) developing informal workout practices. Significant progress has so far been made in a number of Asian jurisdictions in relation to the development of out of court workout processes and in improving the legal framework for rehabilitation procedures, although significant implementation problems persist. There has been little effective development, however, of liquidation procedures, secured transaction regimes, general creditors’ rights, lending culture and corporate governance.

IV. The Implementation Gap

In some cases, personal bravery of the many people responsible for this progress deserve recognition. At the same time, a significant gap has opened up between theory and practice, between rules and their implementation. In part, this gap arises from the inescapable growing pains of assimilating, in a few short years, those rules, practices and attitudes that took decades to evolve in developed markets. On the other hand, by focusing on, and adopting some of, the more advanced aspects of developed-market insolvency regimes, many Asian economies have failed to put in place the fundamentals that make these advanced aspects work.

In effect, these economies have had to try to run before learning to walk. Their crisis-induced haste was understandable. But, now, nearly six years later, many such economies still have not adequately addressed many of the basic problems that gave rise to the crisis. As a result, they may be setting themselves up for another fall. An estimated US\$2 trillion of existing bad debt hanging over Asian economies lends seriousness and urgency to the situation.

It would have been unrealistic to expect that emerging-market insolvency regimes could have both smoothly and effectively incorporated legislative, regulatory, institutional and judicial practices that took decades to evolve in developed economies. Such practices require time to be understood by policymakers, business leaders and practitioners, to be assimilated into the overall legal system, to be implemented and enforced by entirely new or radically redesigned agencies and courts, and to be accepted by the general business and governmental culture.

By focusing on rescue laws and informal workouts without first putting into place credible liquidation procedures, as well as systems that effectively protect creditors' rights and reform managerial and lending practices, many Asian regimes have postponed, rather than confronted, the problems that caused the 1997 financial crisis. When these problems manifest themselves again, regional governments and financial systems may prove inadequate to the task.

Whilst there have been significant developments in the improvement of legislative frameworks in many countries, particularly where new rescue laws have been introduced, implementation problems are significant. Practice has not matched the letter of the law. Indeed, the objectives of some laws have been entirely circumvented by contrary practices. For example, the rehabilitation laws introduced after the crisis in Thailand and Indonesia are fundamentally good laws, judged by reference to most international best practice criteria. However, such an analysis of the written letter of the law is academic and of little or no utility unless the practice or implementation of the law is also considered. The reality is many people do not live and conduct business by the strict letter of the law. In this sense, legislative reform must be seen as a first step toward triggering a change in attitude, culture and behavior.

It is notable that rescue laws were added to the legislative frameworks of many countries such as the United Kingdom, the United States of America and Australia many years, even centuries, after the development of well understood and commonly utilised liquidation laws. These countries sought to develop a rescue culture to prevent companies with potentially viable businesses from being liquidated unnecessarily by a strict application of the liquidation laws. In those countries, the rescue laws sought to introduce flexibility to the strict regimes of existing liquidations. In contrast, in a number of countries in Asia the rescue laws have been enacted in circumstances where there is no credible or efficient liquidation procedure.

In addition, in countries like Thailand, Indonesia, the Philippines and China, rescue laws have introduced a stick available to creditors to use in negotiations with debtors. This is a rather odd role for a rescue law and perhaps one reason why the laws have not worked so well in aggressive rehabilitations commenced by creditors where the debtor has not been co-operative in the process. In these countries the threat of liquidation has not traditionally been a credible threat that creditors could use to force a debtor into sensible conduct or to make a reasonable offer to pay its outstanding debts. The debtor, faced with a threat that if you don't pay we (being the creditors) will put you into liquidation, was often unconcerned as the process would take years there would be plenty of opportunity for delay and all involved realised that the creditor would probably end up receiving little or nothing if it went through with the threat. In addition, in many of these countries creditors do not have efficient civil remedies or secured transactions regimes to which they can resort to recover their debts. With the enactment of new rescue laws and expedited associated court procedures in these countries, creditors have been able to use the threat of bringing a petition for rehabilitation as a threat or stick against debtors. This is a rather odd and inappropriate role for rescue laws. The threat being if you don't pay we will rehabilitate your business! However, that has not been the real threat. The real threat has been if you (the debtor) do not pay or act co-operatively in agreeing to our restructuring terms, we will take away control of your business placing you into rehabilitation.

Hong Kong and Malaysia do not have any rescue laws. Hong Kong is considering the introduction of a rescue procedure. These countries have solid liquidation laws already in place. It will be interesting to see if the introduction of a flexible rescue law in these countries operates in a materially different way than in the other countries discussed above. There is certainly a culture or understanding in Hong Kong and Malaysia of the role of a liquidator and this will probably ease the introduction of any rescue law which envisages the appointment of an independent administrator to take control of the debtor's business.

Progress to date has been real and substantial. In general, the level of understanding throughout Asia of insolvency and the way it should be handled has increased. However, the stigma associated with insolvency is still high – there is not yet a culture of early admission of financial difficulties and an open, collective approach to deal with them.

In the long run, the Asian economic crisis will be viewed as a good thing for Asia, at least from the perspective that it has caused many countries in Asia to begin the process of reforming their corporate insolvency, restructuring and debt recovery laws and procedures. In addition, the capacity of courts, government agencies and regulators to apply insolvency and restructuring laws is improving in many countries and a new breed of consultants, bankers and executives have developed a fuller understanding of the techniques and approaches to corporate insolvency and distress – which are inevitable consequences of corporate business activity in a market system. It is also hoped that the recent increased focus on corporate governance will improve the stability of the investment outlook in Asia. There is, as always, significant room for improvement, however. The first steps have been taken although there is a need to focus on some of the fundamentals of efficient insolvency and creditors' rights systems.

V. Unviable Businesses Trade On and Good Businesses Collapse

Liquidation procedures are perhaps the oldest and most successful form of insolvency procedure. In Asia there has been, in general, an inadequate focus on the development of liquidation procedures as the backbone of insolvency procedures. Liquidation procedures offer the best known mechanism to deal with unviable businesses. Singapore, Hong Kong and Malaysia have probably developed the most efficient liquidation systems in a regional comparative sense. Liquidation laws provide a mechanism to liquidate the assets of an insolvent company with an unviable business and distribute the proceeds to creditors. They permit, if they operate efficiently, a prompt re-allocation of resources from the insolvent company to other, hopefully more successful, economic activities. There are, however, few countries in Asia that have developed efficient and effective liquidation procedures. The consequence of this is that unviable loss making businesses with no hope of recovery have been allowed to continue operating and incurring further liabilities which they will not be able meet.

In contrast, ineffective and slow rehabilitation procedures have also caused good businesses to collapse whilst waiting to pass through rehabilitation procedures. In the Philippines, for example, companies with viable business have collapsed whilst going through restructuring processes due to delays in the approval and implementation of plans. The debtor has been unable to obtain new money needed to fund working capital for its viable businesses (viability here often being considered on the basis of a core business, excluding non-core investments).

VI. Specialised Courts Have Been Plagued

A number of countries have established specialised courts or divisions of courts to handle insolvency cases (Thailand and Indonesia for example) or have designated particular courts and judges to handle these cases (the Philippines for example).

These measures, whilst often successful at the outset at speeding up the consideration of cases, have been plagued by constitutional and jurisdictional problems, the ease at which temporary restraining orders are issued, corruption of judges, inconsistent interpretations of the law, the build-up of caseload, rotation of judges and delay tactics by crafty counsel and recalcitrant debtors.

The Commercial Court in Indonesia has been plagued by concerns of corruption and inconsistent application of the Bankruptcy Act. The remarkable abuses of the court system, notably in the Manulife case (to sanction the arrest of a bona fide Canadian purchaser who had purchased assets from an authorised curator and, separately, in allowing a solvent insurance company to be placed into a bankruptcy administration procedure by holding that an agreement by shareholders that the company would pay a dividend could be the basis for finding that the company owed a debt, upon which a bankruptcy petition could be based, even though the company was not party to the agreement), have brought the credibility of the Indonesian insolvency system into disrepute around the world. The Indonesian Corruption Watch reports of corruption in the legal system is staggering.

In Thailand, the specialised Bankruptcy Court initially made a significant difference after its establishment in 1999 with a number of credible decisions in high profile and controversial cases. For example, in the controversial and hotly contested Thai Petrochemicals Industry (*TPI*) case it held that the company was insolvent, on a balance sheet test of insolvency as required by Thai law, by allowing the assets to be valued using a discount cash flow valuation methodology. This was widely misreported as the court adopting a cash flow test of insolvency. At the time this decision was generally regarded as a litmus test for the Thai system and heralded as a success as creditors were able to force a rehabilitation procedure on a debtor who did not wish to enter the procedure. However, after the TPI case, there has not been a flood of aggressive creditor-led petitions for rehabilitation in Thailand. TPI remains a rare case. Few creditors have been prepared to attempt to force a recalcitrant debtor into rehabilitation. The court has also been not entirely consistent in its assessment of attempts by debtors to utilise accounting techniques or questionable valuations to show that the value of their assets exceeds its liabilities. The court initially benefited from a number of technical assistance training and exposure programme provided to the judges of the Central Bankruptcy Court. However, much of the benefit from that training has been lost as judges have been rotated out of the court in accordance with general practice in Thailand. The court was also extremely successful at expediting the hearing of cases, and remains so, although the backlog of cases has mounted up and things are not as fast as they used to be. More recently, there has been increased concern as to whether corruption and improper influence are affecting results.

Constitutional challenges or uncertainties relating to the bankruptcy laws in Indonesia, the Philippines and Thailand have also been significant. Bankruptcy laws generally interfere with contractual and property rights. This can raise real constitutional issues in countries where these rights are protected under the constitution. There have been a number of constitutional challenges to the Bankruptcy Act in Thailand which result in lengthy delays as the matter is dealt with by the Constitutional Court and, in the meantime, the bankruptcy or rehabilitation case is suspended (in the rehabilitation case of Nakornthai Strip Mill (NSM), the delay has been over one year).

In the Philippines there are significant questions regarding the constitutional validity of any bankruptcy law that interferes with contractual rights. There are also issues regarding the validity of court rules issued to govern the hearing of cases. However, at a practical level there have not been any constitutional challenges to the insolvency laws or related rules. One reason for this is probably that much of the procedure is set out in rules issued by the Supreme Court of the Philippines, which is the same court that would consider any such challenge.

VII. Little Development of Civil Remedies and Secured Transaction Regimes

There has also been little development of civil remedies and secured transaction regimes and related court processes. In many countries, particularly Thailand and Indonesia, enforcement of securities can take many years, even decades. Secured transactions laws are outdated and do not permit a broad enough spectrum of assets to be given as security.

In Thailand while there was widespread reporting of a new foreclosure law being implemented in 1998/9, the reality was that there were no amendments to the foreclosure laws, which still specify that a mortgage cannot be foreclosed unless interest has been outstanding for 5 years.

High registration, transfer and other fees and taxes also limit the utility of securities in countries like the Philippines and Indonesia.

The application of concepts of adequate protection for secured creditors in bankruptcy regimes have been limited. Rarely has a secured creditor been allowed to enforce its security in a rehabilitation case by showing that its security is not being adequately protected.

The ineffectiveness of the legal system in this respect has created instances of a culture of non-payment. Borrowers believe they can borrow money and never have to repay it. There has also been the development of the so-called 'strategic debtor' — the debtor who is able to pay but chooses not to, for no one can compel him to do so.

Restructuring takes place in the shadow of liquidation procedures, secured creditor remedies and general creditors' rights, with the relative efficiency of these laws and rights acting as a stimulant or depressant, as the case may be, to out-of-court restructuring efforts. In Australia, for example, the liquidation procedures and antecedent transactions laws, which enable preferences to be cancelled, operate to make informal workouts almost extinct. Another factor prevalent in other countries that operate to provide a key incentive to prompt recourse to formal rehabilitation procedures is laws imposing personal liability on directors for insolvent trading – these are rare in Asia.

The absence of strong, efficient and well understood insolvency and creditors' rights laws in many Asian countries to underpin, give incentive to and implement realistic restructuring efforts have limited much of the long-lasting utility of "restructuring" that has taken place.

VIII. Inadequate Focus on Prevention of Fraud and on Corporate Governance

In Asia generally, whilst insolvency systems have developed, there has not been a focus or intensive application on the liquidation aspect of insolvency procedures, as many countries have preferred the promotion of restructuring. The investigative and disciplinary aspects of the insolvency laws have been overlooked and that is why corporate behaviour has not changed. Fraudsters can get away with their crimes and systems can be abused. Many laws are not enforced. There has not been a focus on the importance of the interaction between insolvency laws and corporate laws, particularly the fact that insolvency laws create a dynamic that facilitates the proper functioning of corporate laws. They offer the "stick".

The role of insolvency laws in preventing and punishing fraud and in promoting good corporate governance has not received adequate focus in the development and, more importantly, the implementation of new insolvency regimes across the region. The prevention of fraud and promotion of good corporate governance needs to be a primary focus in the formulation and enforcement of new insolvency laws.

This often requires, at the practical level, training and other capacity development and funding of official receivers or other officials or private sector representatives who are appointed as liquidators of insolvent companies.

Insolvency is the one period in the life of a company, admittedly its death, when a comprehensive review of its activities can be undertaken. In the case of rehabilitation, this hospitalisation offers a special one-time opportunity to review a company's history and transactions, and the conduct of its directors. This review, which a liquidator or other administrator is required to undertake, offers perhaps the best opportunity to identify fraud, serious mismanagement and other improper practices. It provides an opportunity to hold directors liable for insolvent trading and other breaches of the fiduciary, statutory or other duties.

However, in many countries in the region (for example, Thailand, Malaysia, Indonesia and the Philippines) the official receiver, official assignee or liquidator will generally only conduct such a comprehensive review if requested to do so and assisted, including financially, by creditors.

None of the countries in the region have established funds or other mechanisms to facilitate the performance of the liquidator's investigation functions in administrations where the insolvent companies have no assets at all. Assetless administrations are often the result of allowing fraudsters to gut their companies of all assets, thereby leaving no resources to be used to investigate and discover their fraud, let alone trace and recover assets.

In informal workouts, even in major workouts covered on the business pages of international newspapers, too often creditors have been offered deals as part of the workout which involve, as a condition of the deal to creditors, that creditors release shareholders or former management and others from liability for some suspected fraud or improper conduct. This is often clearly stated upfront in the offer to creditors. If we pay you X percent, you agree not to investigate this issue any further — that's the deal put to creditors.

Insolvency procedures present a one-off golden opportunity in the life of a corporation to examine whether there has been any fraud or breach of duty by its officers and to hold the perpetrators accountable. Rarely has there been the resolve to seize this opportunity and where the aggrieved parties have been bold enough to pursue the wrongdoers, deficiencies in laws and practices have frustrated their attempts.

IX. An Efficient Insolvency System Is In Itself Not Enough

Creditors and, in particular, debtors, will not utilise an insolvency regime, regardless of how efficient it is or the number of insolvencies existing at that time, unless there is some incentive to utilise the insolvency system.

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

This defence represented an acknowledgment that in handing over an insolvent company to an independent administrator the director was taking the most honourable of steps, acknowledging the position of the company and seeking to protect the interests of the creditors who were true stakeholders of the company at that time.

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

Central bank loan provisioning and loan classification rules can also provide incentives and triggers for restructuring. This is discussed below.

X. Fictional Reschedulings Not Real Restructuring

It is now *passé*, although still clearly true, to say that much of the restructuring that has occurred in Asia has been fictional rescheduling of debt without there being a realistic expectation that the debtor will be able to comply in full with the reschedule timetable for repayment and without any serious attempts at operational restructuring or other real restructuring techniques.

Many restructuring plans do not truly focus on the viability of the business; rather, they are simply a rescheduling of debts with no real expectation that the debtor will be able to comply with the rescheduled debt-reduction programme, in particular the significant balloon payment which is a common feature of many restructurings.

Many formal rehabilitations do not result in the debtor's business being rehabilitated and the business continuing in existence with a fresh start, free and clear of unsustainable debt.

Creditors use restructuring negotiations as a means of extracting additional security, equity or fees when they are not truly committed to the long-term restructuring contained in the restructuring plan in which they extracted that additional leverage or profit and do not expect that the debtor will be able to comply with the plan.

Debt-to-equity swaps are being used as a mechanism for creditors to avoid having to write off their lost investment. There is justification for a debt-to-equity swap if there is perceived to be some possibility that the shares in the insolvent company will, one day, have value. However, in some restructurings, this is not the case — the debt for equity swap can be simply a mechanism to hide the lost investment for a few years as there is no real expectation that the company will be able to comply with its restructuring plan.

XI. Repeat Workouts

It was feared that many of the restructurings entered into in the first few years after the crisis would fail and would need to be reworked. This is already occurring. Many plans contained forecasts which were based on unrealistic hopes of economic recovery, boom in certain markets, expansion of exports markets, ability to secure new capital investment and other dreams that have not materialised.

It is interesting that default under a plan has rarely led to more drastic consequences for the debtor. Default has often resulted in a reworked plan being agreed which is often less onerous on the debtor.

However, these repeat restructurings are not really remarkable. They are to be expected and are a natural consequence of an attempt to enter into a restructuring plan for a long period, of say ten years or more. It is impossible to make accurate economic or financial forecasts over such a long period. In any ten-year plan it must be acknowledged by the parties that they will need to rework the plan at some point, possibly many times, as circumstances change.

However, parties have preferred to enter into these long-term plans, rather than a short-term plan, for say the next two years, which sets out clear requirements for those two years and acknowledges that another round of negotiations will take place at the end of the two-year period to set the terms for the following short-term period.

XII. Failure to Accept Reality Now — the Disguised Standstill

If the macro objective since 1997 has been to achieve stability, at least in the short term, as well as satisfying stated requirements of the international agencies that assisted Asian countries following the crisis, then the restructurings, or rather the reschedulings, have been a success.

Often in a restructuring, there is an initial period called a moratorium where things are frozen or stayed. The reschedulings might be viewed as an extension or adaptation of the moratorium. As one banker said, “We will do the rescheduling now and then do the restructuring next time they default”.

Grudgingly, it must be accepted that the reschedulings may serve a useful purpose. The sad aspect is that many of them are drafted and agreed by stakeholders, knowingly or ignorantly, as fictions (i.e. drafted and agreed as if the parties expect the debtor to comply, for example, by paying the interest deferred in the first few years in later years and then being able to make the 85% bullet payment in the last year of the term).

If what is really intended is an extended moratorium, with additional security and fees being paid by the debtor during the moratorium period, then this is how the deals should be framed.

The nonsense is when any restructuring, regardless of its quality (i.e. even if it is an unachievable rescheduling), is allowed to permit the loans to be reclassified as performing. This, rather than the rescheduling itself, is what will haunt economic development in the years to come.

XIII. Loose Loan Provisioning and Loan Classification Criteria

Countries will be haunted by loose loan classification and provisioning criteria that have enabled fictional debt reschedulings to be reclassified as performing loans. When the Asian financial crisis hit, many economies in the region did not appear to have the ability to accept the effect of the losses caused by the crisis. Certainly, the desire by financial institutions to restructure has largely stemmed from the desire to reclassify NPLs as performing loans in order to alleviate related provisioning requirements. Unrealistic reschedulings with no write-down of debt have often been good enough to allow the NPL to be reclassified. There have been variances in the degree of analysis applied to the restructuring deals by central banks before allowing the loan to be reclassified as performing.

The inability of some banks to take haircuts on debts due to the consequent effect on a bank's balance sheet have skewed the structuring of many reorganisation plans.

Some central banks allowed financial institutions to amortise losses from restructures over time in order to spread the effect of the write-down. This represents an acknowledged fiction, although it does provide a useful carrot to entice banks to move forward with restructurings that involve some write-down or other loss.

XIV. Official NPL Figures Don't Tell the True Story

It is also *passé*, although again completely true, to say that official NPL statistics issued by central banks do not tell the full story of the level of NPLs in an economy. Often these figures, by their nature, only relate to loans in the financial sector or loans issued by certain financial institutions. They do not often contain loans transferred to AMCs or other vehicles. This is not a failing of the statistics as they report exactly what they are intended to – the level of NPLs in the financial sector assessed under applicable loan classification criteria. However, declines in the official NPL figures are often interpreted and reported as representing the status or progress of restructuring in an economy. This is entirely misleading.

Different approaches prevail from country to country as to the relevant loan classification criteria. The definition of NPLs applied in different countries, ranges from payment default for 90 days to 180 days elsewhere. Unofficial estimates by accounting firms and economists significantly exceed the official figures.

In countries such as the Philippines, in addition to looking to official NPL statistics it is important to also analyse the level of acquired or foreclosed assets held by the banks. Banks in the Philippines have been extremely successful at acquiring assets from their borrowers through voluntary debt-to-asset swaps known as *dacion en pago* so that banks have now become significant holders of distressed assets, particularly real estate assets rather than NPLs.

Reports commonly feature a comparison of the total level of NPLs against gross domestic product (*GDP*). The significance of such a statistic is confusing as the NPL figure is an accumulated figure while GDP represents an annual result. The value seen by some in the comparison may be only that it would take a significant or in some cases majority slice of GDP to deal with the NPL problem.

XV. Co-operative Debtors Have Benefited Most

There have been some instances of realistic financial restructuring and true operational restructuring. This has usually occurred where the debtor has been co-operative in the process and expert independent advisers have been engaged. This success has been reflected in share prices for listed companies following a so called 'happy restructuring'. Clever debtors can use the restructuring process to make progress in areas that might otherwise be impossible due to sensitivities or internal political issues — they can blame the creditors or the advisors whilst pushing through changes they want.

There have been few instances of creditors resorting to aggressive actions against debtors seeking their liquidation or rehabilitation in cases where the debtor objects strongly to such action. Where aggressive action has been taken, systems have rarely facilitated the action by the creditors. Debtors have been able to use delay tactics or otherwise frustrate actions by the creditors or their representatives. It has proved to be difficult to take control of businesses held by recalcitrant debtors. Debtors have resisted, often successfully. Even if the resistance has proved ultimately unsuccessful, the debtor may have been able to achieve significant delay or at least sufficient time to arrange its affairs so as to hide frauds, distance assets and otherwise defeat creditors.

In some cases debtors have been able to bring action after action opposing the conduct of creditors or insolvency practitioners. These attacks have also extended to matters beyond the matters in dispute between the parties. As in sports terms, attacking the player rather than the ball. Few, if any, Asian legal systems permit the court to declare a person a vexatious litigant and restrain them from bringing any legal action that suits them.

There have also been concerns for personal safety and alleged threats of violence. These concerns are not illusions. In Thailand on 10 March 1999, Mr. Michael Wansley of Deloitte Touche Tohmatsu was assassinated whilst working on the restructuring of a group of sugar companies. Restructuring experts accept serious risks in performing their role, particularly where it involves taking control of a tycoon or family-run company in countries where business violence is not unusual.

XVI. Role of Advisors Misunderstood and Undervalued

Advisors have been misunderstood and undervalued. They have proved to be easy targets for criticism and there has generally been a failure to appreciate the value that truly expert restructuring advice can add. There has been a focus on fees charged by financial and legal advisors. This is not remarkable in light of the fact that the consultancy fees borne by companies following the Asian crisis in restructuring have probably been the largest ever fees paid by these companies for consultancy services, but this is only a reflection of the fact that never before have companies required such significant levels of consultancy advice. It is often difficult to accept that thousands or millions of dollars in consultancy fees are justified by the contribution made by these experts. This fails to acknowledge that, in many cases, intelligent restructuring advice and approaches can create savings or gains which far exceed the level of consultancy fees. In the larger restructuring cases, debtors can complain endlessly about the advisor's fees whilst failing to compare those fees to interest accruing on their loans. Rarely, even in the largest of restructurings, would consultancy fees exceed a minor fraction of the accruing interest charges.

There has also been a failure to acknowledge the degree of knowledge transfer resulting from the advisers. This extends to restructuring techniques and general business practices.

Advisors also often provide the only source of quality control in a restructuring. Certainly it is essential to ensure that only qualified and reputable people are permitted to be engaged in providing such advice. The reality in many restructurings is that the integrity of the advisors involved and their concerns to protect their own corporate branding provides the dominant source of restraint against tendencies to illegal or questionable approaches in these restructurings.

The reality has also been that Asia did not have the required level of expertise in restructuring to deal with the financial crisis. Consequently, foreign advisors have provided much of the restructuring advice in the first five years following the crisis. This has triggered nationalistic and monopolistic sensitivities in the services sectors in some countries.

There has been a degree of mistrust of foreign advisors and some countries, for example Thailand, have adopted regulations or policies that prefer domestic advisors.

Without foreign advisors it is difficult to envisage how restructuring efforts in the financial and corporate sectors would have proceeded. There has clearly been a high degree of knowledge transfer from foreign advisors. This is evidenced by the new breed of Asian bankers, accountants and lawyers who now understand international best practice approaches to restructuring.

XVII. Creditor-friendly vs. Debtor-friendly Systems — The War is Not Over

The debate as to what type of insolvency system works best is raging in many countries in the Asian region. The historical development of insolvency systems varies from country to country with English, Dutch, Spanish, German and more recently, American and Australian influences featuring prominently. The debate often contains references to cultural issues and it is not unusual to hear views that creditor friendly systems do not suit the multitude of Asian cultures and value systems. In countries that implemented new rescue laws following the crisis, such as Thailand and Indonesia, critics of those laws say that the laws were simply transplanted from Western systems and do not suit Asia. There is a movement now in some countries, for example Thailand, to move to a debtor-in-possession system.

It is notable that no new or innovative approaches to restructuring or insolvency laws have really developed in Asia following the financial crisis. Most of the approaches have followed insolvency laws in other countries or restructuring techniques adopted elsewhere (for example, following the savings and loan crisis and the creation of the Resolution Trust Corporation in America). Cultural resistance to the new rescue laws has been significant and it will be interesting to see if an innovative approach can be developed that addresses these issues and produces an efficient system.

XVIII. Emergency Measures Rather Than Long Lasting Reform

Much of the reform seen in Asia in the last six years has been crisis-related emergency reform. There has been a focus on short-term reforms aimed at providing immediate respite from the effects of the financial crisis. The Asian crisis has seen many new institutions set up to assist in restructuring and recovery efforts. Some of these institutions have been highly effective, others just infrastructures which have been unable to deliver results. Each new institution offers the government of the day political advantages in the sense of allowing them to identify clear initiatives that they have undertaken to address the prevailing economic problems. These emergency reforms have included:

1. the creation of AMCs including such as China's four AMCs and national AMCs (such as Danaharta in Malaysia, the Indonesian Banking Restructuring Agency (*IBRA*), the Korean Asset Management Company (*KAMCO*), the Thai Asset Management Company (*TAMC*)) or collective AMCs (such as the Taiwan Asset Management Company formed by a collective of financial institutions);
2. the creation of rapid disposition agencies such as the Financial Sector Restructuring Authority in Thailand (the *FRA*) which was responsible for disposing of the assets of 58 suspended finance companies in Thailand;
3. the creation of restructuring funds such as the Financial Restructuring Fund in Chinese Taipei which is funded by tax receipts and is used to acquire NPLs from closed financial institutions (although there are proposals to extend the fund at present to enable acquisition of NPLs from other operating financial institutions);
4. the establishment of independent facilitating bodies such as the Jakarta Initiative Taskforce (the *JTIF*) in Indonesia aimed at encouraging restructuring;
5. the creation of restructuring committees such as the Corporate Debt Restructuring Committee (*CDRC*) in Malaysia and the Corporate Debt Restructuring Advisory Committee (*CDRAC*) in Thailand which have administered frameworks, binding and non-binding, for out of court informal debt restructuring;

6. the creation of special legislative environments and vehicles to promote investment in distressed debts and assets such as the mutual funds created by the Securities Exchange Commission in Thailand, numerous vehicles in Korea (such as Corporate Restructuring Vehicles, Corporate Restructuring Companies and Real Estate Investment Trusts), and the proposed special purpose asset vehicles (*SPAVs*) in the Philippines. Restrictions on foreign ownership were put aside and tax waivers and incentives offered to encourage investment.

These measures enjoyed varying degrees of success. Some very successfully promoted the pace of restructuring, while less successfully promoting quality in restructuring. These emergency measures may have also engendered some inappropriate practices, even moral hazards, including a culture of non-payment by debtors whose debts are shuffled around by banks to AMC's and then national AMC's and so on without actually ever being resolved, together with a reckless approach to lending by state banks, in particular, whose huge NPL portfolios were transferred to AMC's without there being any other real managerial or cultural change in the bank's operations, leaving the bank free to again engage in the reckless, or directed, lending practices that initially created its huge NPL portfolio. Examples of these moral hazards are discussed in more detail below.

Most of the specialised bodies mentioned above had a limited life and some have already have ceased operations. In all cases, the focus had been on providing a temporary opportunity or vehicle to promote recovery. None were intended to be long-lasting reforms. Going forward, it is essential that the knowledge and experience built up within these organisations not be lost and that their absence not become a cause of inactivity.

Six years after the financial crisis, it is clear that there is now a need to focus on the long-term development of efficient insolvency systems. That is not to say that these emergency reforms have not had any utility. To the contrary, the remnants of these measures in cultural development and practice in dealing with distressed assets is unquestionable.

XIX. New Reckless and Directed Lending – The Moral Hazard of AMC Transfers

One example of the concerns regarding AMC's is as follows. AMC's enable banks to transfer their NPLs, accumulated over many years and probably including a number of connected, directed or simply imprudent loans to an AMC. These ugly loans are simply transferred off the bank's books in exchange, commonly, for bonds or some other debt instrument that the bank can book as an asset in its balance sheet. The bank, now with a healthy balance sheet free of any NPLs, will commonly build up reserves. As in the post-crisis environment there are few good borrowers to lend to. After a while, the formerly balance-sheet-negative bank is now flush with cash reserves with little idea what to do with them. After investing in treasury bonds for a while and realising that they are a poor substitute for lending, and with lending officers wondering where their bonus is to come from, the bank again looks to lend. However, the quality of the potential borrowers has not changed. Undeterred, the bank, having been able to easily rid itself of NPLs previously, embarks on a wave of reckless lending.

Perhaps a more extreme example of potential moral hazards is the situation where a state bank, with NPLs amounting to 70%, 80% or perhaps more of its outstanding credits, transfers these NPLs to an AMC. Little other restructuring occurs within the bank. Now, assuming that there must have been some level of imprudent or incompetent management within the bank to enable it to develop such high levels of NPLs, or perhaps there was a high level of directed or connected loans or improperly influenced lending decisions, it would seem that some internal restructuring was required. Whatever the problem, something was clearly wrong. The danger of the transfer to the AMC is that the bank, otherwise unchanged, is then utilised by government and directed to lend with little regard to credit risk analysis.

New lending at present is sometimes an indication of a reckless institution. It is odd that in many restructurings new money required for working capital is coming from the institutions that were previously, prior to their transfer to AMCs, the highest holders of NPLs.

XX. Focus on Disposal rather than Restructuring

There has been a focus on bulk disposal rather than restructuring of distressed debt, and numerous debt warehouses have been created which are yet to deal with the real issues.

Almost every bank in Chinese Taipei is looking at or has already begun a process of bulk sale of its NPLs to an AMC or to investors. China also transferred many of the NPLs in the system to its four AMCs. Little restructuring of the debtors' businesses owing these NPLs has occurred although some attempts have been made, progress has generally been slow.

The philosophy has been to deal with the bank's balance sheet issues first and leave the restructuring of the corporate sector until after the financial sector restructuring is complete.

The focus on disposal of NPLs has limited the development of specialised divisions within banks with expertise in handling NPLs — the bad bank. Some banks have been able to develop expertise and have applied the lessons learnt to credit risk analysis at the front end of their business lending. However, this has been limited. For many banks that transferred their NPLs to an AMC or sold them to investors, they have not been able to develop a culture within the bank of managing distressed accounts. From a long-term perspective this is perhaps the most troubling remnant, or missed opportunity, of the emergency steps taken to deal with the crisis.

XXI. Short Institutional Memories

Banks have short institutional memories. This is not true across the board, but is certainly a fairly safe generalisation. Except for some of the major international banks, it would seem that the lessons of the crisis have not become part of the entrenched institutional knowledge of much of the banking sector. Ask a banker whether the bank will make the same mistakes every 5-7 years and few will deny that this is true. Already evidence of reckless lending is beginning to show again. Overlending to bad debtors could again become the latest fashion.

XXII. Haircuts — The New Dynamic?

As the years after the crisis have passed, an interesting change has developed. At the beginning of the crisis, banks were commonly under-capitalised and scarce of funds. Following transfers of NPLs to AMCs and other restructuring and capitalisation measures, the banks' position has now changed. With few good borrowers to lend to, banks have built up cash reserves, preferring to invest in bonds, rather than lend. Consequently, banks are now commonly holding excess liquidity. This has changed the dynamic in restructuring negotiations. Previously under-capitalised banks were reluctant to accept write-offs for the effect on their own balance sheets and capitalisation would have been too drastic. However, in the new period of overliquidity, write-downs have become easier to accept and more common.

That said, many banks still seem to be averse to accepting a write-down of debt. Commonly, this aversion stems from a concern from the responsible account officer or bank committee or board that their decision to accept the write-off will crystallise a loss for which they may be held personally responsible. This is a particular concern in state banks or in institutions where management is prone to change.

XXIII. Rapid Disposition Agencies have developed culture of Bulk Sale

The disposal in bulk sales of NPLs and distressed assets by AMCs and rapid disposition agencies such as the FRA in Thailand have created for the first time in many countries, a culture of bulk sale. The FRA in Thailand is perhaps the best example. It conducted a series of bulk sales, with various packaging approaches, of the assets of the 58 suspended finance companies in Thailand. These sales, which were reported around the world as the largest one day sales in history, were in many cases the first time a bulk sale or co-ordinated programme of sale was undertaken, particularly across a range of selling institutions. It sold the housing loans, the business loans, the artwork, the motor vehicles etc. of these finance companies. There was criticism of the sale prices and some accused it of conducting a fire sale. It adopted techniques to increase prices such as offering profit-sharing arrangements which enabled purchasers to increase prices offered as part of the purchase price was profit sharing from future profits from the asset sold.

One important remnant of the FRA experience is the culture of bulk sale in Thailand. This culture has recently materialised in crucial new procedures adopted by the Legal Execution Department. This department is part of the Ministry of Justice and is responsible for selling property on civil execution cases and in bankruptcy cases as the official receiver. It has recently organised huge bulk sales of foreclosed properties in which it has co-ordinated many financial institutions in sales of their foreclosed assets. These sales, coupled by adjustments in rules regarding minimum sale prices, have created activity in the property sector and for the first time created an effective mechanism to dispose of foreclosed assets in many areas. Never before have foreclosed assets been sold off in this type of bulk sale approach in such a co-ordinated and successful fashion by the official receiver.

XXIV. Strong and Capable Regulators often Key Factor to Success

Measures have been most successful in countries where those measures have been sponsored by a strong regulator, often the central bank. Often the influence of the regulator has not been directly applied, although it has been feared. It is without doubt that the influence of Bank Negara has been central to the success of restructuring in Malaysia. Even in countries like Thailand, where the Bank of Thailand did not directly impose itself as a regulator of restructuring, its influence via the CDRAC process which was conducted under its auspices was a material factor in the progress of restructuring.

Whilst CDRAC in Thailand did not involve itself openly and directly in the reasonableness of the positions of taken by the parties in the restructuring and limited itself to overseeing the timetable for restructuring set by the CDRAC process, there was always a fear in the minds of creditors that unreasonable conduct in a restructuring could affect their general banking business in Thailand. The power of the Bank of Thailand to impose fines for breach of the CDRAC process was, however, rarely invoked.

The CDRC in Malaysia, on the other hand, openly involved itself in the issues in dispute between the parties involved in a restructuring and facilitated a resolution of disputes. It told parties when it thought they were being unreasonable — much of the ability to do so stemmed from the leadership of two individuals heading up the CDRC (Dato Azman and Derrick Fernandez). A similar approach might not be accepted or be as successful in other jurisdictions due to cultural differences.

In Indonesia, the JTIF was set up entirely independently of the central bank, Bank Indonesia. It was not supported by a strong regulator. It had little by way of "sticks" to enforce reasonable conduct by parties and one real "carrot" (namely, certain tax incentives which applied to restructurings carried out under its auspices). Its success in progressing the pace of restructuring efforts has been limited by these factors.

One of the major dynamics affecting restructuring in Asia has been the fear of personal liability for commercial decisions. This has been a feature of the operation of state banks and agencies operations. The concern stems from a fear that the application of any level of discretion or commercial judgement could be questioned retrospectively where the result has caused damage or losses. This is particularly so where there are concerns that there will be a change of government or subsequent review of the conduct of the relevant agency. These concerns often result in stagnation of activity. There have been prosecutions of individuals involved in the FRA sales in Thailand. Fear of personal liability has affected the speed at which IBRA has been able to make decisions. There are also concerns that these factors could stagnate the activities of the TAMC.

XXV. AMC's Work Best When Recapitalisation Function Separate

AMCs can be used to facilitate the recapitalisation of the banking sector. This generally occurs by the AMC paying for the transferred loans at a price which exceeds the true market value of the loan. The inflated transfer price is really a quasi-recapitalisation of the bank. This approach can have a restrictive effect on the ability of the AMC to restructure individual loans. This is particularly the case in national or state AMCs where there is a concern that in agreeing to a restructure, disposal or other dealing with the loan which results in a loss when compared to the transfer price, the individuals involved could be causing damage or loss to the state.

In contrast, in Malaysia, the recapitalisation function was performed by Danamodal, leaving the national AMC, Danaharta, which acquired the NPLs, free to restructure them without regard to an inflated transfer price.

XXVI. AMC's Need Resources and Clear Procedures — Corporate Governance

It is interesting to compare the level of resources engaged by the national AMCs in the region. IBRA, which is now one of the largest asset owners in Indonesia, employs thousands of people, although its life is coming to an end. Danaharta also has a large workforce. The offices of these agencies are impressive commercial properties (commonly acquired from a defaulting debtor or closed bank). The TAMC, the youngest of the region's national AMCs, faces a significant challenge in developing a qualified workforce to handle the significant portfolio transferred to it — outsourcing may offer part of the solution to this challenge.

Defined and transparent procedures, such as those contained in Danaharta's operations manuals, are crucial in establishing an effective national AMC. These procedures can avoid any issue of personal discretion being applied, thereby avoiding the stagnation effects discussed above. It is also notable that the Danaharta board contains independent directors including a number of foreign experts.

XXVII. The Hole in Asian Economies — Corporate Losses Converted to Sovereign Debt

It is arguable that the collapse seen in the crisis economies of Thailand, Indonesia, Korea, Malaysia and, although the real effects of the crisis were felt later, in the Philippines and Chinese Taipei, would have occurred at some point soon, notwithstanding the currency collapses which began in Thailand, inciting the consequent contagion.

This view relies on the position that there were economic losses in the corporate sectors that had accumulated over previous years, and even decades, but remained hidden. The Asian crisis forced the economies to put the true picture into their balance sheets. During the boom, which preceded the crisis in most of these economies, inflated project prices, inflated investments and inflated material purchase prices were common, as it seems was fraud, although these were not revealed as the economies chugged along. The momentum stopped with the crisis and all was revealed. The effect of the crisis hit directly on the financial sector and the banking system rather than the corporate sector. Distrust of the systems by the international market (investors) and the local market (depositors) soon became clear. Bank runs were feared and most governments were faced with a decision to either do nothing and let the market prevail or intervene. Almost all intervened. Blanket or qualified guarantees of bank deposits were provided for banks which were not closed down. Government funded AMC's were established in some countries and numerous other techniques adopted which ultimately see the government, and therefore the taxpayer, bear the burden of ultimate losses.

The funding provided by the IMF and the bonds issued by governments to fund the acquisition of NPLs by national AMC's together with the recapitalisation of the banking systems could be viewed as a surrogate for the accumulated losses in the corporate sector.

XXVIII. Multilateral Agency Criteria May Shape Investment Decisions

There has been considerable activity at the multilateral level since the Asian financial crisis began in July 1997.

In April 2000, the Asian Development Bank (*ADB*) published a report entitled *Insolvency Law Reform in the Asian and Pacific Region*. The report involved a study of a number of economies and analysed and compared the legal systems in those countries. These studies were reviewed and discussed at a symposium at the ADB in Manila in October 1999, which was combined, in part, with a symposium on Secured Transactions Law Reforms. This enabled a discussion of the intersection of corporate debt financing, secured transaction financing and corporate insolvency. The ADB also published a report entitled *The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reform*. The ADB is presently engaged in a three-year regional technical assistance focussing on three areas: cross-border insolvency, informal workouts and the intersection between secured transactions and insolvency law regimes. The ADB has issued an issues paper in relation to this regional technical assistance which was recently discussed at a workshop at the ADB's headquarters in Manila on 30 September - 1 October 2002.

The IMF also published an important work in March 2000 entitled *Orderly and Effective Insolvency Procedures*. Drawing on the experience the IMF gained in providing technical assistance on insolvency procedures, the report identifies key issues that arise in the design and application of orderly and effective insolvency procedures and attempts to identify the advantages and disadvantages of different approaches.

The Group of 30, a private non-profit organisation of senior executives of global financial institutions and central banks, has published a comprehensive survey of the efforts by multilateral agencies. This report is entitled *Reducing the Risks of International Insolvency: A Compendium of Work in Progress*.

The United Nations Commission on International Trade Law (*UNCITRAL*) has also focussed on insolvency. Following on from *UNCITRAL*'s work, completed in 1997, to produce a Model Law on Cross-border Insolvency, *UNCITRAL* and the International Federation of Insolvency Professionals (*INSOL International*) organised an International Insolvency Colloquium in Vienna in December 2000. At this colloquium it was resolved to recommend that *UNCITRAL* produce a legislative guide to assist countries with insolvency law reform. *UNCITRAL* has now commenced work on the preparation of Model Legislative Guidelines for an Insolvency Law (and also a Model Legislative Guidelines for Secured Transactions Law).

In October 2000 *INSOL International* also issued a Statement of Principles for a Global Approach to Multi-Creditor Workouts. This sets out eight principles, which are intended to be regarded as best practice for all multi-creditor workouts. It is hoped that these principles will be used in out of court workouts globally. The principles envisage a standstill, a moratorium on claims, co-ordinating committees, provision of information, confidentiality and priority for new funding – many of the concepts are already features of workout practices that have been adopted in Asia.

There has also been work in the secured transactions and insolvency law area by other organisations including the European Bank for Reconstruction and Development, the Organisation of American States, the American Law Institute and the International Bar Association.

The World Bank, as part of a wide effort to improve the future stability of international financial systems, led an initiative to identify principles and guidelines for sound and efficient insolvency systems and for the strengthening of related debtor-creditor rights in emerging markets. It developed *Principles and Guidelines for Effective Insolvency and Creditors' Rights Systems* (Principles and Guidelines) based on a series of working papers at a symposium on Building Effective Insolvency Systems and regional workshops designed to provide specific and detailed information on the applicability of the draft principles and guidelines to specific countries, taking into account unique geographical practices, customs and experiences. The World Bank is now undertaking assessments of insolvency and creditors' rights regimes in countries against these Principles and Guidelines under a programme called *Reports on Observance of Standards and Codes*, a joint World Bank-IMF initiative designed to assess systems against international standards and codes. The World Bank is also presently seeking to establish a Global Forum on Insolvency Risk Management (*FIRM*) which will bring together all of the above efforts.

As can be seen from the above, it is fair to say that the level of international focus on insolvency laws is at an unprecedented high mark. It may well be that, in the future, investor decisions, particularly in capital markets, will be determined with considerable regard to how a country's law and practice stands up when assessed against international benchmarks distilled by multilateral agencies.

There has also been discussion and some activity by multilateral agencies in funding the creation of specialised institutions to act as market movers in stimulating disposal and restructuring of NPLs. Preliminary suggestions of the creation of a collective AMC funded by multilaterals and banks, perhaps, to purchase NPLs on a country or regional basis have also been made.

XXIX. Regional Overview

The following is a brief summary of recent developments in selected countries in the Asian region. It is not exhaustive, focussing on emerging markets, and merely provides an overview of some recent developments. It is intended to provide a thumbnail sketch of major developments.

China

The People's Republic of China introduced a Bankruptcy Law in 1986, which applies only to state enterprises. With subsequent movement to a more market-oriented economy, privately-owned enterprises have developed but still remain limited relative to state-owned enterprises. The Bankruptcy Law applies to international trust and investment corporations or "itics" such as "Gitic" whose insolvency is internationally reported. A liquidation team or liquidator committee, often made up of government officials, is appointed to administer the process. A restructuring process is also provided for but it has not been used. The protection and resettlement of employees in order to maintain order and stability in society is required by government directive as a first priority in application of the Bankruptcy Law.

The Corporate Law was enacted in 1994 to introduce the concept of shareholders' rights. There is no comprehensive law dealing with the insolvency of corporations, but there is separate legislation for foreign invested enterprises (*FIEs*). New rules for FIEs were introduced on 1 September 2002 — these envisage the appointment of an Enterprise Committee to conduct a restructuring, if appropriate.

Much of the bankruptcy activity in China to date has been policy directed bankruptcy under the National Plan whereby the government effectively directs the bankruptcy of a state-owned enterprise. China has not yet really used its Bankruptcy Law in a substantive fashion.

There have also been some alternative approaches to restructuring such as the so-called Changchuan Approach which involves the transfer of profitable assets into a new entity funded by the major creditor. The funds generated by the new entity are then used to repay that creditor. The process is similar to a technique known as a hive down. The major creditor who funds on going operations is effectively preferred while other creditors receive nothing. The rationale underlying this approach is that the business continues in operation, jobs are saved and many of the other creditors who are either employees or trade creditors will benefit if the business continues in operation.

China's accession to the World Trade Organisation in December 2001 and the expansion of private commercial activity will provide an impetus for China to improve insolvency and restructuring processes.

The Chinese government is drafting a new bankruptcy law, which does contain a corporate rescue procedure.

There has been limited activity in out of court informal workouts. Four AMC's have been set up to receive transfer of problem loans from state-owned banks but their attempts to restructure loans have been limited. There have been a few sales of NPLs and distressed assets by these AMC's although completion of the sales has been drawn out. This has caused significant frustration to investors. A recent sale of a portfolio of approximately US\$1 billion in assets was entered into by The Great Wall Asset Management Company to Goldman Sachs.

Restructuring efforts by the AMC's have been frustrated by lack of resources (even though the AMC's employ thousands of people) when compared to volume of NPLs in their portfolio. Some AMC's have over one million debtors in their portfolio spread across numerous provinces. There have also been significant barriers (such as hefty local government taxes) and lack of co-operation and a misunderstanding on the part of provincial governments as to the role and authority of the AMC's.

Hong Kong

Hong Kong has well-established laws dealing with the major types of insolvency procedures including compulsory and voluntary winding up and schemes of compromise and arrangement. These laws derive from the laws that applied in the UK prior to the introduction of the Insolvency Act 1986 as a result of the recommendations of the Cork Report in 1981. This means there is no corporate rescue regime in Hong Kong. Receivers may also be appointed pursuant to the terms of a security document or by a court.

Informal workouts are common and the Hong Kong Association of Banks and the Hong Kong Monetary Authority have developed Guidelines on Corporate Difficulties, which set out guidelines for workout procedures to be applied by members of the association. These guidelines are loosely derived from the so-called London Approach developed in the United Kingdom. The guidelines are useful in multi-creditor workouts, which are common due to the local lending culture.

Insolvencies and restructurings in Hong Kong often involve major Chinese creditors (the state, in the case of Chinese window companies which are established to enable Chinese state-owned enterprises to obtain foreign funding). Hong Kong companies also often have investments or assets in China – this often introduces an additional layer of complexity.

The corporate shells of insolvent listed companies are also used to enable investors to obtain a back door listing on the Hong Kong Stock Exchange. This has become a mini industry in Hong Kong.

In January 2000, legislation revising Hong Kong's insolvency laws was submitted to the Hong Kong Legislative Council for approval. The main proposals under the Companies (Corporate Rescue) Bill are to:

1. allow a company in financial trouble to apply for a moratorium for 30 days (extendable to six months) to protect it from civil proceedings, winding up petitions and proceedings to enforce securities;
2. enable a company to be placed under the control of a provisional supervisor who would then prepare a proposal to creditors to put in place a voluntary scheme of arrangement for the company;
3. provide for the provision of funds to pay employee wages and other entitlements – although the proposal that this provision must be established before the company can have access to the moratorium is controversial and may restrict the use of the procedure;
4. facilitate action against directors and senior executives who are involved in insolvent trading; and
5. provide for a priority for new money or capital injected into the company in the event of a subsequent winding up.

These proposals are intended to apply to all companies incorporated in Hong Kong and all foreign companies that have established a place of business in Hong Kong. The proposed legislation discussed above has been postponed for some time. There is some doubt as to whether the proposals will ever become law.

Chinese Taipei

Chinese Taipei, along with the Philippines, is one of the few economies where official NPL figures are increasing. It is acknowledged that Chinese Taipei adopts loose loan classification criteria and many suspect that the true figure of troubled loans is much more than official figures.

Chinese Taipei was able to withstand the initial effects of regional financial crisis that dramatically affected other, more top-heavy economies, such as Korea, Thailand and Indonesia. The recent global economic slowdown has however affected the banking sector in Chinese Taipei and asset quality has continued to deteriorate. The banking sector is now aggressively tackling these rising loan defaults, particularly over the last 1212 months.

As part of a legislative reform package, the government has announced a series of measures to facilitate restructuring in the financial sector. The Financial Institutions Merger Act was enacted on 24 November 2000 to facilitate mergers and acquisitions within the finance sector. The move was aimed at helping address the banking sector's biggest headache: over-banking. Taiwan has around 53 domestic banks and around 39 foreign banks. Many now blame the saturated banking market on the rush to deregulate in 1991. The Act created a legal framework for the establishment and operation of the Taiwan Financial Asset Service Corporation (*TFASC*) and Taiwan Asset Management Corporation (*TAMCO*). TAMCO is spearheaded by the ROC Bankers Association, and has been formed with a capital injection of NT\$16 billion by a consortium of 33 banks.

There have been a number of high profile bank mergers in the last 12 months, including Fubon buying Taipei Bank and Cathay Financial Holding buying United World Chinese Bank. It is expected that Taishin Financial Holding Co will complete its merger with Taiwan Securities Corp. and Taishin Bills Finance Corp. in early January 2003.

In addition, there has been an influx of foreign investors including Goldman Sachs Group Inc., Morgan Stanley Dean Witter & Co., Lehman Brothers and Lend Lease Corp. that have or are in the process of setting up private AMCs with individual banks. Some of the incentives provided to encourage to sell their NPLs to AMCs include allowing the banks to amortise their losses over five years, reducing business taxes and allowing transfers to be effected by public announcement.

The Ministry of Finance has demanded that the NPL ratio be reduced to less than 7% by the end of 2002 and 5% by the end of 2003.

Taiwan is presently a hotbed of activity in bulk NPL sales. As discussed above, the first sale by First Commercial Bank to Cerberus, Lone Star, GE Capital and TAMCO has stimulated a flurry of similar activity by other domestic banks.

The government has also established a quasi-RTC-type fund called the Financial Restructuring Fund. The Fund was initially capitalised by a 2% tax and has been funded to the amount of NT\$140 billion. The Fund is used at present to acquire NPLs from bankrupt financial institutions. It is proposed to enlarge the function of the Fund to deal with the overbanking problem and to permit the Fund to purchase NPLs from all financial institutions. The Ministry of Finance proposes to boost the amount of the fund through issuing public bonds, in addition to extending the time span for monetary institutions to pay business taxes from the originally designated four years to an unspecified period.

A law to facilitate securitisation has also been enacted, although is yet to be utilised.

Chinese Taipei has a formal liquidation and reorganisation procedure. The reorganisation procedure is limited to listed and public companies. There is no formal procedure for other companies. In the last four years, around 40 listed companies have applied for reorganisation, with only a small number of these culminating in approved plans. The debtor must approve the reorganisation plan. The system is not regarded as being efficient and a number of amendments to the Bankruptcy Laws are presently being considered.

Indonesia

The formal restructuring and liquidation processes in force in Indonesia are contained in the Bankruptcy Ordinance 1905 although they were not used until the ordinance was amended by a Government Regulation in Lieu of Law in 1998 following the financial crisis.

Under the Bankruptcy Ordinance, the Commercial Court can suspend payments to unsecured creditors and appoint a licensed curator and supervisory judge to assist in the management of a debtor's assets.

The Commercial Court which was set up to administer the Bankruptcy Ordinance has not been consistent in its interpretation of Indonesia's bankruptcy laws. This has caused most creditors to negotiate with the debtors on an informal basis in preference to using formal rescue processes.

Confidence in the Indonesian Commercial Courts performance was not assisted by the debacle in the Manulife case where a solvent subsidiary of the Canadian insurer was placed into bankruptcy, although the decision was overturned on appeal. There is no insolvency test under the Bankruptcy Act as part of the commencement criteria. The initial decision flowed from an interpretation of the concept of debt. The Manulife subsidiary was held to owe a debt by reference to a shareholders' agreement to which it was not a party — under that agreement the shareholders had agreed to certain dividend entitlements. This followed earlier scandals involving the arrest of Canadian representatives of Manulife after their legitimate purchase of interests from an authorised curator.

One interesting development is the establishment of a group of seven local lawyers and judges known informally as 'Team 7'. This team was put together with funding from the IMF and the ADB. Its role is to evaluate decisions by the Commercial Court and will publish a report on those decisions.

To assist in this informal restructuring, JITF and the Financial Section Policy Committee (*FSPC*) were created. The JITF can force debtors to mediation. Debtors that fail to mediate can be reported to the FSPC, which may result in the government filing for bankruptcy of the debtor.

The Indonesian Bank Restructuring Agency (*IBRA*) was established to acquire, hold and manage assets of closed banks and otherwise acquired NPLs. IBRA is a creditor in most restructurings – some of which have been frustrated by management changes at IBRA and delays in approval processes. The government is trying to strengthen Indonesia's poor economic recovery by accelerating the sale of the assets managed by IBRA. Investor interest has also been affected by safety concerns following the bombings in Bali.

IBRA is under pressure to wind down completely by the end of 2003. It's 4000 employees and contractors will slowly be dismissed. IBRA is the largest land owner in Indonesia and its wind-down will be a significant exercise.

Korea

Korean corporate liquidation law is contained in the *Bankruptcy Act 1962* (which was amended in 1998). Prior to the financial crisis, two rescue processes existed:

1. a composition process governed by the *Composition Act 1962* (amended in 1999); and
2. a company reorganisation governed by the *Company Reorganisation Act 1962*.

Korea is unusual in this respect as it had in place reorganisation procedures at the time the crisis hit although these processes seem to be extremely slow.

More recently, Korea has established a range of vehicles that can acquire NPLs, distressed assets and assist in the restructuring and recovery process. There has been the creation of a variety of vehicles including mutual funds, Corporate Restructuring Specialist Companies, Real Estate Investment Trusts and Corporate Restructuring Vehicles (*CRVs*) that can acquire distressed assets and NPLs and facilitate restructuring efforts.

In 1998 an Agreement for the Promotion of Corporate Workouts (*Workout Agreement*) was agreed by financial institutions to set out a framework for out of court workouts. Like similar arrangements in other countries such as Thailand, it binds only those financial institutions who have signed it.

KAMCO has acquired over 98 trillion won worth of NPLs from financial institutions. It disposes of NPLs either by outright sale or by the issue of securities over healthy assets to generate liquidity.

There have been a number of high-profile restructurings of chaebols such as Daewoo and Hyundai.

The present insolvency law of Korea is contained in the Corporate Restructuring Promotion Law (*CRPL*), which has effect from 15 September 2001 and will be in force for a five-year period. It provides a statutory framework by which creditors grant a moratorium to debtors and allow them to prepare a Memorandum of Understanding for their restructuring. This is quite similar to the provisions of the Workout Agreement, however it requires the use of *CRVs* and therefore it is hoped that it will streamline the resolution of creditor disputes.

There is presently a move to produce a consolidated insolvency law. Drafts of this have been prepared this year. The drafts contain proposals for an individual rehabilitation procedure. There are also proposals to adopt the UNCITRAL model law on cross-border insolvency.

Malaysia

Malaysia has been very successful at dealing with its overbanking problem and in recapitalising its banking sector following the financial crisis.

The Malaysian government established a National Economic Action Council in 1998 which has introduced a number of measures to assist with corporate and financial restructuring. For example, the government owned Danaharta Corporation was established in 1998. A similar special purpose agency for the recapitalisation of banks, Danamodal Nasional Berhad was also established.

Danaharta may, of its own accord or at the request of the company, acquire the assets and liabilities of a company in financial difficulty. Danaharta may also appoint a special administrator to operate a distressed company as a going concern. Danaharta has dealt with almost all of its total portfolio of NPLs.

In 2001 Danaharta entered into a securitisation programme, issuing asset-backed securities that were hugely over-subscribed.

The CDRC was established following the financial crisis to assist creditors and debtors to agree on restructuring and workout programme. As at the end of July 2001, the CDRC was involved in the restructure of over 26 billion ringgit worth of debts, representing about 40% of the total value of debts referred to the CDRC. In 2001, the membership of the CDRC was expanded to include representatives of Danaharta and the Federation of Public Listed Companies. The revamp of the CDRC in August 2001, particularly the fact that Dato Azman, the chairman of Danaharta, was also appointed chairman of CDRC, materially affected the pace of restructuring. The process was made compulsory and significant pressure applied to finalise cases. Most cases have now been resolved and the CDRC has now been wound up.

In 2001, the Kuala Lumpur Stock Exchange (*KLSE*) also introduced practice notes and guidelines increasing the disclosure and reporting obligations of distressed companies listed on the KLSE.

Malaysia has had in place liquidation, scheme of arrangement and receivership laws since 1965. A company in financial difficulty can propose a scheme of arrangement to be approved by its creditors and the High Court, who may order all proceedings against the company to be suspended while the application is before the court.

A receiver can take over the management of a company under the terms of a security agreement. A court may also appoint a receiver, if a receiver cannot be contractually appointed and the assets of the company are in danger of being diluted or disposed of or if the interests of creditors would otherwise be prejudiced.

One of the sleeping issues in the Malaysian insolvency system stems from the decision in *Kimlin Housing Development*, a 1997 case, where a receiver was held to no longer have powers of management over a debtor's secured assets following the appointment of a liquidator. The Malaysian courts expressly decided not to follow the position taken in Australia and the UK who have similar legislation. There are numerous instances where, before this decision, receivers continued to operate businesses and exercise rights in relation to secured assets following the appointment of a liquidator. There is a 12 year limitation period that applies in these cases where the receiver has sold land by private treaty and it is expected that there will be a flood of litigation relating to prior cases.

The restructuring of the financial sector has also been quite remarkable, with the central bank, Bank Negara, at one point directing the banks to merge and form 10 anchor banks. There are further consolidations expected, although the central bank has stated that it is not forcing mandatory mergers. The recapitalisation of the banks by Danamodal was successful — the recapitalisation loans made by it have been repaid.

Philippines

The Philippines initially seemed to weather the storm better than some of its neighbors, although it experienced lower growth in the decade after the crisis. Economic and political instability in 2000 and 2001 affected investment in the Philippines economy, marked by dramatic declines in the stock exchanges indices and devaluation of the Peso to an all time low of P 53 in July 2001.

Aspects of the underlying insolvency law and procedures in the Philippines are outdated, inconsistent, lacking in adequate detail, defective, subject to constitutional and jurisdictional uncertainties and simply do not provide sufficiently useful procedures to adequately assist in the solving of the growing NPL and distressed asset problem. A number of legislative changes coupled with the abrupt transfer of jurisdiction over insolvency cases from the Securities Exchange Commission (*SEC*) to the regional trial courts (*RTC*s) have further hampered efforts at restructuring. Recent proposals for insolvency law reform have been hotly debated with opposing policy views delaying progression of the proposals. Other legislative initiatives designed to expedite restructuring and attract foreign investment such as proposed SPAV laws have been delayed or defeated by opposing policy objectives.

The Insolvency Law of the Philippines was originally enacted in 1909. It provides for two types of proceedings: suspension of payments and insolvency (voluntary and involuntary) proceedings. It applies practically the same principles and procedures to corporations as it does to individual debtors and it contains no provision for reorganisation or rehabilitation of corporate debtors and many of its other provisions are out of step with the modern approach to bankruptcy and insolvency proceedings in other jurisdictions. Very few proceedings have been brought under it.

In 1981, by a Presidential Decree from President Marcos known as PD 902-A, the SEC was given jurisdiction over suspension of payments. The Supreme Court clarified that suspension of payments cases under the SEC's jurisdiction were limited to intra-corporate disputes and not proceedings in respect of individual debtors. The SEC was given the power, among other things, to grant the remedy of rehabilitation in suspension of payment cases. There were a number of high profile cases, such as Philippine Airlines, administered by the SEC.

In August 2000, a new Securities Regulation Code was enacted that abruptly transferred the quasi-judicial jurisdiction of the SEC over suspension of payments and rehabilitation proceedings to the RTCs. The SEC's responsibilities were guided by the adoption in the year 2000 of procedural rules governing petitions for suspension of payments and rehabilitation known as the *Corporate Recovery Rules*. The Supreme Court developed Interim Rules of Procedure (Interim Rules) to govern rehabilitation cases under PD902-A (using the framework of the prior SEC rules), effective from 15 December 2000. The Interim Rules assume that rehabilitation under PD902-A remains an available remedy. There are constitutional questions in relation to the Interim Rules.

There has been discussion led by the Capital Markets Development Council for the last two or so years of proposals for a new insolvency law. House Bill No.11867, first introduced in August 2000, contained a new insolvency regime. It was criticised as being unduly complex, overly protective of shareholders' interests and novel or radical in many respects, particularly in relation to proposals for a so-called "fast track rehabilitation" system which involved complex transfer of assets and claims and a claim auctioning process. The latest draft of the proposed law represents a far simpler approach than House Bill No.11867 and is more similar to rehabilitation approaches adopted in other jurisdictions.

The proposed law is called the Corporate Insolvency & Recovery Act contains four different remedies: (1) Suspension of Payments provides a moratorium, limited to three months, on debt repayment to enable a debtor to negotiate an out of court restructure with its creditors. (2) Court-Supervised Rehabilitation involves preparation of a plan for approval by creditors and the court. (3) Pre-Negotiated Rehabilitation sets out an expedited procedure for a plan which has been pre-agreed with a majority of creditors with objecting creditors and shareholders being provided with an opportunity to object to the plan before it is approved by the court. (4) Liquidation and Dissolution — there is no ability to seek liquidation as an immediate remedy — it is only available on a defective filing for other relief or on conversion from other forms of relief.

There have also been proposals developed by investment banks and Bangko Sentral for legislation to support the creation of special purpose asset vehicles to acquire non-performing assets, including loan assets and real and other properties, currently burdening the financial sector. As discussed above, banks have been successful in obtaining large amounts of transferred real estate by *dacion en pago*, judicial and extrajudicial foreclosure. Much of this collateral, both core and non-core assets of debtors, now sits idle on bank balance sheets as market prices fall below the net book value of the loans. Banks, hoping for improvement in economic conditions and hoping to avoid capital write-downs, have held on to assets waiting for higher prices. As a result, assets and capital are not circulating in the economy and banks have become large inefficient holders of non-performing assets. Given this background, domestic banks have engaged in discussions with foreign investors for the disposition of their non-performing portfolios. However, to date, investors have been reluctant to proceed with investments.

The original intention of the proposed legislation was to create a positive legislative regime for the investment of foreign capital into non-performing loans and assets. The original intention was not to implement a general amendment of insolvency and creditors' rights laws or provide for concessions or exemptions with broad perpetual application. It was envisaged that, building on similar legislation in Thailand and Korea, the legislation would provide for a limited prescribed eligibility period for the creation of a SPAV by eligible investors, a limited period from enactment to make investments, together with a limited disposition period for acquired assets. It is was originally envisaged that the SPAV would be a tax-exempt entity in terms of corporate income tax, capital gains tax and other taxes and duties but that all fee and tax incentives expire within a specified period from enactment.

The SPAV was to be entitled to the benefit of special provisions which ensure expeditious implementation of the SPAV's objectives and prohibit the lower courts and the regional trial courts (but not the Supreme Court) from issuing temporary restraining orders and a power in instances where the SPAV holds more than 50% of the amount of debt within the secured creditor class, such that 75% of the secured creditors have the power to vote down a suspension of payments application, and then again has the right to vote down the plan when submitted – with no discretion to the court.

However, much of the original intention of the proposed legislation has been lost in amendments proposed in committee discussions such as mandatory provisions giving the debtor a 90-day period to restructure or renegotiate its loans or reacquire the properties before the financial institution can offer to sell them to a SPAV together with a mandatory bidding process, in which the borrower is able to participate, to apply to any proposed transfer to a SPAV, have led to revised SPAV bills being described as a farce. Many of the original incentives and tax waivers have been also been removed or watered down. It is unlikely that the revised SPAV bills, if passed in their present form, would attract foreign investment into distressed assets although they may well create serious impediments to other restructuring efforts and create opportunity for abuse and delay. It is envisaged that the form of the bill be settled in a bicameral committee shortly.

There has also been a new proposed securitisation law. Debate of this bill has, however, largely been outweighed by the focus on the SPAV bills.

Thailand

Thailand introduced a number of legislative reforms to its insolvency laws and practice following the financial crisis, including;

- a) enacting a new corporate reorganisation procedure in April 1998 (during the reorganisation process, a “planner” is appointed to prepare a reorganisation plan for consideration by a meeting of creditors and subsequently for court approval.), establishing a specialised Bankruptcy Court in June 1999 and by amendments in 1999 to enhance the efficiency of the bankruptcy and reorganisation procedures;
- b) implementing frameworks for out of court workouts which were agreed to between a number of financial institution creditors under the auspices of the CDRAC, a committee established by the Bank of Thailand and various associations. Despite the legislative developments discussed above, most of the initial restructuring efforts continued to take place outside the court system and were perceived to be moving slowly. The pace of restructuring negotiations did not progress significantly until the implementation of binding frameworks for out of court workouts which were agreed between a number of financial institution creditors under the auspices of the CDRAC;
- c) establishing the FRA to take over the operations of 58 finance companies that were suspended following the financial crisis. All but two were closed down. The FRA held auctions of the assets of the finance companies, selling everything from cars and artwork, to housing loans and business loans. The auctions were touted as the biggest one-day sales ever seen in the world. The FRA was a very efficient disposition agency. However, due to some of the complex profit-sharing arrangements entered into to maximise sale prices and other complexities, there has been delay and considerable difficulties in calculating dividends for creditors. These finance companies have now been placed into bankruptcy and their management has been handed over from the FRA to the official receiver; and

- d) introducing taxation and other incentives to promote restructuring and investment including legislation permitting the establishment of mutual funds to facilitate investment in distressed assets established. A number of AMCs were also established to enable banks to transfer NPLs off their balance sheets.

As of September 2001, Thailand has established a national AMC known as the TAMC. The TAMC has had NPLs transferred to it by state banks and some commercial banks. It has been granted broad powers to manage and restructure those NPLs including the power to place the debtor into a reorganisation procedure. The TAMC may well significantly change the landscape in restructuring in Thailand. However, its impact is really yet to be felt, as few restructurings have really progressed under its management. Its portfolio is a troubled one, and it faces significant challenges in adequately resourcing itself to handle the role it has been designated. Its powers and procedures are subject to a number of constitution questions, although there have been no challenges to date.

There are also initiatives to amend the Bankruptcy Act – one proposal is to make creditors responsible for fees incurred in preparing and implementing a plan if the application for rehabilitation is brought by the creditors. Another proposal involves moving away from the balance sheet test of insolvency as an entry requirement for access to the reorganisation procedure toward a liquidity test. A further proposal is to extend the stay to guarantors. There were also proposals to increase the plan-approval thresholds, require that the Supreme Court rather than the Chief Justice of the Central Bankruptcy Court, decide whether or not appeals may be made against court orders and also to clarify the priority of new money provided during the rehabilitation process.

There are, however, other proposals for amendments to the Bankruptcy Act, and some include movement to a clearly debtor in possession system. At present there is no clear policy position held by the government. These competing proposals will need to be reviewed and a policy decision taken by the government.

Ministerial regulations governing the regulation of planners have also been issued. These regulations require planners to be Thai entities, and set out a system of licensing. The planners are required to place deposits or other security prior to accepting an appointment in a reorganisation. The amount of security is significant in large cases. However, the licensing and security deposit requirements do not apply if the debtor or its executives are appointed as the planner. Consequently, these regulations have emphasised the movement in Thailand to more of a quasi- debtor-in-possession system.

Accountants or other expert insolvency practitioners are reluctant to act as planners in contested cases due to the level of litigation, including vexatious litigation, that is often involved, difficulties in securing payment of their fees and expenses and personal security issues. More often than not, the debtor or a related party to it or its shareholders is appointed as the planner in many rehabilitation cases. Moreover, the number of expert financial advisors generally engaged in Thailand has decreased markedly since the end of 2001.

There have also been proposals to introduce a new type of “business security”, although these proposals have been dormant for some time.

India

India is possibly the next major market for bulk NPL sales. It is a significant economy which has boomed in recent times. Its NPLs are significant and largely have arisen as a result of heavy government regulation and directed lending. State banks hold a significant share of the finance market.

The Sick Industrial Companies (Special Provisions) Act regulates the rehabilitation of corporations, while the Companies Act regulates liquidation proceedings.

Lenders are faced with significant difficulties in recovering debts and traditionally have brought proceedings to the Debt Recovery Tribunals that specialise in handling debt recovery cases. The processes have generally not been efficient and a dynamic for out of court voluntary informal workouts has not developed.

A recent development has been the introduction in June/July 2002 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance. The purpose of this law is to enhance secured creditors' rights and create a facilitating environment for asset reconstruction companies (*ARCs*), India's version of an AMC. There are some ARCs that have already been established and investors are involved in discussions to set up more.

In addition, there have recently been proposed amendments to the Sick Industrial Companies Act and the Companies Act. These proposals stem from the Eradi Committee, headed by Justice V.B. Eradi. The Committee is charged with the task of reforming India's insolvency laws. Under these proposed amendments, when an industrial company has become sick, the board of directors is required to file a reference with the proposed National Company Law Tribunal (NCLT) for determination of the measures which shall be adopted with respect to the company. This tribunal is designed to replace the existing Board for Industrial and Financial Reconstruction (BIFR). It is envisaged that NCLT will be equipped with greater powers than BIFR, and should fast track the process of referring companies to rehabilitation.

Pakistan

Pakistan has enacted a number of laws recently relating to insolvency and it is perceived that many of these laws are overly creditor-friendly and have not created an environment to facilitate cooperative or effective reorganisation of viable businesses. Some laws are regarded as being overly punitive on debtors and are regarded as having frustrated attempts at restructuring.

In 1997, a Recovery Act was enacted, and this was subsequently amended in 2001. The Act facilitated self-help mortgagee sales and required that debtors obtain leave of the court to defend against creditor actions. In 1999, the National Accountability Bureau was established by the military regime, with rather drastic provisions which labeled a 30-day non-payment as a willful default which was punishable by imprisonment. The law was not implemented in a consistent fashion. In 2000, the Corporate and Industrial Restructuring Corporation (CIRC) and the Committee for the Rehabilitation of Sick Industrial Units (CIRSU) were established. The CIRC is an AMC which has acquired a relatively small percentage of Pakistan's NPLs and the CIRSU is a committee for facilitating restructuring.

Most recently, the Banking Laws Review Commission of Pakistan (BLRC) commissioned the preparation of a new proposed Corporate Rehabilitation Ordinance (CRO). The CRO contains procedures for rehabilitation and liquidation. It is aimed at providing a balance between debtor and creditors' rights. The rehabilitation procedures envisage the appointment of an administrator in certain circumstances, although it is acknowledged that there are few competent people who can fulfil this role without further training. The proposals contain a number of interesting aspects. The Act provides for the appointment of an Advisory Committee, which is to operate as an expert panel that the court may seek opinion from in relation to certain matters. This three man expert advisory committee effectively acknowledges that there is limited expertise in the judicial system in handling insolvency cases.

In addition to advising whether a proposed plan is fair and equitable the role of the advisory committee includes advising on issues of adequate protection and advising as to possible modifications to a plan.

In reorganisation cases the debtor remains in possession and control of its property unless the court orders otherwise. However, a party in interest or the Official Administrator (a government-appointed position) may apply to appoint an Administrator in listed circumstances such as fraud or gross mismanagement of the affairs of the debtor or if it is in the interest of the creditors or equity security holders. One reason the Ordinance adopts the formulation it has is to make the reorganisation procedure attractive, at the entry point, to debtors. It is suspected that debtors will realise that other provisions of the Ordinance operate to provide for the management's powers to be superseded by the appointment of an Administrator. Nonetheless, the dynamic this may create is that if management realises that it can conduct the reorganisation in a manner that is acceptable to creditors and devise a plan that creditors are happy with, it will be able to retain control of the business.

The Ordinance also provides that a statement of affairs must be audited by an auditor. Many countries exempt companies in a formal insolvency procedure from needing to have their accounts audited. The rationale for such exemptions is often that the auditing and accounting standards will not apply to a company in an insolvency proceeding and often cause unnecessary expense to a company which is controlled by an independent Administrator (who effectively provides an independent review similar to that provided by an auditor) and therefore decrease the ultimate return to creditors. Monthly statements which the Administrator is also required to file together with detailed accounts every six months must also be audited. Whilst this is an interesting and perhaps necessary development from a corporate governance perspective, the onerous nature of it may well shock insolvency practitioners experienced in other markets. There are many other laudable aspects of the proposals including automatic conversion to liquidation proceedings if no rehabilitation plan is approved.

China

BANKRUPTCY LAW REFORM IN CHINA

by

*Dr. Jingxia Shi*⁴

I. Introduction

This short essay will address two aspects regarding Chinese bankruptcy law reform. One aspect involves the New Draft Bankruptcy Law (2002 Draft) and the other concerns the New Rules on Hearing Bankruptcy Cases recently promulgated by the Supreme People's Court of China.

In China, bankruptcy law reform has been put on the national legislative schedules since 1994 to accommodate China's transition from a command economy to a market economy. In 1995 a comprehensive draft of the uniform bankruptcy law containing 10 chapters and 193 articles was completed and submitted to the higher authority for consideration, but was unfortunately deferred for a while due to unsuitable social and legal conditions. The drafting process was resumed in 1998 and is now in progress.

The latest version of the draft is the 2002 draft entitled "The Enterprise Bankruptcy and Reorganisation Law of the PRC". This draft is mainly based on the 2001 draft proposed by the drafting group and was discussed among academics, government officials and practitioners earlier this year. Many articles of 2002 draft are drawn from foreign advanced bankruptcy systems, in an endeavour to bring China's bankruptcy legislation in line with international standards. This draft is still subject to further revisions by the National People's Congress of China and, at the time of writing, the enactment has yet to be placed on the agenda of the national legislature. As such, it is not clear to what extent this draft will be further revised and when it may be adopted.

Against this backdrop, in order to meet the urgent demands and to hear more and more bankruptcy cases in China, the Supreme People's Court recently promulgated a judicial interpretation entitled "Provisions on Several Issues in the Hearing of Enterprises Bankruptcy Cases" (hereafter referred to as "The New Rules"). The New Rules signify a landmark development in the history of PRC bankruptcy laws and regulations.

II. The New Draft 2002

The 2002 draft is composed of 10 chapters and 162 articles. It includes general provisions, as well as specific provisions on the application and acceptance of bankruptcy cases, administration of assets, filing of claims, creditors' meetings, reorganisations, compositions, bankruptcies, liquidations, legal responsibilities and supplementary provisions. Several features in this draft are summarised as follows:

1. *The Scope of Draft Law (Article 3, 160)*

The scope of application defined in Article 3 covers enterprise legal entities, partnership enterprises and its partners, individual proprietorship enterprises and investors and other profit-making

⁴ Jingxia Shi is an Associate professor at the University of International Business & Economics in Beijing, China

organisations which are established in accordance with the law. This is a big improvement compared with the 1986 Enterprises Bankruptcy Law (EBL) which only applied to the state-owned Enterprises (SOEs). There are three issues arising from this scope of application:

Firstly, the bankruptcy of SOEs. It is widely recognised that the bankruptcy of SOEs is a very tough issue in China. None of the major issues has been so hotly and intensively debated. To a large degree, this constitutes one of the main impediments for the draft bankruptcy law. The 2002 draft covers the SOEs, but according to Article 3, the State Council is authorised to stipulate regulations concerning special issues of bankruptcy conducted by SOEs that were established before the company law of the PRC took effect. Although this is a relatively pragmatic solution to deal with the SOEs bankruptcy, it is still expected that there will be much to debate before the 2002 draft is enacted. There was strong support for the view that the new bankruptcy law should not cover the SOEs. Therefore the scope of the next draft will possibly exclude SOEs.

The second issue for consideration is consumer bankruptcy. Whether the 2002 draft shall be widened to include natural persons (or consumers) or not has also been the subject of a lengthy debate in China. Some argue that it is necessary for China to introduce consumer bankruptcy as soon as possible since more and more non-business persons have or may have personal debt problems. Although supporters list many reasons for China to create consumer bankruptcy, there are also a lot of negative opinions. Consumer bankruptcy involves many issues that are considerably different from those in enterprise bankruptcy. More time is needed for China to consider this issue before making decisions. In the 2002 draft, natural persons who engage in commercial matters, particularly sole proprietorship and the partners of partnerships are included, rather than consumers. In the future it will be possible to add consumer bankruptcy provisions or to devise a separate law.

The third issue for consideration is the bankruptcy of financial institutions. Pursuant to article 160, the bankruptcy of commercial banks is not covered by the provisions of this law. In many jurisdictions, the bankruptcy of commercial banks is the subject of separate laws, as commercial banks are savings institutions, which are heavily regulated by other legislation. Given that deposit insurance has not existed in China until now, it may not be appropriate to provide any provisions on commercial banks in bankruptcy law. At a later stage, the areas of consumer bankruptcy and banking bankruptcy may be added to the general bankruptcy law, or separate legislation may be necessary. There was some discussion as to whether the banking exemption should be extended to other types of financial institutions, such as insurance companies, securities companies, etc. There may be continuing debates in this respect.

2. *Bankruptcy Test — Cash Flow (Article 4)*

The 2002 draft adopts the threshold criteria of a cash flow test for bankruptcy instead of a balance sheet test. Where a debtor is unable to pay the debts due, its debts shall be liquidated in accordance with the procedures prescribed in this law. A debtor who ceases to pay off debts shall be presumed unable to pay unless otherwise provided. Some argue that the law should establish a threshold criteria that combines elements of both the cash flow test and the balance sheet test. But due to the operational difficulties arising from the balance sheet test, this advice has not been accepted. Even under the proposed cash flow test, there remain issues to be clarified. For example, there is no indication of what 'cessation of payment' means or what is required to indicate there has been a cessation of payment.

3. *Administrator (Article 16, 27-32)*

Although some believe that China shall opt for the US model of DIP (Debtor-In-Possession) system, the 2002 draft provides for the appointment of an administrator. The power to appoint the

administrator is given to the court. Article 27 sets out the qualifications required for an Administrator setting qualifying and disqualifying criteria. A lawyer or a certified public accountant or a relevant social intermediary institution can be appointed as administrator. With the entry of China into the WTO, it is possible for foreign bankruptcy practitioners to be appointed as administrators.

The Administrator shall have a good reputation, necessary professional knowledge, have obtained the practice qualification through examination, and be neutral and independent. The State Council shall separately stipulate the necessary qualifications and examining methods for the Administrator. Individuals who have been convicted of criminal offences or have had their professional licenses revoked within a five-year period cannot be appointed as an administrator. In the long-term, the development of an appropriate training and certification programme for administrators is very crucial to the operation of the new bankruptcy law. The functions, responsibilities and liabilities, remuneration and the conditions for the replacement of the administrator are clearly set out in the relevant articles.

4. *Fraudulent Transaction and Preferences (Article 33-38)*

To achieve the equitable treatment for all creditors, the 2002 draft provides for the application of what are commonly referred to as “avoidance powers”. The administrator may try to rescind these transactions entered into by the debtor within a certain time of period (six months or one year under different circumstances) prior to the commencement of a bankruptcy case. But like the former version, the 2002 draft has still no provisions on “insider trading” which often occurs especially in listed companies. It does not differentiate between insider trading and non-insider trading for the purposes of the length of the relation back period.

5. *The Creditors’ Meeting (Article 54-64)*

Chapter IV of the 2002 Draft is comprised of two sections dealing with the creditors’ meeting. All creditors who have declared their claims according to this law are members of the creditors’ meeting. In this part, the most significant provision is Article 56, detailing the broad “functions and powers” of the creditors’ meeting, such as investigating claims, deciding to continue or terminate the debtor’s business, etc. This is an illustration of the principle of “creditor’s autonomy” although the creditors’ meeting may be less important in some jurisdictions.

In this Chapter, the 2002 Draft also establishes the position of Supervisor, who may be selected and appointed by the creditors’ meeting and recognised by the court in writing. Article 63 sets out the duties and powers exercised by the Supervisor, such as supervising the management and handling of the debtor’s property, the execution of the composition agreement, etc.

Given the 2002 Draft introduces many new functionaries including the Administrator, the Supervisor, the Chairman of the creditors’ meeting, and the court in the bankruptcy proceeding, it is very critical to properly allocate the relevant powers and responsibilities among them. There may be power struggles between these functionaries and therefore it would be helpful if the draft 2002 was clearer as to the division of powers as between the Supervisors and the creditors, or as between the Supervisors and the Administrator.

6. *Reorganisation (Article 65-94)*

In keeping with current trends in modern insolvency regimes, the 2002 draft also incorporates the reorganisation scheme. One of the major focuses in the draft law is reorganisation, with an emphasis

on the promotion and encouragement of the use of corporate rescue. There is a specific Chapter (Chapter VI) that deals with reorganisation.

The main contents of Chapter VI involve the application for reorganisation, examination and approval of reorganisation application, business operations during the interim period of reorganisation, reorganisation plan, etc. Articles 65-67 set out the reorganisation application process. According to Article 66, either debtor or creditor may apply for reorganisation. Article 67 states that reorganisation is only available for enterprise legal entities. This provision has been the subject of a lengthy debate on whether China should permit non-enterprise legal entities to use the reorganisation scheme. The purpose of the present provision is said to be designed to avoid possible abuse of reorganisation and unreasonable delays in the exercise of creditors' rights.

The 2002 Draft also provides for a definition of a "period of protecting reorganisation" in Article 68. The period may be extended for up to six months and may be extended again for an additional six months. In order to increase the possibility of reorganisation, Article 71 provides for an automatic stay on proceedings made by secured creditors and for the rights of secured creditors regarding their collateral.

7. *Composition (Article 95-111)*

There has been a great deal of discussion as to whether composition should be deleted from the 2002 draft, as it seems this mechanism has been seldom used in practice. But considering that composition is advocated by Chinese civil law and can play a role in resolving insolvency, it is appropriate to keep it in the 2002 draft. Article 95 limits the right of applying for composition only to the debtor.

In addition, it is possible to convert procedures between liquidation and composition. On the one hand, where the draft composition agreement is not passed at the creditors' meeting, the court shall declare the debtor bankrupt. On the other hand, after the court accepts the bankruptcy case, if the debtor reaches an agreement concerning the disposal of the claims and debts with the creditors who unanimously agree, they may request the court to make a decision, recognising the agreement and at the same time terminating the bankruptcy case.

8. *Bankruptcy Liquidation (Article 112-148)*

It is expected that liquidation proceedings will be most often used for resolving insolvency, compared with the two other proceedings: reorganisation and composition. Chapter VIII deals with the declaration of bankruptcy, recovery of property and right to separate satisfaction, bankruptcy claims and right of setting off, appraisal, disposition and distribution of bankruptcy property and termination of bankruptcy proceedings.

There are some important articles which should be examined in detail. According to Article 114, termination of bankruptcy by the court before the declaration of bankruptcy is allowed where a third-party guarantees, or pays off, the debts of the debtor, or the debtor has paid off all the debts that are due. Article 117 allows for the owners or parties with rights over property that does not belong to the debtor to obtain possession from the Administrator. Article 118 gives a right of stoppage in transit and recovery to a non-bankrupt seller who ships goods to a bankrupt that have not been fully paid for, but then gives the administrator the right to pay the full price and receive the goods.

In addition, pursuant to Article 134, bankruptcy property, being property subject to the bankruptcy process, shall be sold by auction unless creditors provide otherwise. Article 135 stipulates the repayment order after deduction of the Expenses of Bankruptcy and Debts of Common Benefit from the bankrupt property as follows: workers' entitlements, taxes and ordinary bankruptcy claims. In the event that the bankrupt property is insufficient to meet the claims within a priority class, the distribution will be made on a pro rata within that class.

9. *Legal Liabilities (Article 149-159)*

The provisions on "Legal Liabilities" in Chapter IX of the draft 2002 are very severe, providing a mix of fines and liability for losses. However, for some violations, only a fine is imposed. For others, liability for actual losses caused is imposed. In addition, the draft raises the amounts of fines imposed on various wrongdoings by significant amounts, indicating a strengthening of the seriousness with which bankruptcy matters are regarded.

The 2002 draft provides for three kinds of legal liabilities: administrative, civil and criminal in addition to disqualification. In particular, the 2002 draft adds several articles on civil compensation that are not included in the previous drafts. A change was made to Article 157 from the 2001 draft, with the article now imposing a fine rather than liability for losses caused, and eliminating any requirement of proof that losses were caused by the violation. Article 159 imposes a special liability on the administrator, reorganisation executor, or supervisor for losses caused by negligence of duty or other unlawful activities, and if there are significant losses, the responsible party may be fined or detained with criminal responsibilities.

III. *New Judicial Rules*

The New Rules with 106 articles were promulgated on 30 July 2002 and came into effect on 1 September 2002. The following is a short summary of some important provisions in the New Rules:

1. *Jurisdiction (Article 1)*

The bankruptcy case shall be under the jurisdiction of the court in the place of the debtor's domicile. The debtor's domicile means the place where the debtor has established its main place of business. Where the debtor has no place of business, the bankruptcy case shall be under the jurisdiction of the court in the place of the debtor's Registered Office.

2. *Eligible Debtor (Article 4)*

The debtor applying for bankruptcy shall be a legal person. Non-legal-person enterprises, or partnerships may not apply for bankruptcy according to the New Rules. But foreign investment enterprises (FIEs) are eligible to apply for bankruptcy provided that the FIE is a legal person. This provision improves the process of hearing the FIE bankruptcy case as the previous provisions set out in the Civil Procedure Law (CPL) of the PRC applicable to the bankruptcy of FIEs are too simple to function in practice.

3. *Prevention from Abuse of Bankruptcy Proceedings (Article 12, 14)*

Avoiding abuse of bankruptcy proceedings by the debtor or certain creditors is one of the main focuses of attention in the New Rules. To achieve this goal, the New Rules stipulate that the court shall not accept a bankruptcy application rendered by a debtor who conceals or transfers its assets and has original intention of escaping debts. Likewise, the same thing happens to a bankruptcy application rendered by a creditor who tries to impair fair competition through the bankruptcy application. Even after the court accepts the bankruptcy case, it still has the power to dismiss the bankruptcy case if the above criteria are satisfied.

4. *Enterprise Supervision Group (Article 18)*

After the court accepts the bankruptcy application, unless the court declares the debtor bankrupt and appoints the liquidation committee immediately, the court may appoint an Enterprise Supervision Group (ESG) if the original management of the debtor cannot perform its management duties. Members of the ESG are appointed from the senior department-in-charge or shareholders, the debtor's original management, its major creditors and intermediaries such as accountants and lawyers. The ESG, under the supervision of the court, is responsible for, *inter alia*, the protection of the assets of the debtor, verification of its debts and the performance of other work approved by the court.

The ESG performs, among other things, the functions of a provisional liquidator in common law jurisdictions and helps to preserve the assets of the enterprise for the benefits of its creditors at least before the appointment of the liquidation committee. This is a big improvement in China bankruptcy practice as it is common to find that assets of the debtor are illegally disposed of by the debtor's shareholders, employees or creditors. However, it is not clear whether the ESG will continue to function after the liquidation committee is appointed or whether the ESG should be dissolved and then its members reappointed as members of the liquidation committee.

5. *Composition (Article 25-30)*

The New Rules provides for composition and restructuring proceedings although there are very limited articles. The composition proceeding applies to all debtors. After the court accepts the bankruptcy case, the debtor may apply to the court for composition prior to the closure of bankruptcy proceedings. In addition, during the hearings of the bankruptcy case, the court may also provide a composition proposal for the debtor and creditors to consider.

The restructuring proceedings are very simply stated in the New Rules. Only three articles deal with this important issue. The restructuring proceedings only apply to SOEs. Moreover, the applicant can only be the senior department-in-charge of the SOEs. Where the SOE has no senior department-in-charge, the shareholders may apply for restructuring.

From these articles, it can be seen that the restructuring proceedings in the New Rules has been devised in response to China's national conditions and is inconsistent with international standards in this regard. Presumably, the very short provisions on the composition and restructuring may be attributed to the main purpose of the New Rules – it is mainly concerned with the hearings of bankruptcy cases.

6. *Liquidation Committee and Insolvency Practitioners (Article 48, 49 And 75)*

Members of the liquidation committee may be appointed from the senior department-in-charge, different government departments and intermediaries such as accountants and lawyers. With the court's approval, the liquidation committee may appoint intermediaries such as law firms and accounting firms to carry out debt collection and other liquidation work.

It is an encouraging sign that the important role of professional insolvency practitioners such as lawyers and accountants has received judicial recognition in China. With the participation of such practitioners, the quality and speed of the bankruptcy procedure would definitely get better.

7. *Bankruptcy Assets (Article 64, 73)*

Bankruptcy assets shall include all assets owned or managed by the debtor at the time when the debtor is declared bankrupt. This provision raises the issue of whether Chinese bankruptcy proceedings may affect the assets of debtors located outside of China. Although the New Rules gives no explanation as to the meaning of "all assets", it is still safe to draw a conclusion that the New Rules try to cover assets located outside China because article 73 states that assets located outside China shall be recoverable by the liquidation committee. Certainly, how this provision could operate in practice is still not very clear due to lack of relevant supporting details.

8. *Reservation of Title (Article 71)*

Whether to recognise reservation of title or not in bankruptcy proceedings is a controversial issue internationally. In some jurisdictions, reservation of title is regarded as a non-possessory security interest. Its effect may not be recognised when the buyer becomes bankrupt. The New Rules adopts a contrary solution in this respect. According to article 71, bankruptcy assets do not include the assets of which the debtor has not acquired the title in a title reservation sale.

9. *Debt Allocation (Article 94)*

Debts owing to the debtor that have been classified as bankruptcy assets and verified by the court may be allocated to a creditor. The liquidation committee shall provide Debt Allocation Letters to such creditors who may then request the relevant debtors of the debtor to pay the outstanding debts directly to them. If such debtors refuse to make payment, the creditor may apply to the court for mandatory execution measures against such debtors. Whilst this procedure seems to be rather creative and could reduce the burden of the liquidation committee and expedite the bankruptcy process, it is far from clear how it will function in practice.

10. Supervision by Higher Courts (Article 104)

If the Supreme People's Court or a higher court discovers any errors in any lower court bankruptcy decisions, it shall notify such lower courts to rectify the errors or order them to reconsider their decisions.

With the introduction of the New Rules, the legal framework of the Chinese bankruptcy procedure is now more detailed and self-contained, particularly when it is very difficult for a new bankruptcy law to be enacted due to various reasons in China. However, there are still many provisions in the New Rules which require further judicial clarification in order to explain how they are intended to be applied in practice.

Hong Kong China

THE CURRENT STATUS OF CORPORATE RESTRUCTURING IN HONG KONG

by

*Nick Hill*⁵

The purpose of this paper is to provide a brief introduction to Provisional Supervision, the introduction of which has been pending in Hong Kong for some time now, and to touch on an interesting development, how provisional liquidators are being used to effect moratoriums and corporate rescue in the absence of Provisional Supervision.

Hong Kong is not somewhere that has ever had many floating charges. When I first came to Hong Kong, I tried to borrow some money from a bank. I was told, repeatedly, that there will be no difficulty in my borrowing the money so long as I deposited an equal amount. Bizarre but true, this process of lending money only against deposits of an equal amount has led to a culture in which receivers are relatively few and far between. This arrangement continues until the customer has built up sufficient trust with the bank. I have been the receiver of one listed group that has been relisted with the new investor but I am not aware of any other examples.

There is also no business rescue process in Hong Kong with a moratorium. As those who have tried to do a restructuring with no moratorium will have quickly found out, you either have a small number of large creditors or the scheme is likely to fail from individual creditor pressure.

Provisional Supervision

For nearly a decade we in Hong Kong have recognised the need for a rescue mechanism that contains a moratorium.

The Genesis of Provisional Supervision and the Corresponding Legislation in Australia and the UK

The Law Reform Commission of Hong Kong's Report on Corporate Rescue and Insolvent Trading of 1996 ("The LRC 1996 Report") made specific reference to the influence the legislation in Australia and the United Kingdom had had on the LRC's deliberations. I shall briefly look at them in turn.

In Australia, the corresponding legislation is known as Voluntary Administration. The Voluntary Administrator may be appointed by the company's board of directors, a secured creditor or the company's liquidator or provisional liquidator. He acts as an agent of the company and, although personally liable for the liabilities he incurs, has a right of indemnity out of the assets of the company, except out of those assets covered by a fixed charge.

The whole process is very quick: a meeting must be held within five working days of the Voluntary Administrator's appointment to consider whether the Voluntary Administrator should be replaced and to appoint a committee of creditors.

⁵ Nick Hill, RSM Nelson Wheeler, Corporate Advisory Services Limited, Hong Kong, China

After the first meeting there follows a convening period, which normally lasts 21 days, during which the Voluntary Administrator will formulate a recommendation which he will put to creditors at a meeting held at the end of this 21-day period. The recommendation will be which of the following three options the Voluntary Administrator considers is in the creditors' best interests, specifically whether:

- the company should enter into a scheme of arrangement, known as a Deed of Company Arrangement;
- be wound up; or
- be returned to the control of the company's directors.

If a Deed of Company Arrangement is agreed to, the Voluntary Administrator usually becomes the deed administrator. The Deed of Company Arrangement will normally include a moratorium or a compromise on creditors' debts or, sometimes, a combination of both. A Deed of Company Arrangement does not require Court approval. It is agreed by a simple majority of creditors.

In the UK, the company, its directors or one or more of its creditors may apply for an Administration Order if the company is:

- insolvent or likely to become insolvent;
- is not in liquidation; and
- is likely that Administration will achieve one or more of the following purposes:
 - the survival of the company, and the whole or part of its undertaking, as a going concern;
 - the approval of a voluntary arrangement;
 - the sanctioning of the compromise or arrangement between the company's creditors; or
 - a more advantageous realisation of the company's assets than will be effected in a liquidation.

The petitioner must prepare an affidavit giving details of the company's financial position. This will normally be accompanied by a report of an insolvency practitioner recommending Administration.

The Administration Order imposes a moratorium and appoints an Administrator to manage the affairs, business and property of the company.

Anyone who has the power to appoint an administrative receiver, that is a receiver over *significantly all* of the company's assets, is then given the opportunity to appoint a receiver (although this right can be overreached by the court).

Following his appointment, the Administrator must give notice to the creditors, within 28 days, including by advertisement in the Government Gazette and a suitable newspaper. He then acts as both agent of the company and as an officer of the court with powers to appoint and dismiss directors and with wide powers to manage the affairs and property of the company. In particular he can deal with

assets that are subject to a floating charge as if that charge did not exist (although the secured creditor retains his rights over whatever replaces the secured assets, normally cash). The Administrator may even dispose of assets secured by a fixed charge if he gets the court's approval.

The Administrator is allowed three months to prepare a proposal for the creditors and must give them 14 days notice of the meeting at which the proposal is presented. The proposal can be wide-ranging but in practice normally contains detailed recommendations for saving the company, or its business, and some form of compromise of the creditors' claims. Approval of his proposal is by a simple majority of creditors.

There is currently no time limit on an Administration (although that will change when the Enterprise Act becomes law). The Administrator has to send a progress report to the creditors every six months. The Administration comes to an end by order of the court when, in most cases, the objects have been achieved or it is clear that they will not be (in which case the company will normally go into liquidation).

So what are the core features of the Australian and the UK legislation? Well, firstly, a third party takes control of the company, essentially replacing the powers of the directors, normally at the instigation of the company or its officers: it is debtor driven. Secondly, both procedures seek to maximise the chances of an insolvent company continuing in business and, where that is not possible, to produce a better return to the company's creditors. Thirdly, there is a limited period during which time the independent third party who has taken control, who must be suitably qualified, protects and preserves the company's assets and business, reviews the current position and comes up with a plan which is put to the creditors to vote on. Fourthly, during the time that he is in control, individual creditors cannot, in general, take action: the so-called moratorium. All quite simple and all very sensible. And we shall see that this is exactly what Provisional Supervision seeks to be.

The Provisional Supervision Bill (The "Bill")

The latest draft of the Bill was introduced into the Legislative Council on 15 May 2001. The accompanying Legislative Council brief set out the background to the Bill and the arguments for the introduction of the legislation.

The Legislative Council's brief's starting point was that while companies approaching insolvency could agree a scheme of arrangement with their creditors pursuant to Section 166 of the Companies Ordinance, it noted that Section 166 did not protect the company from its creditors taking action to wind up the company (or seizing assets etc by obtaining execution of judgment debts) while these arrangements were being formulated. As such, the starting point, well- recognised by the Law Reform Commission, is that there needs to be a moratorium in place to protect the company from its creditors.

A decision then has to be taken as to who controls the company in this period. Unlike the debtor in possession legislation of the United States (e.g. Chapter 11), Hong Kong, as with other Commonwealth jurisdictions, has always been a creditor-friendly jurisdiction. The Bill proposes that during this moratorium an outside person, described as an independent third party, takes over the control of the company and formulates an arrangement for agreement with its creditors. This person is to be known as a Provisional Supervisor and, in practice, is likely to be a professional accountant experienced in corporate recovery.

The Legislative Council's brief specifically notes that the corporate rescue procedure would give companies in financial difficulty an opportunity to "try to turn around" and, at least to some extent, the chance to preserve employment.

Pausing at this stage, I would note in passing that the desire for the company to "try to turn around" is in itself naïve. Hong Kong has not yet faced, and is unlikely to face, a major restructuring where a company trades out, such as Worldcom, and they do not happen very often; whatever we accountants may say, we are not particularly good at business restructuring. What we really do is debt restructuring. This is borne out to a large extent by the reorganisation of various PRC "window companies" — Hong Kong companies, often listed, that are a conduit for funds from the PRC: these were large debt reorganisations with the injections of new assets. Much more realistic is that Provisional Supervision will allow time to arrange a scheme by which creditors take a discount and/or a new investor is found; outcomes plainly not inconsistent with the desire to maintain the business unit and to preserve employment; the second issue being even more relevant to Hong Kong now even than when the Bill was introduced.

Thus we find that in the Bill the purpose of the appointment of the Provisional Supervisor is to enable the Provisional Supervisor to make a proposal which would achieve one or more of the following purposes:

1. a more advantageous realisation of the company's property than would be effected on a winding up of the company;
2. the survival of the company, in whole or of any part of the undertaking, as a going concern; and/or
3. the more advantageous satisfaction, in whole or in part, of the debts and other liabilities of the company.

These purposes are essentially lifted straight from the UK's law on Administration.

The Provisional Supervisor's duties are those of a super provisional liquidator; he is able to trade but also has a duty to investigate prior transactions. He also has to decide early on whether any of the purposes for which Provisional Supervisors are appointed are possible. And of course, he has to prepare a proposal as quickly as possible.

The cornerstone to this procedure is the moratorium. The Bill envisages the moratorium starting from the commencement of the Provisional Supervision (i.e. when the Provisional Supervisor is appointed) and running for 30 days initially (this period being capable of being extended by up to six months by the court). After this six-month period, the court will step back and the future of the Provisional Supervision will be dependent upon the creditors.

To make it workable, the moratorium does not subsist for transactions after the appointment of the Provisional Supervisor, so he can trade freely. The only difficulty he will face is that he will be liable for contracts he enters into personally, except to the extent that he contracts out of this personal liability, although he will have an indemnity out of the assets of the company. Significantly however, the Provisional Supervisor is personally liable for all contracts for employment he adopts in the 14 days after his appointment (although this must be a positive adoption).

The Provisional Supervisor shall, as soon as possible, give notice to the relevant persons, essentially the directors and senior staff, to prepare a Statement of Affairs within seven days of his notice.

Post-provisional Supervision Lenders, essentially banks, will receive a super-priority over the assets of the company for repayment of monies they advance, to encourage them to lend.

Existing floating charge holders can veto the Provisional Supervisor's appointment at the beginning but if they do not and the Provisional Supervision goes ahead then, at least in broad terms, their rights remain unaffected.

Significantly, the Provisional Supervisor will have the power, and by implication the responsibility, to investigate voidable transactions, essentially preferences, made prior to the start of the Provisional Supervision.

While he is doing all this trading and taking personal liability, the Provisional Supervisor must also pursue his main task, which is to formulate a proposal for creditors.

After 28 days (or such extended period the court allows) the Provisional Supervisor calls his meeting and puts his proposal to the creditors. To my mind, there is no limit on what this proposal can be. In practice, it will normally take the form of a scheme of arrangement; namely, it will provide the flexibility necessary to meet the circumstances. If the creditors approve the proposal, the company proceeds to enact it through a scheme. If the proposal is rejected then the company goes into creditors' voluntary liquidation (or back to compulsory liquidation if this was on foot prior to the appointment of the Provisional Supervisor).

So let us compare the basics of Provisional Supervision with Australia's Voluntary Administration and the UK's Administration. All three have a lot of common core features:

A suitably qualified, independent third party takes over the company, effectively replacing the directors, whose powers are suspended.

The appointment is normally at the instance of the company or its officers.

The achieving of a better result than on a winding up is sufficient but each of the processes is designed to facilitate the survival of all or part of the company's business.

The appointee prepares and presents a proposal to creditors, who then vote on it.

During the currency of the appointment there is a moratorium, preventing a creditor from taking pre-emptive action.

Unlike the UK (but like Australia), Provisional Supervision anticipates no court involvement to commence the process. Perhaps as a consequence the creditors' meeting at which the proposal to creditors is presented must be held within only 28 days, compared to normally 21 in Australia but three months in the UK (although under each regime the Court can extend this period).

The Problems with the Legislation

There are three foreseeable problems.

1. Personal liability of the Provisional Supervisor..
2. The need for a trust fund to protect the amount due to employees.
3. 30 days being too short to arrange a proposal.

1. Personal Liability

As drafted, the Bill makes the Provisional Supervisor liable for all liabilities arising after his appointment, including all liabilities for any employees, such as severance pay, for all employees whose contracts he adopts within 14 days; although he does have an indemnity out of the assets and he can contract out of non-employee liabilities. This creates a number of problems.

Firstly, this presents a major obstacle to adopting long-serving employees (unless their liabilities are covered by the trust fund, which I shall come on to).

Secondly, it would appear that the company, and thus the Provisional Supervisor, is liable for the unauthorised acts of a director.

Thirdly, it is not clear how the undischarged liabilities of the Provisional Supervisor are transferred to what follows: the liquidator, the scheme administrator or the directors.

Speaking for myself, I anticipate that I shall want to contract out of this personal liability, so that suppliers will contract with the company (in Provisional Supervision). At this stage I envisage doing this within the advertisement announcing my appointment. In theory, if there are sufficient assets, this will make no difference to the supplier being paid. In practice of course it does. Therefore, when (or if) Provisional Supervision is introduced, the supplier, and his legal adviser, should consider each case on its merits and if the Provisional Supervisor is not prepared to take on the personal liability, the first question that should be asked is why. In practice I anticipate a compromised situation where liability is accepted by the Provisional Liquidator up to a certain amount. The practical difficulty that a Provisional Supervisor will face is that he will not be able to protect his own position by reserving sufficiently out of the assets to cover an unforeseen liability. Thus, if he ships a container load of cigarette lighters and half of them blow up causing a raft of personal injuries, he is facing a very difficult situation unless he has limited his liability. Consequently, there will be difficulties with particular industries — but this is nothing new.

2. The Trust Fund

A contentious aspect of the legislation as originally drafted was that the company has to pay a sum equivalent to all amounts due to all employees at the commencement of Provisional Supervision into a bank where it will be held in trust to pay the employees. This has since been modified to a cap of just over US\$30,000 per employee, the same cap as operates for the Protection of Wages on Insolvency Fund, the government funded employee compensation fund. This trust account will have to provide for all sums outstanding to previous employees (so you cannot sack everybody just before the commencement of Provisional Supervision) and amounts due, including severance pay, etc. to all employees intended to be laid off after the commencement of the Provisional Supervision.

This arrangement is entirely a result of lobbying by supporters of employees in Hong Kong and, in many cases, will make Provisional Supervision unworkable: companies facing a cashflow crisis do not, by definition, have sufficient sums to pay all employees in cash. More worryingly, this flies in the face of the worldwide trend of getting rid of preferential creditor status (indeed it effectively creates a statutory preference of 100% of employees' claims) and will lead to a lack of co-operation from employees who will know that if the Provisional Supervision fails there is a pot of money available to pay their claims in full. However, until such time as the Hong Kong government introduces a safety net for dismissed employees, and uses it for that purpose rather than seeing it as a loan (as the Protection of Wages on Insolvency Fund is currently operated), this is a fact of life. Companies will still be able to use Provisional Supervision but considerably more care will need to be taken in what decisions are reached prior to the commencement of Provisional Supervision; essentially the Provisional Supervisor and the directors will not be able to conclude that they need to lay off some of the employees because they will be compelled to put down large sums for severance pay. In other words the legislation is encouraging insincerity.

In practice, the trust fund will make Provisional Supervision much less workable except where a company has lots of cash or very few employees.

3. 30 Days

In practice, if the Bill is enacted as currently drafted, I foresee that in nearly every case the Provisional Supervisor will apply to the court to seek an extension of the moratorium. From a policy standpoint, I think this is undesirable. Undoubtedly, there will be occasions when an extension is not only beneficial but even necessary. Unfortunately, as anyone who has ever been inside a Court knows, the Court can only rely upon what it is told. Although it would make my life more difficult, I personally think that the Provisional Supervisor should be required to canvas the views of creditors, either within a meeting or by circular letter, prior to his application to Court for an extension and the views of the creditors on an extension should be conveyed to the Court.

In conclusion, if introduced, Provisional Supervision will improve corporate rescue in Hong Kong but will be of very limited application while the requirement for a trust fund to provide for up to US\$30,000 per employee remains. No better example of the despondency that the Bill has now attracted is a quotation from Legislator Eric Lee (the Hong Kong Society of Accountants' representative in Parliament). Eric noted, "It's not going to rescue anything by the time it's finished. It's not going to be of any great help. I don't think it's going to make a large impact for business". Sadly, I think we all agree.

New Uses for Provisional Liquidators

What is of interest is the recent development of corporate rescue by provisional liquidators.

Hong Kong is a litigious place and the problem of no moratorium mechanism arises.

The Hong Kong Monetary Authority and the Hong Kong Association of Banks have issued the Hong Kong Approach to Corporate Difficulties, a series of non-statutory guidelines covering how institutions should deal with customers in difficulties. To a large extent, this is based on what has become known as the London Approach. This recognises the benefits to all the stakeholders of businesses surviving, and thus the desirability of a workout. Its underlying principles are that the banks should support a company in difficulties; decisions should only be based on reliable information; whether to offer further financial assistance should be a collective decision; and all the banks should co-operate to agree a restructuring plan, rather than one standing alone.

This is good, and works from time to time, but of course does not prevent an individual creditor from taking individual action.

However, in Hong Kong, the appointment of a provisional liquidator effectively prevents the continuance (and commencement) of legal and enforcement actions. I shall now briefly go through a few developments on this front.

The Law

A liquidator appointed provisionally (at any time before the making of the winding up order) has traditionally been appointed to secure the company's property pending the outcome of the petition and to avoid any creditor obtaining an advantage, etc. It is normally necessary to show that the company's assets are at risk. The court will be reluctant to appoint a provisional liquidator unless there is a good *prima facie* case that a winding up order will be made subsequently.

However, in the 1985 US case of Megarry VC, the judge rejected the argument that there is a need to show that a company was likely to be wound up. The judge concluded that the court had complete discretion to appoint a provisional liquidator and, although the appointment would have a serious impact on the company, and this should be considered, there were undoubtedly other reasons why it would be appropriate to appoint a provisional liquidator.

In Hong Kong, many listed companies are incorporated in Bermuda or the Cayman Islands. Therefore, Hong Kong insolvency practitioners will normally be considering at least two jurisdictions for the presentation of winding up petitions and the appointment of a provisional liquidator.

The Bermuda jurisdiction was the first to embrace the idea that a provisional liquidator could be appointed with a view to implementing a scheme of arrangement between the company and its creditors. More recently, the Hong Kong Court has adopted a similar approach and in September 2002 specifically empowered provisional liquidators to implement a scheme of arrangement in the order of appointment.

The Effects

So what is the effect of the new practice? Well many of Hong Kong's listed companies have experienced major difficulties over the last few years. In the majority of cases the only remaining asset of value is the listing, which effectively third parties are prepared to pay for by being willing to inject funds into the company in return for the issuance of sufficient new shares to provide the new investor with control. The advantages of this to the new investor are obvious: he avoids the three-year track record requirement for assets and businesses that he wishes to inject and he is able to acquire a company with a low share price, which affords considerably greater scope to structure the terms of investment.

In practice, a provisional liquidator is appointed and steadies the ship. After establishing the assets and liabilities, he invites expressions of interest from third-party investors. Listed company shells now have a value of \$7.5m/US\$10m in Hong Kong and this could be realised for the creditors by issuing shares to this value and the proceeds used to form a scheme of arrangement for the creditors and shareholders. What of course this means is that while the scheme is being formulated there is a moratorium, arising under Hong Kong law from the appointment of a provisional liquidator, which prevents individual creditors upsetting the process. The return to creditors, the preservation of jobs and the on going prospects for suppliers are all at least as good as would be the case in a winding up.

In addition, given that the Stock Exchange adopts a rigorous and conscientious approach to the consideration of proposals, there is unlikely to be any improper assets or unqualified directors going into the business. In short, all the stakeholders do at least as well as they would on liquidation and most do better.

Going Forward

The delay with the introduction of Provisional Supervision has been a considerable disappointment to many in the profession in Hong Kong. There is widespread skepticism as to the benefit of how useful the legislation as drafted will be. The cap on the payout to employees does little more than reduce the scale of a major problem. However, the development of a greater flexibility by the courts to allow rescue plans by provisional liquidators provides a useful alternative route. I also believe that we can expect to see more directors looking to save businesses before banks and other creditors force liquidation on them.

India

PROPOSALS FOR REFORMS — THE INDIAN POSITION

by

*Sumant Batra*⁶

I. The Prevailing Corporate Insolvency & Restructuring System

India does not have a composite law dealing with insolvency of companies. While Sick Industrial Companies (Special Provisions) Act, 1985 deals with the revival and rehabilitation of corporate entities, the Companies Act, 1956 deals with their liquidation and winding up.

In August 2001, the Companies (Amendment) Bill, 2001 and the Sick Industrial Companies (Special Provisions) Repeal Bill, 2001 were introduced in the Parliament of India. The Bills are the legislative products of the recommendations of Justice V.B. Eradi Committee which was set up by the government of India in 1999 to remodel the existing laws relating to insolvency and winding up of companies and bringing them in line with the international practices in this field. The Bills, if passed in their present form will bring the curtains down on the Sick Industrial Companies (Special Provisions) Act, 1985 and will restructure the Companies Act, 1956 in a big way leading to the new regime of tackling corporate rescue and insolvency procedures in India.

In July 2002, the President of India promulgated an Ordinance on Asset Reconstruction and Realisation of Security Interest namely, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002.

This paper brings out some of the salient provisions of the existing legislations and the Ordinance, highlights the weaknesses in the legislations, sets out some of the significant changes in the proposed enactments and the said Ordinance and provides a critical analysis of their provisions.

A. *Sick Industrial Companies (Special Provisions) Act, 1985*

Board for Industrial and Financial Reconstruction (BIFR)

SICA is basically and predominantly remedial and ameliorative in so far as it empowers the quasi-judicial body, Board for Industrial and Financial Reconstruction to make appropriate measures for revival and rehabilitation of potentially viable sick industrial companies and for liquidation of non-viable companies.

⁶ Sumant Batra is Partner (Litigation), Kesar Dass B & Associates, New Delhi, India. He is Honourary Secretary, INSOL India and Director on the Board of INSOL International

BIFR comprises of a chairman and not less than two and not more than fourteen members and shall be persons who have been or are qualified to be High Court judges or are persons of ability and integrity and have special knowledge and professional experience of not less than fifteen years in the field of science, technology, economics, banking, industrial reconstruction, investment, law, labour matters, industrial finance, industrial management, accountancy, marketing, administration or any other matter.

Invoking jurisdiction of SICA

SICA requires that when an industrial company has become a sick industrial company, the Board of Directors of the said company shall, within 60 days from the date of finalisation of the duly audited accounts of the company for the financial year as at the end of which a company has become a sick industrial company, make a reference to BIFR for determination of the measures which shall be adopted with respect to the company. However, if the Board of Directors has sufficient reasons, even before finalisation of accounts to form an opinion that the company has become a sick industrial company, it shall, within 60 days after it has formed such an opinion, make a reference to the BIFR.⁷

With the promulgation of the said Ordinance, however, 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% of secured creditors initiate action under the Ordinance.

The central or state government, Reserve Bank of India or a Public or state financial institution or a scheduled bank may, if it has sufficient reasons to believe that any industrial company has become a sick industrial company under SICA, make a reference in respect of such company to the BIFR.⁸

Sick Industrial Company

For the purposes of SICA, a sick industrial company means an industrial company (being a company registered for not less than five years and employing 50 or above workers) which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth.⁹ Net worth¹⁰ has been defined as the sum total of the paid up capital and free reserves. For the purposes of net worth, “free reserves” means all reserves credited out of the profits and share premium account but does not include reserves credited out of revaluation of assets, write-back of depreciation provisions and amalgamation.

Registration of Reference and Enquiry by BIFR

The reference filed by a sick industrial company or by any of the parties prescribed under SICA is registered and placed before BIFR for consideration. The BIFR may make such inquiry, as it may deem fit for determining whether the company has become a sick industrial company.¹¹ If BIFR deems necessary or expedient to do so for the expeditious disposal of an inquiry, it may appoint any Operating Agency (OA) to enquire into and make a report with respect to such matters as may be

⁷ Section 15(1) of SICA

⁸ Section 15(2) of SICA

⁹ Section 3(1)(o) of SICA

¹⁰ Section 3(1)(ga) of SICA

¹¹ Section 16 of SICA

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.

Preparation and sanction of scheme

- If on making an inquiry, the BIFR is satisfied that a company has become 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 such company, such directions as it may deem fit to make its net worth exceed the accumulated losses.¹²
- If the BIFR decides that it is not practicable for a sick industrial 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 providing for such measures in relation to such company as it considers necessary from out of the parameters laid down under the Act.¹³
- The OA, if possible, prepares a scheme providing, *inter alia* for any one or more of the measures – the financial reconstruction of the sick company by change in or takeover of the management of the sick company; the amalgamation of the company with any other company; the sale or lease of a part or whole of any industrial undertaking of the sick company; the rationalisation of managerial personnel; such incidental, consequential or supplemental measures as may be necessary; change in Board of Directors, etc.¹⁴

Operating Agency

The OA assists BIFR in the discharge of its functions. Generally, BIFR appoints any 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.

Circulation/Sanction of scheme

- Where the scheme prepared by the OA relates to preventive, ameliorative, remedial and other measures with respect to any sick industrial company, it may provide for financial assistance by way of loans, advances or guarantees or reliefs or concessions or sacrifices from the central government, state government, any scheduled bank or other bank, a public financial institution or state level institution or any institution or other authority to the sick industrial company.
- Every such scheme is required to be circulated to every person to provide financial assistance for its consent within a period of 60 days from the date of such circulation, If no consent is received within the said period, it is deemed that consent has been given and the BIFR shall sanction the scheme and on and from the date of such sanction, the scheme shall be binding on all concerned.

¹² Section 17(1) and Section 17(2) of SICA

¹³ Section 17(3) of SICA

¹⁴ Section 18 of SICA

- If the consent so required is not given, in that case the BIFR may adopt such other measures, including the winding up of the sick industrial company, as it may deem fit.

Winding up of sick industrial company

Where 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 should 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 winding up of the company and may proceed and cause to proceed with the winding up of the sick industrial company in accordance with the provisions of the Companies Act, 1956.¹⁵

Suspension of legal proceedings and Contracts

Where in respect of an industrial company, an inquiry is pending or any scheme is under preparation or consideration or a sanctioned scheme is under implementation or where an appeal is pending, no proceedings for the winding up of the industrial company or for execution, distress or the like against any of the properties of the industrial company or against its guarantor or for the appointment of a Receiver shall lie or be proceeded with further except with the consent of the BIFR or as the case maybe, the Appellate Authority.¹⁶

Appellate Authority

There is an Appellate Authority for Industrial and Financial Reconstruction (AAIFR) which comprises of a retired High Court Judge as its chairman. The AAIFR hears appeals from the parties aggrieved by the orders of BIFR.

B. Companies Act, 1956

The Companies Act, 1956 (1956 Act) *inter alia* deals with the winding up or liquidation of the companies incorporated under the said Act. The winding up of a company under the 1956 Act can be by an order of court or voluntary.

Cases in which a company may be wound up by the court

- (a) The court may wind up a company¹⁷
- (i) if the company has by special resolution resolved that it be wound up;
 - (ii) if the company does not commence its business within a year from its incorporation, or suspends its business for a whole year;
 - (iii) if it is unable to pay its debts¹⁸;

¹⁵ Section 20 of SICA

¹⁶ Section 22 of SICA

¹⁷ Section 433 of Companies Act, 1956

¹⁸ A company shall be deemed to be unable to pay its debts — if a creditor to whom the company is indebted in a sum exceeding 500 rupees, has served on the company a demand by registered post at its registered office requiring it to pay the sum so due and the company has for three weeks thereafter neglected to

- (iv) if a default is made in delivering the statutory report to the Registrar or in holding the statutory meeting;
- (v) if the number of members is reduced in the case of a public company below seven and in the case of a private company below two;
- (vi) if the court is of the opinion that it is just and equitable that the company should be wound up.

Who can present the petition for winding up?

An application to the court for the winding up of a company, can be by way of a petition presented¹⁹

- by the company;
- by any creditor or creditors including contingent or prospective;
- by any contributory or contributories;
- by the Registrar of Companies;
- in a case falling under Section 243 of the Companies Act, 1956, by any person authorised by the central government in that behalf.²⁰

Power of court on hearing petition

On hearing a petition, the court may dismiss it or adjourn it conditionally/unconditionally or make any order of winding up or pass any interim order or make any other order as it may deem fit, including appointment of Provisional Liquidator.²¹

Appointment of Official Liquidator

An Official Liquidator (OL) appointed by the central government shall be attached to each High Court who shall be a whole time officer unless the central government considers that there will not be sufficient work for a whole time officer in which case, a part-time officer may be appointed.²²

Custody of company's property

Where a winding-up order has been made or where a Provisional Liquidator has been appointed, the Liquidator shall take into his custody or under his control all the property, effects and actionable

pay the sum; or if execution or other process issued on a decree or order of any court in favour of a creditor of the company is returned unsatisfied; or if it is proved to the satisfaction of the court that the company is unable to pay its debt.

¹⁹ Section 439 of Companies Act, 1956

²⁰ Such an application is made by Central Government if, on investigation into the affairs of the company, it finds that it is just and equitable that the company be wound up.

²¹ Section 443 of Companies Act, 1956

²² Section 448 of Companies Act, 1956

claims to which the company is or appears to be entitled. All the property and effects of the company shall be deemed to be in the custody of the court as from the date of the order for the winding up of the company.²³

Voluntary winding up

A company may be wound up voluntarily when the period if any, fixed for the duration of the company by the Articles has expired or the event, if any, has occurred on the occurrence of which the Articles provide that the company is to be dissolved and the company in general meeting passes a resolution requiring the company to be wound up voluntarily or if the company passes a special resolution that the company be wound up voluntarily.

Application of insolvency rules in winding up of insolvent companies

In the winding up of an insolvent company, the same rules shall prevail and be observed with regard to debts provable; the valuation of annuities and future and contingent liabilities; and the respective rights of secured and unsecured creditors as are in force for the time being under the law of insolvency with respect to the estates of persons adjudged insolvent provided that the security of every creditor shall be deemed to be subject to a *pari passu* charge in favour of the workers to the extent of the workers' portion therein and where a secured creditor instead of relinquishing his security and proving his debt opts to realise his security, the Liquidator shall be entitled to represent the workers and enforce such charge.

²³ Section 456 of Companies Act, 1956

Stay of legal proceedings on winding up order

- When a winding up order has been made or the OL has been appointed as Provisional Liquidator, no suit or legal proceeding can be commenced, or if pending at the date of the winding up order, can be proceeded with against the company except by leave of the court and subject to such terms as the court may impose.²⁴
- The court which is winding up the company shall have jurisdiction to entertain or dispose of any suit or proceeding by or against the company; any claim made by or against the company. Secured creditors, however, can choose to stay outside the winding up proceedings.
- Any suit or proceeding by or against the company which is pending in any court other than in which the winding up of the company is proceeding may be transferred to and disposed of by that court.

Preferential payments

In the winding up of a company, workers' dues and debts due to secured creditors to the extent such debts rank *pari passu* with such dues, shall be paid in priority to all other debts. The debts payable shall be paid in full unless the assets are insufficient to meet them in which case they shall abate in equal proportions.²⁵

C. Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (Second) Ordinance, 2002

Asset Reconstruction Companies (ARC)

Chapter II of the Ordinance provides for the setting up of the Reconstruction and Securitisation Companies for "Securitisation" i.e. acquisition of financial assets from its owner, whether by raising funds by such Securitisation or Reconstruction Company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise. The Ordinance deals with the Registration of these Companies, their prerequisite qualifications etc.

Measures for Asset Reconstruction

The measures that a Securitisation or Reconstruction Companies can take for the purpose of Asset Reconstruction are:

- Takeover of the management of the business of the borrower.
- Sale or lease of a part or whole of the business of the borrower.
- reschedulement of payment of debts payable by the borrower.
- Enforcement of security interest in accordance with the provisions of the ordinance.
- Settlement of the dues payable by the borrower.

²⁴ Section 446 of Companies Act, 1956

²⁵ Section 529 of Companies Act, 1956

- Taking possession of secured assets.

Additionally, such Company can perform the following functions:

- Acting as an agent for any bank or financial institution for the purpose of recovering their dues from the borrower on payment of such fees as may be mutually agreed.
- Acting as a Manager.
- Acting as a Receiver.

Acquisition of Rights of Interest in Financial Assets by ARC

An ARC can acquire financial assets by issuing a debenture or bond or any other security in the nature of a debenture for consideration agreed and by incorporating such terms in the agreement; or entering into an agreement for the transfer of such financial assets to such company on such terms and conditions as may be agreed.

The terms and conditions of acquisition, including those relating to consideration for acquisition can be negotiated and agreed between the parties. However, such terms and conditions would have to be in consonance with the guidelines framed and directions issued by Reserve Bank of India from time to time under Section 12 of the Ordinance.

Legal Consequences of Acquisition

ARC shall be deemed to be the lender and all rights of lender shall vest in the ARC in relation to such financial assets.

All contracts, deeds, bonds, agreements, power of attorney, grants of legal representation, permissions, approvals, consents or no objections and instruments relating to financial assets subsisting before the acquisition of financial assets by the ARC shall have full force and be enforced as if they had been issued in favour of ARC or as the case maybe.

No suit, appeal or proceedings shall be abated or be discontinued for the reasons of acquisition of financial assets by the ARC. However, the appeal may be continued, prosecuted and enforced by or against the ARC. However, no reference can be filed by such company in respect of which acquisition of assets is carried out by an ARC.

Procedure for Acquisition — Notice of Acquisition

Though no procedure, as such, has been laid down under the Ordinance, a notice of acquisition may be sent to the Obligor (generally speaking, the borrower) or to any other concerned person (such as, co-lenders, statutory authorities etc.) and the Registering Authority in whose jurisdiction the asset is located. Such notice is not mandatory. The notice is not of proposed acquisition but of the acquisition already carried out. If any payment is received from the Obligor after acquisition, the same shall be in trust and be forwarded to ARC.

Registration of Transaction

Chapter IV of the Ordinance provides for setting up of a Central Registry to keep a record of Securitisation transactions, for filing of transaction etc. Only when the Rules are framed, the obligations of parties to acquisition under this Chapter would become known.

Resolution of Disputes

Disputes relating to non payment of any amount due including interest arising amongst Bank, FIs, ARC and Qualified Institutional Buyer shall be settled by conciliation or arbitration as provided in the Arbitration and Conciliation Act, 1996.

Enforcement of Security Interest

Invoking the Provisions Relating to Security of Interest

The Ordinance provides that where any borrower makes any default in repayment of secured debt or any instalment thereof, and his account in respect of such debt has been classified by the secured creditor as non-performing asset, then, the secured creditor may call upon the borrower by way of a written legal notice to discharge in full, his liabilities within 60 days from the date of the notice failing which the secured creditor would be entitled to exercise all or any of the rights set out in sub-section 4 of Section 13 of the Ordinance. The provisions of the Ordinance relating to security of interest can be invoked by:

- any bank or
- public financial institution under Section 4A of the Companies Act, 1956 or
- any institution specified by central government under sub clause (ii) of clause (h) of Section 2 of Recovery of Debt due to Banks and Financial Institutions Act, 1993 or
- any other institution or non-banking financial company as specified by central government or
- International Finance Corporation or a consortium thereof.

The provisions of the ordinance *inter alia* do not apply to any case in which the amount due is less than 20% of the principal amount and interest thereon.

Non-payment or part-payment by borrower

If the borrower does not make full payment demanded or makes part payment in discharge of its liability, the creditor would be well within its rights to pursue its rights under the Ordinance.

Taking Possession of Assets

On the expiry of 60 days if the debt is not fully paid by the borrower, the officer(s) so authorised can enter the premises where the secured asset lies and take its possession. If there is resistance or there is likely to be resistance from the borrower and/or its agents in the taking over of the possession, such officer may write a request to the Chief Metropolitan Magistrate (CMM) or the District Magistrate (DM) in whose jurisdiction such secured asset is situate to take possession.

Takeover of Management of Secured Assets

Another option available under the Ordinance is to take over the management of the business of the borrower. The manner and effect of take over has been set out under the Ordinance. While in possession of borrowers business, the secured asset can be sold simultaneously to recover the dues.

Appointment of Manager for the Secured Assets

The duties and responsibilities of the manager are not defined anywhere in the Ordinance. However, it appears that the function of a manager would be confined to managing the asset and not to sell or transfer the asset. The manager would be a custodian of the assets and will otherwise have full control over the asset to the extent empowered. Manager can be assigned the responsibility to manage the asset but can not be empowered to sell unless the manager is also acting under clause (a) of sub-section (4) of section 13.

Procedure in case of Takeover of Co-financed Assets

In the case of financial assets by more than one secured creditor or joint financing of a financial asset by secured creditors, no secured creditor shall be entitled to exercise any of the rights conferred on him unless exercise of such rights is agreed upon by the secured creditor representing not less than three-fourths in value of the amount outstanding as on record date and such action shall be binding on all secured creditors.

Appeal before Debt Recovery Tribunal

Any person (including borrower) aggrieved by any of the measures referred to in sub-section (4) of section 13 taken by the secured creditor or his authorised officer under this chapter, may prefer an appeal to the Debts Recovery Tribunal having jurisdiction in the matter within forty-five days from the date on which such measures had been taken. However, such appeal shall not be entertained by the Debts Recovery Tribunal unless the borrower has deposited with the debts Recovery Tribunal 75% of the amount claimed in the notice. Any person aggrieved by any order by the Debts Recovery Tribunal under section 17 may prefer an appeal to an Appellate Tribunal.

Protection to Secured Creditors

No suit, prosecution or other legal proceedings shall lie against any secured creditor or any of his officers or manager exercising any of the rights of the secured creditor or borrower for anything done or omitted to be done in good faith under this Ordinance. However, any offence by the company during the time the Directors of the secured creditor are holding appointment would be treated as would an offence committed by a company in a normal case. This means that such Directors would be fully responsible for the offence committed by the company.

Jurisdiction of Civil Court barred

No civil court will have jurisdiction over any of the matters stated under the Ordinance.

II. Author's Analysis of Existing Laws:

SICA has proved to be a complete failure with BIFR having failed to turn around sick companies. Burdened with over Rs. 85,000 Crores of Non Performing Assets, the lenders find SICA to be the biggest obstacle to recover their dues. Only 254 companies had been revived until December 2000 —

a mere 7% percent of the companies that approached BIFR since 1985. The 1956 Act is a slow and cumbersome legislation. The Ordinance, in as much as it talks of Reconstruction, is yet to be experienced since it is only a couple of months old.

Lack of comprehensive bankruptcy code and road map to bankruptcy

Existing Indian law lacks a specific comprehensive Bankruptcy Code to deal with corporate bankruptcy, which encompasses in itself the corporate restructuring possibilities preceding insolvency and winding up. The bankruptcy proceeding needs to be based on the fundamental objective of assets value maximisation, and hence the law has to facilitate protection of assets against all risks of further diversion, decay and destruction. A self-contained Bankruptcy Code facilitates corporate restructuring and fast track winding up on insolvency. In the fast changing scenario of growing cross-border investment, trade and commerce, cross-border insolvency problems are bound to increase and a comprehensive Bankruptcy Code alone can address such issues taking into consideration international practices. There is a need to introduce the road map of the bankruptcy proceedings viz. application for initiating bankruptcy proceedings; appointment of Trustee: empowerment of the Trustee; operational and functional independence; accountability to the court, including the power of the court to remove Trustee in case of mismanagement; relationship with current management; monitoring or substitution; day-to-day operations, etc; timebound restructuring/recognition plan: who should submit; procedure of acceptance; mechanism to sell off; pro-active initiative of the Trustee; number of time bound attempts for restructuring; decision to go for insolvency and winding up; and strategies for realisation and distribution.

Lack of timely commencement of proceedings and defective trigger point to invoke SICA jurisdiction

Under the existing law, a company can approach the BIFR for adopting steps for its revival, on erosion of its entire net worth. The erosion of entire net worth is too late a stage to attempt restructuring as by the time the net worth is eroded the company is too sick to be revived and has lost its resilience to restructure and revive itself.

Misuse of protection against recovery/distress proceedings

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 BIFR becoming a haven for defaulting companies. Erring debtors have misused SICA to seek protection and moratorium from recovery proceedings. The companies are easily able to enter into the reference, sometimes by manipulating their accounts to reflect net worth erosion. They are then able to attract immunity against the recovery action by creditors and this benefit is then attempted to be perpetuated. Registration of reference is dependent upon the erosion of net worth and this can be achieved by accounting manipulations. The provisions for suspension of legal proceedings are misused and perpetuated. This problem arises due to the fact that unscrupulous promoters enter into the process of rehabilitation by manipulating sickness, taking undue benefits arising out of delay in the decision-making of BIFR. If the reference is rejected, a fresh reference is filed with respect to accounts for the next year and the cycle goes on endlessly. There is no fear of reprisal or punitive action against companies indulging in this malpractice.

Procedural and legal delays

There is inherent procedural and legal delay in proceedings before BIFR. The BIFR takes nearly one year to determine whether a company is sick. Thereafter, it takes around one year to formulate

revival strategy. Consideration of the same also takes substantial time since banks and financial institutions have their own hierarchy in decision-making, leading to avoidable delays and the decisions by the banks are also neither transparent, nor subject to judicial review. There is gross lack of coordination between the banks inter se and banks and financial institutions and many a times the whole process is held up due to adamancy of one of them delaying the whole process of rehabilitation. By the time decisions are taken and communicated, the plan, which had been conceived has lost its viability resulting in failure of revival schemes even after sanction.

Defective policy for appointment of BIFR members and their inadequate strength

SICA has become a rehabilitation centre for retired bureaucrats. Rather than appointment of experts to BIFR and AAIFR, the government has, by and large, filled up the positions by appointing retired and influential bureaucrats who have no experience and expertise of revival and rehabilitation of companies. The highest number of members in BIFR at a given point of time has not exceed 50% of its sanctioned strength. With a large number of companies approaching BIFR for revival in the last decade, inadequate strength of members of BIFR has contributed to delay in disposal of cases.

Bureaucratisation of winding up proceedings

The process is hamstrung due to bureaucratisation of the winding up process through the Liquidators who are usually Government Officers associated with this process. The delay is also caused due to procedural delays in the sale of assets and determination of amounts payable to the interested parties. As such, there is no fear on the part of the debtor corporations that failure of the rehabilitation scheme would result in any loss or prejudice to it. This does not lead to any seriousness on the part of the management to succeed in the revival process.

Poor enforcement mechanism

SICA is a very comprehensive and self-contained legislation as far as organisation is concerned. There are adequate penal provisions in SICA. However, the mechanism for its implementation is so poor that violations take place without fear of legal consequences. The misuse of the said forum in making an entry by manipulating or feigning sickness must be curbed by strict penal consequences for such misuse. However, this aspect and solution to this problem has to be found in the proposed legislation.

International insolvency in India

Indian insolvency laws do not have any extra-territorial jurisdiction, nor do they recognise the jurisdiction of foreign courts in respect to branches of foreign banks operating in India. Therefore, if a foreign company is taken into liquidation outside India, its Indian business will be treated as a separate matter and will not be automatically affected unless an application is filed before an insolvency court for winding up of its branches in India. At present, thankfully, the government is considering the adoption of UNCITRAL Model Law on Cross-Border Insolvency to meet the demands of globalisation of the economy and to deal with international insolvency. This will radically change the orientation of Indian law and make it suitable for dealing with the challenges arising from globalisation and increasing integration of Indian economy with the world economy.

While drafting the substantive and procedural rules of bankruptcy, international standards for both national and cross-border insolvency should be taken into consideration which, based on Indian situation, should be suitably incorporated.

In India, the winding up of companies under the 1956 Act is a long drawn affair. Before a company is finally dissolved with the sanction of the court, it takes years to obtain the statement of affairs, books of account, records and assets, realisation of debts and sale of assets, settlement of list of creditors and contributories, distribution of assets to creditors, members etc. In the process, substantial corporate assets remain unrealised and undistributed. The inordinate delay in proceedings mars the possibilities of rapid use of productive assets laying dormant throughout the country. This process has been found to be completely ineffective.

Lack of Professional Liquidation Department

In India, Liquidators work under the Ministry of Company Affairs of the government of India. The Department of Official Liquidators lacks professionalism and works under a highly bureaucrat controls.

III. Onset of Reforms in Insolvency and Related Laws

With the globalisation of economy, the issues relating to cross-border insolvency assumed great significance and a need has been felt for long for bringing about reforms in this branch of law. Moreover, with the Indian economy having opened up for investment by foreign creditors and, internationally, the Indian corporate also making investments in companies outside, the issues relating to cross-border insolvency has also assumed great significance.

In 1999, the government of India set up a High Level Committee headed by Justice V.B.Eradi, a superannuated Judge of Supreme Court of India, to examine and make recommendations with regard to the desirability of changes in existing law relating to winding up of companies and a self-contained law on winding up of companies having regard to Sick Industrial Companies (Special Provisions) Act, 1985, and the Securities Contracts (Regulation) Act, 1956, with a view to creating confidence in the minds of investors, creditors, labour and shareholders.

The committee completed its work and submitted its report to the central government in the year 2000.

Recommendations of the Committee

The committee recommended that

- the jurisdiction, power and authority relating to winding up of companies should be vested in a National Tribunal which should be vested with the functions and power with regard to rehabilitation and revival of sick industrial companies, a mandate presently entrusted with BIFR under SICA.
- the 1956 Act should be suitably amended to take the power away from High Court and the transfer of the pending winding up proceedings to the Tribunal.
- the adoption of the international trend in law relating to corporate bankruptcy, namely, sell the assets first as quickly as possible, and relegate to a later stage the adjudication of claims and distribution of proceeds.

- an in-depth assessment of the office of Official Liquidators in view of inadequate and incompetent manpower and absence of latest office equipments and technologies.
- a liquidation committee consisting of creditors of the company on the lines of Section 141 of the Insolvency Act, 1986 of UK be set up to assist the Liquidator.
- the repeal of SICA and recommended the ameliorative, revival and reconstructionist procedures obtaining under it to be reintegrated in a suitably amended form in the structure of the 1956 Act.
- the procedure would be similar to the measures for Administration Order Procedure and winding up which are now provided integrally as part of U.K. Insolvency Act, 1986.

Cross-Border Insolvency

The committee sought guidance from the ‘UNCITRAL Model Law on Cross-Border Insolvency’ and the views expressed by the International Monetary Fund on key issues relating to ‘Orderly and Effective Insolvency Procedures’. The Committee recommended that Part VII of the Companies Act, 1956 should be suitably amended to incorporate the relevant provisions of ‘UNCITRAL Model Law’.

The Committee noted the Cork Committee’s suggestion to introduce the concept of Professional Insolvency Practitioners and recommended setting up of a panel of professionals and prescribes rules for their qualifications and appointments and uses their services as Liquidators.

The recommendations of the committee have since been translated into the Companies (Amendment) Bill, 2001 and the Sick Industrial Companies (Special Provisions) Repeal Bill, 2001.

IV. Broad Features of The Proposed Bill

National Company Law Tribunal

The Companies (Amendment) Bill, 2001 proposes amendment of Article 323B of the Constitution of India and provisions of Part VII of the Companies Act, 1956 for setting up of a National Company Law Tribunal (NCLT) and its Appellate Tribunal. The Bill proposes repeal of SICA and abolition of Company Law Board.

Jurisdiction of NCLT

Under the proposed legislation, NCLT will have:

- The power to consider revival and rehabilitation of companies – a mandate presently entrusted to BIFR under SICA. SICA will be repealed and pending reference before BIFR and appeals before AAIFR would abate.
- The jurisdiction and power relating to winding up of companies vested in the High Courts. The winding up proceeding pending in High Courts shall stand transferred to the Tribunal.
- The jurisdiction and power exercised by Company Law Board under the Companies Act, 1956 be transferred to NCLT.

Structure of proposed Tribunal

- NCLT will consist of a President and such number of Judicial and Technical Members not exceeding 62 in number.
- The President of NCLT will be a sitting or a former judge or any one qualified for appointment as a High Court Judge who will be appointed in consultation with the Chief Justice of India.
- The Principal Bench will be located at New Delhi and other Benches at principal seats of each High Court.
- Each of the Benches of NCLT will comprise of a Judicial Member and a Technical Member.

Invoking jurisdiction of NCLT

- The Bill requires that when an industrial company has become a sick industrial company, the Board of Directors of the said company shall make a reference to NCLT for determination of the measures which shall be adopted with respect to the company. However, the company will prepare and submit along with the reference a scheme for its revival and rehabilitation.
- Such a reference will be required to be filed within 180 days from the date on which the Board of Directors has come to know the causes of making a reference. The reference would be accompanied with Auditors Certificate certifying causes of sickness.
- The central government or Reserve Bank of India or a state government or a public financial institution or a state level institution or a scheduled bank may, if it has sufficient reasons to believe that any industrial company has become a sick industrial company under SICA, make a reference in respect of such company to NCLT.

Sick industrial company

A sick industrial company means an industrial company which has at the end of any financial year accumulated losses equal to 50% or more of its average net worth during the four years immediately preceding such financial year, or has failed to pay its debts within any three consecutive quarters when its repayment by a creditor or creditors of such company has been demanded.

Net worth

Net worth means the sum total of the paid up capital and free reserves. For the purposes of net worth, “free reserves” means all reserves credited out of the profits and share premium account but does not include reserves credited out of revaluation of assets write-back of depreciation provisions and amalgamation.

Declaration of sickness

On receipt of a reference, the NCLT may make an order as to if the said industrial company has become a sick industrial company and such an order shall be final.

Enquiry by NCLT

On a reference received, the NCLT may make such inquiry, as it may deem fit for determining whether the said company has become a sick industrial company and may appoint an Operating Agency to enquire into the scheme for revival and make a report with respect to such matters as may be specified by it.

Preparation and sanction of scheme

- If after making an inquiry about the sickness of the company, NCLT is satisfied that a company has become sick, the NCLT shall decide whether it is practicable for the company to make its net worth exceed the accumulated losses or make the payment of its debt within a reasonable time. If NCLT decides that it is practicable for a sick company to make its net worth exceed the accumulated losses or make the payment of its debt within a reasonable time, it shall give the company, such directions as it may deem fit to make its net worth exceed the accumulated losses or make the payment of its debt within a reasonable time.
- If NCLT decides that it is not practicable for a sick industrial company to make its net worth exceed the accumulated losses within a reasonable time and it is necessary to adopt remedial measures, it may direct an Operating Agency to prepare a scheme providing for such measures in relation to such company as it considers necessary from out of the parameters laid down under the Bill.
- The Operating Agency, if possible, prepares a scheme providing, *inter alia* for any one or more of the measures – the financial reconstruction of the sick company by change in, or takeover, of management of the sick company; the amalgamation of the company with any other company; the sale or lease of a part or whole of any industrial undertaking of the sick company; the rationalisation of managerial personnel; such incidental, consequential or supplemental measures as may be necessary; change in Board of Directors, etc.
- The creditors (if approved by at least two-thirds) of the company may also prepare a scheme for revival and rehabilitation and submit to NCLT.

Operating Agency

The Operating Agency has been defined under the Bill as a group of experts consisting of persons having special knowledge of business or industry in which the sick industrial company is engaged and includes public financial institutions, banks or any other person which may be specified as the Operating Agency by NCLT.

Circulation/Sanction of scheme

- Where the scheme prepared by the Operating Agency relates to preventive, ameliorative, remedial and other measures with respect to any sick industrial company, it may provide for financial assistance by way of loans, advances or guarantees or reliefs or concessions or sacrifices from the central government, state government, any scheduled bank or other bank, a public financial institution or state level institution or any institution or other authority to the sick industrial company.

- Every such scheme is required to be circulated to every person to provide financial assistance for its consent within a period of 60 days from the date of such circulation. If no consent is received, it is deemed that consent has been given and NCLT shall sanction the scheme and on and from the date of such sanction, the scheme shall be binding on all concerned.
- However, if the consent so required is not given, in that case NCLT may adopt such other measures, including the winding up of the sick industrial company, as it may deem fit.

Winding up of a sick industrial company

Where the NCLT comes to the conclusion that the sick industrial company is not likely to make its net worth exceed the accumulated losses within a reasonable time while meeting all its financial obligations and that it is not possible to revive the company in future and that it is just and equitable that the company should be wound up, it shall record its finding and order winding up of the company.

New time frame

- Reference to be filed within 180 days from the date the Board of Directors of the Company have come to know of the relevant facts giving rise to causes of such reference. The period is extendable by another 90 days.
- Enquiry stage – 21 days – extendable to 40 days.
- Final order on concluding enquiry within 60 days from commencement of enquiry — extendable by 90 days.
- Operating Agency to prepare a scheme in 60 days from the date of order – extendable to 90 days.
- Draft Scheme – suggestions/objections within 60 days.
- Sanction within 60 days.

Appellate Tribunal

There will be a National Company Law Appellate Tribunal (NCLAT) to hear appeals from the orders of NCLT. The Chairperson of NCLAT will be a sitting or retired Judge of Supreme Court of India or the Chief Justice of a High Court.

Cases in which a company may be wound up by the court

Apart from the existing grounds, the following two additional grounds for winding up of a company are proposed to be added:

- If the company has acted against the interest of the sovereignty and integrity of India, the security of the state, friendly relations with foreign states, public order, decency or morality.
- If the company has defaulted in filing with the Registrar its Balance Sheets and Profit & Loss Account or annual returns for five consecutive financial years.

- If the NCLT comes to the conclusion that the sick industrial company is not likely to make its net worth exceed the accumulated losses within a reasonable time while meeting all its financial obligations and that it is not possible to revive the company in future and that it is just and equitable that the company should be wound up.

Formation of Rehabilitation and Revival Fund

The new Bill requires the creation and setting up of a Rehabilitation and Revival Fund. The Bill requires levy and collection for the purposes of rehabilitation or revival or protection of assets of the sick industrial company, a cess at such rate not less than 0.005 % and not more than 0.1 % on the value of turn over of every company or its annual gross receipt which is ever more. This fund will be transferred to the Consolidated Fund of India and released to NCLT from time to time.

Appointment of Official Liquidator

The proposed Bill provides for:

- Official Liquidator to be appointed from a panel of professional firms of Chartered Accountants or a body corporate consisting of professionals or full -time or part-time officers appointed by the central government.
- their remuneration to be approved by Tribunal.
- the creditor or contributory may appoint professionals or legal practitioner entitled to appear before Tribunal.

V. Author's Perception of the New Bill²⁶

No Comprehensive Bankruptcy Code and Road Map

The Bill stops short of providing comprehensive Bankruptcy Code to deal with corporate bankruptcy. The attempt to provide a solution by amending the 1956 Act is to go in the wrong direction. 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 Code can address such issues taking into consideration international practices. It does not introduce the required road map of bankruptcy proceedings viz. application for initiating bankruptcy proceedings; appointment of the Trustee; empowerment of the Trustee; operational and functional independence; accountability to the court, including the power of the court to remove the Trustee in the case of mismanagement; relationship with current management; monitoring or substitution; day-to-day operations, etc; time-bound restructuring/recognition plan: who should submit; procedure of acceptance; mechanism to sell off; pro-active initiative of the Trustee; number of time bound attempts for restructuring; decision to go for insolvency and winding up; and strategies for realisation and distribution.

²⁶ The analysis of the new provisions and the suggestions made in the paper are strictly authors own opinion based on his perception of the existing and the proposed legislations and do not necessarily represent the views of INSOL India.

Tribunalisation of Justice

Though tribunalisation of justice is now a recognised trend, the Indian experiment with Tribunals has been nothing to boast about. They have largely failed to serve the purpose with which they were set up.

Over-Burden

Flowing from such diverse dimensions of judicial functions, NCLT would be burdened with a workload of enormous magnitude and in the process would be likely to lose focus on revival and rehabilitation of sick entities. Change in eligibility criterion for making a reference would itself generate a greater work-load. In the process, the objective of expedient disposal of the matter could become a casualty, which NCLT would have to decide relating to its other two functional roles. Though the number of members has been fixed at 62, past performance has shown that even under SICA, with the number of members fixed at 15 (including the Chairman) the BIFR has never worked with a full contingent of members and even now is functioning with less than 50% strength for the last two years.

Time frame for filing reference

In 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 proposed bill 50% of erosion in average net worth for the last four years from 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, the objective of bringing a case of incipient sickness into purview of NCLT would be defeated considering the period of 180 days and a further extension of 90 days being provided for filing a reference.

Definition of net worth and sick industrial company

Redefining net worth is a very good development, though the proposed definition may also suffer from the same problem which besets the present legislation, which is to prevent and curb the flair for creative accounting by changing the accounting policies to feign sickness. This could have been curbed by making the definition of “erosion of net worth” and “accumulated losses” more clear and unambiguous. The new dispensation could have provided for a water tight definition, which could be linked to delegating the powers to the judicial forum put into place to implement the rescue legislation, to notify the accounting policies on the basis of which net worth/accumulated losses would be worked out for determining sickness.

Certificate by Auditors

The new provision for establishing a panel of Auditors to give a certificate with regard to the parameters of sickness is a good move. However, it may turn out to be a duplication, as under the present dispensation the Statutory Auditors are required to give their opinion on sickness of a company under the Manufacturing and other Companies (Auditors Report) Order, 1988. It is not clear as to how this duplication would help, as the Auditors on the panel will come from the same stream of Chartered Accountants and may be liable to the same failings as the Statutory Auditors of the Company.

Lack of severe penal consequences

Lastly, the misuse of the said forum in making an entry by manipulating/feigning sickness must be curbed by strict penal consequences for such misuse, which should be demonstrably used to ensure that no entity attempts to misuse these provisions. However, this aspect and solution to this problem has to be found in the proposed legislation.

Suspension of proceedings

In order to do away with the mischief of Section 22 like provision, the bill takes away the provisions of suspension-of-recovery proceedings against sick companies and the guarantors which is not a good development as suspension-of-proceedings is a part of any good restructuring system. In any case, if the secured creditors feel that the moratorium protection is being misused, a pending reference before BIFR can always be frustrated if 75% of secured creditors initiate action under the Securitisation Ordinance.

Trustees

The government should also consider appointment of Trustees by the court from empanelled professional chartered accountant firms, law firms, consultants, financial institutions, etc. for managing the company as a going concern; initiating the process of negotiation for time-based restructuring of the company, and failing which, initiate insolvency proceedings to wind up the company. Trustees can be empowered to appoint financial advisers, managers, liquidators, auctioneers, etc. to help them to bear their remuneration.

Bankruptcy proceeding for banks and financial institutions

Bankruptcy proceedings against banks and financial institutions have a very special significance as it affects the domain of the monetary system and management and financial stability. In several developed countries there is a separate bankruptcy code for banks and financial institutions. In India, this is primarily a responsibility of the Reserve Bank of India. The new law and procedure should be structured to handle the bankruptcy proceedings in the case of banks and financial institutions in consultation with the Reserve Bank of India.

International insolvency in India

Indian insolvency laws do not have any extra-territorial jurisdiction, nor do they recognise the jurisdiction of foreign courts in respect of branches of foreign banks operating in India. Therefore, if a foreign company is taken into liquidation outside India, its Indian business will be treated as a separate matter and will not be automatically affected unless an application is filed before an insolvency court for winding up of its branches in India. At present, thankfully, the government is considering the adoption of UNCITRAL Model Law on Cross-Border Insolvency to meet the demands of globalisation of the economy and to deal with international insolvency. This will radically change the orientation of Indian law and make it suitable for dealing with the challenges arising from globalisation and increasing integration of the Indian economy with the world economy. While drafting the substantive and procedural rules of bankruptcy, international standards for both national and cross-border insolvency should be taken into consideration and, based on the Indian situation, should be suitably incorporated.

VI. Securitisation and Asset Reconstruction Law: An Analysis

The concept of securitisation has, of course, come a long way from the ordinary shares and has acquired a typical meaning of its own. It now means a device of structured financing where an originator pools together its rights and interests in an identified stream of cash flow which are in turn transformed into securities through the special purpose vehicle (transformation device). This method of securitisation cannot be confused with a transaction of providing a loan as in this case the ultimate holder of the security gets an ownership right in the very asset it has financed. The securitisation process is a highly complex and efficient financial arrangement and employs various tools such as security enhancement, creates various classes of securities and involves concepts of synthetic securitisation, etc.

Asset reconstruction as a concept is a financial tool for takeover of financial / non-financial assets and rebundling them to achieve maximum recoveries. The manufacturing assets may be rebundled into operating units for optimum gain and in case they cannot be converted into economic operating units, then disposing off the assets either on lump sum basis or on piecemeal basis.

Coming to the various provisions of the Ordinance which deals with the securitisation / asset Reconstruction, I would like to point out to start with is that securitisation transactions / asset reconstruction is being carried out in our country even before this ordinance and as such the ordinance at the most, revalidates the said business and puts a regulatory framework for the conduct of the said business in this country.

The term securitisation is defined in Section 2(1)(z) as “acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise”. The other definitions specific to the securitisation issues are the obligor [section 2(1)(q)] being a person liable to the originate to pay a financial asset or discharge any obligation in respect of the financial asset; originator [section 2(1)(r)] which means the owner of the financial asset which is to be acquired by a SC / ARC and security receipt section [2(1)(zq)] which means a receipt or security issued by a SC / ARC to a qualified institutional buyer pursuant to a scheme evidencing acquisition by the holder of an undivided right, title or interest in the financial asset.

It is very significant that the term originator has not been restricted to Banks and Financial Institutions and as such the business of securitisation can originate from entities other than Banks and Financial Institutions. The Ordinance also defines the “Securitisation Company” in terms of Section 2(1)(za) and a “Reconstruction Company” in terms of Section 2(1)(v) as a company formed and registered under the Companies Act, 1956 for the purpose of securitisation / asset reconstruction respectively.

However, in terms of Section 3, a Securitisation Company (SC) or an Asset Reconstruction Company (ARC) cannot carry on the business of securitisation / asset reconstruction without obtaining a certificate of registration from the RBI. It is also provided that a SC / ARC shall have its own funds of not less than Rs.2 Crores or such other amount not exceeding 15% of the total financial assets acquired or to be acquired by the securitisation. Section 3(3) also provides for various conditions which are required to be fulfilled for the purpose of registration including *inter alia* restriction on the number of directors who are nominees of the sponsors (promoters) of the SC / ARC to a maximum of half the Directors on the BOD on the Company, the SC / ARC not having incurred losses in the preceding three Financial Years and complying with the prudential norms specified by RBI etc.

Section 4 provides for cancellation of the certificate of registration by the RBI in certain cases. Section 5 provides for a SC / ARC to acquire financial assets of Banks or Financial Institution by issuing debentures, bonds or any other securities for the agreed consideration on terms and conditions as may be agreed and for transferring of such financial assets to the SC /ARC. This section provides for a deeming provision whereby upon acquisition of the financial assets of a Bank or Financial Institution, the SC / ARC shall become the lender and all the rights of the Banks and Institution shall vest in the said SC / ARC. Section 6 provides for the obligor to discharge its obligation to the SC / ARC once the financial asset is acquired by such company.

Section 7 provides for issue of securities by the SC / ARC to Qualified Institutional Buyers (QIB) for raising funds from the said QIBs for formulating schemes for acquiring the financial assets and maintenance of separate and distinct account of each scheme for every financial asset so acquired. Section 7(3) also provides that in case of non-realisation of the financial assets, QIBs holding security receipt of not less than 75% of the value for the said scheme may call a meeting and the resolution passed shall be binding on the SC / ARC. Section 8 provides for exemption from registration of the security receipt issued by the SC / ARC for transfer of such security receipts.

Section 9 provides wide powers to the SC / ARC for the purposes of Assets Reconstruction subject, of course, to guidelines to be framed by RBI in this regard which *inter alia* include the powers for takeover and change in management of the business of the borrower, sale or lease of part of whole of the business of the borrower, rescheduling of debts, settlement of dues of the borrower and enforcement of security interest and taking possession of the secured assets in accordance with the provisions of the Ordinance. It is significant that the power of takeover of business of borrower / change of management is provided to a SC / ARC when such power is not provided to a Secured Creditors u/s 13(4).

Section 10 provides for other functions that can be performed by the SC / ARC including the power to act as Agent / Manager for a Bank or FI for recovery of their dues in terms of Section 13(4)(c). Section 11 provides for resolution of the disputes between SC, ARC, secured sreditors etc. through the process of arbitration under the Arbitration and Conciliation Act, 1996. Section 12 provides for powers of RBI to determine policy and issue directions.

Enforcement of Security Interest

The basic thrust of the Ordinance is on Enforcement of Security Interest. The rationale behind the provision for enforcement of security interest is the burgeoning problem of Non- Performing Assets (NPA) faced by the Banks and FIs and the ineffectiveness of the existing legal system for recoveries of their dues. The government of India concerned with the blockage of public funds in NPAs had taken a significant initiative in setting up Debt Recovery Tribunals (DRT) under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (DRT Act). Even though 29 DRTs and five DRATs have been set up, however, these forums have really been ineffective in making a dent in recovery of dues of the Banks and FIs. The government of India felt that more drastic action is required and there has been a feeling that the legal set up has been a stumbling block in enforcing recoveries in as much as whatever legal system is set up for adjudication of the dues of the Banks and Institutions and recovery of the same, it gets bogged down by the rules of natural justice, pleadings, etc. and the borrowers are able to find loopholes to delay the entire process. Thus arose the need to by-pass the legal process altogether and give powers to the Banks and Institutions for foreclosure of their loans and enforcing their securities without going through the legal process.

This concept of bypassing the legal system and enforcing the security interest unilaterally by the Banks and Institutions has come under fire from the borrowers as also various jurists and the vires of the Ordinance has been challenged before various High Courts. It is difficult to say whether the said provisions would be upheld by the judicial process or not. However, there is an emerging consensus amongst the intelligentsia, the Banks/FIs, borrowers, Jurists that these provisions would need to be re-looked and would need a more practical, pragmatic and workable legislation so that this legislation also does not become ineffective and results in no practical benefit to the Banks and Institutions in the rough and tumble of their day-to-day operations and recovery of their dues. Be it as it may, the provisions, concerning the enforcement of security interest are covered in Section 13 and 19 of the Ordinance. But before we proceed to analyse the same, we need to analyse some of the significant terms defined in the Ordinance relating to the enforcement of security interest.

The first is obviously a Secured Creditor defined in Section 2(1)(zd) as a Bank or a Financial Institution and including a Debenture Trustee appointed by the said Bank / FI; a Securitisation Company (SC) or an Asset Reconstruction Company (ARC), in whose favour security interest is created for due repayment by a borrower of any financial assistance. The Term Bank (Section 2(1)(c) means a banking company (Section 5(c)) of the Banking Regulation Act, 1949, a corresponding new bank or SBI or a subsidiary bank or a bank notified by the central government for this purpose. A Financial Institution (Sec.2(1)(m) means a public financial institution within the meaning of Section 4A of Companies Act, 1956 any institution specified by central government under Section 2(h)(ii) of DRT Act, International Finance Coop. (established under International Finance Corporation (Status Immunities and Privileges) Act 1956) and any other institution or NBFL notified by central government for this purpose. The term “security interest” is defined in Section 2(1)(zf) and is a very broad definition covering any right, title interest of any kind upon property created in favour of the secured creditor. Financial asset defined in Section 2(1)(l) is also a very broad definition including *inter alia* claims to debt or receivables, secured or unsecured, any debt or receivable secured by mortgage of or charge on immovable property, mortgage, charge hypothecation of movable property or any beneficial interest in property.

Section 13 provides for the mechanism of enforcement of security interest where a secured creditor whose debt has become NPA can issue a notice to the borrower requiring the borrower in writing to discharge his dues within 60 days failing which the secured creditor shall be entitled to exercise its rights under sub-section 4. Sub-section 3 provides that the details of the amount payable by the borrower and the secured assets intended to be enforced by the secured creditor in the event of non-payment should be set out in detail.

In the case the borrower fails to discharge his liability within 60 days of issue of the Notice u/s 13(2), the secured creditor is entitled to take one or more of the following measures as set out in Section 13(4) of the Ordinance.

Section 13(7) provides that the amounts received by the secured creditor in adopting the measures as mentioned in Section 13(4) shall be held by him in trust and be utilised firstly in payment of cost, charges and expenses of enforcement of the security interest; secondly in discharge of the dues of the secured creditor and the residue of the money so received shall be paid to the persons entitled thereto in accordance with the rights and interests. Section 13(9) provides that in case of financial asset held by more than one financial creditor, or joint financing of the financial asset by secured creditors, no creditor shall be entitled to exercise the right in terms of sub-section 4 unless secured creditors representing not less than three-fourths the value of the amount outstanding as on record date agreed upon such action.

The proviso to Section 13(9) further provides that in the case of a company in liquidation, the amount realised from the sale of secured assets shall be distributed in accordance with the provisions of Section 529A of the Companies Act. Significantly, the provisions of Section 530 of the Companies Act have not been considered. As such, the question of the priority to be given to the Statutory dues, workers' dues, ranking of the dues of the secured creditors, etc. will create a lot of uncertainty and may lead the process of distribution of monies recovered by enforcement of security interest getting bogged down in long drawn litigation.

Section 13(10) provides that if the dues of the secured creditors are not satisfied even after enforcement of security interest they may file an application before the DRT for recovery of the balance amount. Section 13(11) provides for the right of the secured creditors to proceed against the guarantors or sell pledged assets without taking the recourse to the measures specified in Section 13(4). Section 13(12) provides that the rights of the secured creditor under the Ordinance may be exercised by one or more officers authorised on his behalf in such a manner as may be prescribed. However, no such regulations prescribing the manner in which the officers of the secured creditors would be authorised have been issued as yet.

Section 13(13) is very significant as it prohibits the borrower from dealing with the secured assets in any manner whatsoever (otherwise in the normal course of business) once notice under Section 13(2) is issued. As such, once notice u/s 13(2) is issued it acts as an automatic injunction against the borrower from dealing with or encumbering his assets.

Section 15 provides for the manner and effect of the takeover of management of the business of the borrower. There is a significant issue here in as much as the secured creditor has not been given power for the takeover of management of the business of the borrower in Section 13(4). The measure for the takeover of the business of borrower is only provided u/s 9 to a SC/ARC. However, Section 15 provides for procedure to be followed by a "secured creditor" for taking over the management of the business of the borrower. This section does not refer to SC or ARC. This anomaly would require to be sorted out as it may become difficult to implement the said provision in its present form. In any case, the procedures as set out in Section 15 require the secured creditor to publish a notice in the newspaper, appointing directors of the borrower company, and in the case of a non-corporate borrower, the Administrator of the business. It further provides that on publication of such notice all persons holding office of director shall be deemed to have vacated the office and the directors/administrator appointed by the secured lender will take over the administration and management of the business of the borrower. The rights of the shareholders to nominate or appoint the director and pass resolution will also be suspended. Significantly, it also provides that there shall be no proceedings for winding up of the company or appointment of a receiver without the consent of the secured creditor. This effectively means that the powers of the secured creditor would now clash with the powers of the High Court under the provisions of the Companies Act especially with respect to winding up of a company u/s 433 etc. of the Companies Act and the powers of the High Court shall be made subject to the consent of the secured creditor. This aspect also is subject to a substantive challenge as the powers of the High Court cannot be subject to the will of a creditor.

It is very significant that in terms of Section 17 of the Ordinance no right of appeal has been provided under the Ordinance when notice is issued u/s 13(2) up to the stage when measures have been taken u/s 13(4). It is only that after an action is taken u/s 13(4) that any person aggrieved by adoption of any of the measures under Section 13(4) may file an appeal before the DRT. However, under sub-section 2 the appeal by the borrower shall not be entertained by the DRT unless 75% of the amount claimed by the said borrower in the notice u/s 13(2) is deposited.

This is of course subject to DRT reducing or waiving the amount to be deposited for reasons to be recorded in writing. However, since the restriction for pre-deposit is only on the borrower, it is possible that appeals will be filed by other concerned parties viz. promoters, labour, etc.

Chapter VI deals with various miscellaneous provisions. Section 31 provides that the Ordinance would not apply to a lien on any goods, money or security given under the Indian Contract Act, 1872 or Sale of Goods Act, 1930, a pledge of movables within the meaning of Section 172 of the Indian Contract Act, 1872, creation of any security in any aircraft as defined in clause (1) of Section 2 of the Aircraft Act, 1934, creation of security interest in any vessel as defined in Section 3(55) of the Merchant Shipping Act, 1958, any conditional sale, hire-purchase or lease or any other contract in which no security interest has been created, any rights of unpaid seller under Section 47 of the Sale of Goods Act, 1930, any properties not liable to attachment or sale under the first proviso to sub-section (1) of Section 60 of the Code of Civil Procedure 1908, any security interest for securing repayment of any financial asset not exceeding Rs.1 lac, any security interest created in agricultural land, any case in which the amount due is less than 20% of the principal amount and interest thereon.

Section 41 is another very significant provision whereby it is provided that the various enactments will be amended in the manner set out in the schedule. The amendment in Section 4(a) of the Companies Act is consequential in as much as SC or ARC who has obtained registration u/s 3(4) of the Ordinance shall be treated as a Public Financial Institution. The amendment to Security Contract Regulation Act, 1956 (SCRA) is also consequential as the security receipts as defined in Section 2 (zq) of the Ordinance is being inserted as sub clause 1(b) in clause 2(h) of the SCRA. However, the third amendment which inserts two provisos u/s 15(1) of the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) are significant in as much as they provide for bar from filing references in cases where assets have been acquired by any SC or ARC u/s 5(1) of the Ordinance and also provides that in case where secured creditors representing not less than three-fourths in value of the amount outstanding against financial assistance disbursed to the borrower have taken measures to recover their debt under sub-section 4 of Section 13 of the Ordinance, then the reference which is pending before the BIFR shall abate. This amendment has the effect of making a significant alteration in the provisions of another enactment. It is not clear whether by this Ordinance the SICA can be amended or whether a separate amendment will have to be carried out in SICA by a separate Ordinance / enactment and this aspect is also likely to lead to substantial litigation.

From the above it may be seen that the basic thrust of the working of the SC and ARC under the Ordinance is with respect to the Non-Performing Assets (NPAs) of Banks and FIs and this seems to be the basic purpose of inclusion of the aspect into this Ordinance.

VII. Conclusion

The essential features governing a formal model restructuring process in any part of the world are common, if not alike, though they may be structured differently. SICA, in India, is structured, more or less, on the above principles. The question which, thus, arises for consideration is as to why SICA has failed to work. In my opinion, any sound legislative framework for its success is dependent upon predictable and effective judicial process coupled with efficacious enforcement mechanisms. We need to focus and improve upon our implementation and execution mechanism. Also, there is a need for more creative and commercial approach to corporate entities in financial distress and attempt to revive them rather than applying the more traditional and conservative approach of liquidation or bankruptcy. As such, socio-economic necessities dictate that before liquidating financially distressed companies, some attempts must be made towards corporate rescue operations.

The 2002 Ordinance is a hurried attempt to provide oxygen to the NPA-ridden Banks and Financial Institutions. The Ordinance contains various vague and ambiguous provisions which are likely to lead to litigation and confusion. It is likely to multiply options as well as litigation.

Pakistan

THE FINANCIAL SYSTEM AND THE LEGAL ENVIRONMENT IN PAKISTAN

by

Salman Ali Shaikh²⁷

The year 1997 was a turning point for both the financial system and the underlying legal environment in Pakistan for a variety of reasons.

The powers of the Central Bank (the State Bank of Pakistan — SBP) were enhanced and its independence was strengthened and re-enforced by amendments to the Banking Companies Ordinance. Financial sector reform, supported by the World Bank, was initiated. The senior management of all public sector banks was changed, and individuals from the private sector were inducted.

The Non-performing Loan (NPL) issue, previously buried under the carpet through “innovative” tools and practices such as annual “cosmetic” rescheduling(s) of corporate debt, hit the national radar for the first time. The sudden realisation of the extent of the NPL problem caused a series of knee-jerk reactions and policies.

In the first half of 1997, the Central Bank made a major (debtor-friendly) gesture. It announced a nationwide “incentive scheme” designed to reduce the stock of old NPL. Under the terms of this scheme, incentives were offered to non-performing borrowers in inverse proportion to the age of the underlying NPL. If, for example, a borrower had not serviced (i.e. total non-payment) his debt for over 20 years, he could now settle his liability by paying P plus 10%. P was defined as the originally disbursed principal amount. However, if a borrower had not serviced his debt obligations for only two years, he could settle his liability by paying P plus 40%. While this “incentive scheme” was moderately successful in reducing NPL, but it left in its wake a “moral hazard” affecting the psyche of borrowers throughout the country – i.e. it has resulted in the promotion of a culture of non-payment of debt based on the premise that such “incentive schemes” will continue to be announced periodically. This scheme was the carrot, which was soon followed by a stick. In fact, followed by a series of sticks.

The stick was the enactment of a new creditor-friendly recovery law in the form of the Recovery Act of 1997 (RA 1997). Under RA 1997, financial institutions were entitled to charge interest from the date of the decree (by the court) against the borrower. Hence, NPL became (in theory) a profit-centre for the banks. RA 1997 changed the basic ground rules for obtaining a decree. Debtors now needed to seek the permission of the court to defend proceedings. Specialised banking courts were created throughout the country.

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Mr. Salman Ali Shaikh is a consultant with Turnaround Recovery & Restructuring in Lahore, Pakistan

This law has recently been re-packaged as the Recovery Ordinance of 2001 (RO 2001) and made even more creditor-friendly. Banks can now auction mortgaged assets, through a private sale, without the intervention of the court. Under RO 2001, banks are allowed to add (via accrual) their cost of funds (COF) to the outstanding NPL from the date of default. This draconian provision (even more creditor-friendly than the accrual from the date of decree provisions of RA 1997) is causing several absurd distortions in the banking system. To amplify, the period between “default” (i.e. NPL status) to the date of execution (i.e. auction of the borrower’s assets) can typically be between 3-5 years. During this period, under the compounding effect allowed by both the recovery laws, the NPL figure increases by 50%-70%. During the same period, owing to a variety of factors (e.g. persistent economic recession, obsolescence, pilferage, etc.) the forced sale value (FSV) of the underlying assets has gone down by around 30%-40%. Consequently, the practical effect of these laws has been to magnify the eventual write-off(s) in the whole financial system. Furthermore, since over 75% of the NPL resides in public sector financial institutions, which are consistently being re-capitalised, this annual “artificial” compounding of NPL is becoming a major cost to public resources and the beleaguered taxpayer.

Relevant Legal Enactments – 1997-2002

During this period, the recovery of debts owed under NPLs became a key national priority. Successive waves of creditor-friendly laws were enacted on a regular basis, particularly after the military takeovertakeover in 1999. The legal environment in Pakistan has always been uniquely complex owing to the recurring demand of the religious elements to transplant features of Islamic (Shariah) law onto the pre-existing common law tradition. Since the military takeovertakeover in 1999, lawmaking became the domain of the military (with a “martial law” tradition). During the period 1999 to late 2002, parliament remained “suspended”. Consequently, all legal enactments were done through a Presidential decree. Both the balance between creditors’ and debtors’ rights has been badly damaged as a result of these successive enactments. The creditor-friendly laws enacted during this period have had, and are continuing to have, a major impact on the financial landscape, particularly the investment climate in Pakistan.

National Accountability Ordinance of 1999 Leading to the Creation of the National Accountability Bureau (the NAB)

This was the first major law enacted by the military regime that 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.

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”. Thus, a large proportion of the country came under the ambit of this draconian law. Wilful defaulters were subject to imprisonment, barred from holding any public office and put on the Exit Control List (i.e. barred from foreign travel).

For bankers, the NAB could declare any transaction, for example, a corporate debt re-structuring, to be “against the public interest” without providing any reason whatsoever. Likewise, they could punish any write-off and/or any form of relief granted to a defaulting borrower. The NAB Ordinance has provisions that permit the formation of committees to settle complex NPLs. These provisions have remained substantively unused primarily owing to a lack of expertise. It is worth mentioning that senior military officers with no financial sector experience and no exposure to corporate finance ran the NAB. To provide assistance on technical issues, a few bankers were inducted into the NAB. However, the military commanders take all the key decisions, and they comprise the entire top echelon of the organisation.

The underlying theory/premise was very simple – the full value of the various NPLs was considered recoverable. The un-recoverable portion of each NPL, it was believed, must be lying somewhere – for example, in the borrower’s house. By arresting borrowers the NPL problem would, therefore, be “solved” in a few years. Needless to say, in spite of dozens of well-publicised arrests of prominent individuals and businessmen the NAB has failed to make a dent on NPLs, which have actually increased during the past three years.

In practice, this law was used in a highly selective and discriminatory manner – primarily against the political opponents of the military regime. For this reason, it failed to achieve its “design objectives”, including a reduction in the NPL debt. Although this law has lost its credibility, it is still on the books backed by a large and threatening bureaucratic machinery. In late 2002, Pakistan had national elections and has now reverted back to “parliamentary democracy”. However, through a constitutional amendment decreed prior to elections, the NAB would continue to report to the President. Therefore, both the Parliament and the Prime Minister would have little or no impact on the working(s) of the NAB. Nor would they be able to influence its agenda, direction and scope of work.

Corporate and Industrial Restructuring Corporation Ordinance of 2000 Leading to the Creation of the Corporate and Industrial Restructuring Corporation (CIRC)

CIRC is an asset management company (AMC), 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. Under the CIRC Ordinance, all public sector financial institutions have to offer their NPLs to CIRC. The rights to choose (cherry-pick) as to which NPLs are acquired by CIRC and which ones are “returned” to the parent bank(s) rests with CIRC. Each of the four High Courts (one in each province of Pakistan) has nominated judges with a mandate to handle CIRC’s cases and CIRC-related litigation. It was created with a specific “sunset clause”, whereby CIRC is supposed to complete its mandate and be wound up six years after starting operations – i.e. by September 2006.

With only half its “mandated life” left, CIRC’s progress so far has been a major disappointment on several counts. Firstly, the organisation has not developed the internal capacity to perform any role other than auctioning NPLs acquired by it. Secondly, by acquiring assets at a purchase price (PP) that is well below the forced sale values (FSV) established by the banks themselves, the organisation has had a negative effect on the secondary market price of industrial assets. Thirdly, this pricing methodology has resulted in a situation whereby the AMC generates a large profit on asset sales and leaves the parent bank(s) with a write-off which is larger than would have been had CIRC not been created. The following chart, based on CIRC’s latest performance data, illustrates this point (figures have been converted to US\$ in millions – conversion rate of \$1 = Pak. Rupees 57.80): -

- NPL of 40 industrial units in the banking system: \$99.08
- Forced sale value (FSV) established by the banks: \$30.21
- Purchase price paid (PP) to the banks by CIRC: \$10.41
- Sale price(s) achieved by CIRC in auction: \$33.77
- CIRC’s “profit” on the sale: \$23.36
- Balance of unsecured NPL (awaiting write-off): \$88.67

Note: The above data shows that in Pakistan the banking system does a fairly realistic job in evaluating the FSV of industrial assets as can be seen from the sale price(s) actually achieved by CIRC. It also shows that had the banks auctioned their assets themselves, the write-off on their books would be reduced by over 26%.

From this it appears that the AMC seems to be using its (monopoly) clout to cherry-pick “easy” NPL at unreasonably low prices from the banking system. The banking system would have been better off if CIRC had chosen to spend its energies on the rehabilitation of sick industrial units (a more difficult task) rather than merely auctioning assets (a relatively easy task, especially assets where decrees were already in place). As of December 2002, the AMC had acquired 277 units from the banks with NPL of \$953 million, which is a very small percentage of the total pool of distressed assets in the country. Of this total, only 64 entities had auctioned and settled with NPL of \$149 million. At this pace, CIRC will either have to be drastically revamped in both terms of management quality as well as processes and procedures or be allowed to fade away before its stated “shelf life” of September, 2006.

The Creation of the Committee for the Rehabilitation of Sick Industrial Units (CIRSU)

CIRSU was created through a notification of the Ministry of Finance (MOF) in May 2000. This body, therefore, does not operate under an enabling law. It does, however, have considerable moral suasion owing to the backing of both the Central Bank and the MOF. CIRSU comprises representatives from the large public sector financial institutions and senior industrialists. At the time of its creation (i.e. three years ago), Pakistan’s economy was very fragile. Low GNP growth rates had persisted since the mid-1990’s. 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 has chosen to act as an “arbitration window” on NPLs between the banks and the borrowers. Periodic meetings are held in which very basic data (normally submitted by the banks) is considered. Typically the debt is rescheduled and “revival” is declared. There is no internal capacity for industry analysis and post-revival monitoring. This is a consequence of poor people selection for a complex task and a tendency to accept “band-aid” financial restructurings as an expedient to temporarily show a decline in the NPL graph. Up to December 2002, this committee had considered the cases of around 325 borrowers, of which the debt of 151 borrowers had been rescheduled. In terms of actual revival defined as a closed unit coming back into production, data is not maintained by CIRSU. However, in a recent study (on CIRSU’s performance) it was stated that only four closed units (with a NPL of \$14 million) had resumed production. The committee appears to be an unnecessary appendage to the banking system. The MOF should actively consider its closure. However, a committee (think tank) that has the capacity to give long-term strategies for reducing industrial sickness is still required in Pakistan as several major industrial segments have highly unsustainable debt levels, and several other segments have structural problems like over capacity, obsolescence, unsustainable plant size, etc.

Underlying Reasons and Rationale for the New Corporate Insolvency Law

The “hard” approach adopted by Pakistan’s military government towards resolving the NPL problem has clearly not worked. This is partly because of the simplistic manner in which it was implemented and also because of inadequate and inappropriate management resources in the major structures that are implementing this agenda.

The ratio of NPL to total lending remains virtually unchanged at 20%. Positive progress on “stock” has been overtaken by new NPL “flows”. The NPL to capital ratio remains at well over 100% — a serious threat to the capital base of the banks. The investment to GDP ratio (well over 20% over a decade ago) has plummeted to a new low of 14%. Likewise, corporate credit demand has slumped, causing excess liquidity. All the banks are now aggressively promoting consumer finance products. Owing to the NAB law, bankers are not willing to take any financial risks. They have become trigger-happy and tend to favour liquidation as the only option to recover corporate debt, even for companies that remain in full production.

It is in this context that the Pakistani government was persuaded to modify their approach. More specifically, consideration is now being given to the enactment of a new corporate rehabilitation law that would decriminalise default, thereby encouraging risk-taking and an overall improvement in the investment climate. The new legislation also seeks to change the legal environment from one of “wilful default”, which assumes that the full value of all NPLs is recoverable, to one of “sustainable debt”, where there is a recognition by creditors that the absorption of some losses on their part is required if the NPL issue is to be successfully addressed.

Concepts and Design Issues in the Drafting of the Corporate Rehabilitation Act (CRA)

The Banking Laws Review Commission (BLRC) considered three alternative models, while drafting the CRA, namely: -

- An empowered administrative body (the Indian model);
- Judicial administration (the English model); and
- Chapter 11 (the American model).

Due to the power of Pakistan’s bureaucracy, the idea of an authority empowered by an insolvency law like India’s Sick Industrial Companies Act (SICA) had a degree of support. The counter-argument was that giving jurisdiction to a group of disinterested and financially untrained bureaucrats would not solve the NPL issue. After considerable debate, this argument was accepted by the BLRC.

A widespread suspicion about the underlying motives of debtors led to consideration of the English model, involving “debtor-eviction”. The perceived advantage was “contested entry”, which was seen as a method to remove the danger posed by countless frivolous insolvency petitions. A further advantage was management by a judicial administrator who would also prepare the rehabilitation plan for the court.

The key hurdle in adopting this model is Pakistan’s lack of competent administrators who could perform such functions under the law. In fact, even basic supporting institutions, such as qualified receivers and auctioneers, do not exist.

There was also a feeling within the BLRC that a contested entry system would add an extra layer of litigation, causing unnecessary delays to the process.

What has finally been adopted is the US model with significant modifications.

Entry into rehabilitation proceedings is a right. However, debtors must consider such a step carefully because of the provision for automatic conversion into liquidation in the event that no rehabilitation plan is approved.

The process is entirely stakeholder driven. Both the debtor and the creditor(s) can file plans. The court will consider the latter if the debtor's plan is not approved.

The entire process has been compressed with finite timeframes. For example, the debtor has a maximum of one month after entry into rehabilitation proceedings to file a plan. In fact, there are fairly stringent timeframes throughout the whole process.

In Pakistan, taxes, levies and government dues enjoy substantial legal protection. For example, income tax, sales tax and customs officers can "reopen" cases several fiscal years later. In fact, bankers have often engineered rehabilitation via a change of management or the induction of a new entrepreneur only to be thwarted by extortionist claims for back taxes. In the CRA, all such taxes and levies are classified as unsecured debts. The idea is to move some of the costs of the inevitable losses away from the banking system.

The BLRC has recognised the limitations of Pakistan's "weak judicial capacity", where no specialised judges sit in the superior courts, by inserting a provision, which establishes a three-man Advisory Committee (comprising bankers, corporate finance specialists, etc.) to assist the insolvency judge/court. This committee should be an excellent resource for judges and courts that are unsure about the correct treatment of complex financial issues. Furthermore, they should be able to offer lucid advice in the likely event of several competing plans being submitted – particularly when the new cram-down feature is being exercised.

In the United States, the cram-down feature is a threat designed to force consensus on a rehabilitation plan. In Pakistan's context, the BLRC expects fairly active use of this provision – at least, in the first few years before case law emerges and the whole system develops maturity.

Implementation is the Key Issue

Pakistan's history is unfortunately littered with good ideas that have floundered due to weaknesses in implementation and insufficient attention to the building of necessary capabilities. There is also the need to adopt a more pro-active and consistent approach to policy-making rather than reacting to events. For example, the "incentive scheme" of 1997 was supposed to be a one-off window of opportunity to reduce the stock of old NPL. Both the Central Bank and the government of Pakistan had stated that there would be no such windows of opportunity in the future, and that recovery laws would be tightened, insolvency laws introduced and the "default culture" of habitual non-payment would be actively discouraged. However, recently (in October 2002) the Central Bank announced a new "incentive package" aimed at reducing the stock of NPL. The current package is very debtor-friendly. It allows large sections of NPL to be settled by paying the forced sale value (FSV) of the mortgaged assets irrespective of the amount of NPL. A borrower can qualify by depositing only 10% of the FSV and paying the balance over three years. The current package will further re-enforce the culture of non-payment that had earlier received major encouragement from the Central Bank's "incentive scheme" of 1997.

The CRA is a specialised law. It can only fulfil its full "design" potential if the government provides post-enactment support by creating a strong institutional infrastructure. At a minimum, support will be needed for judicial training, the creation of self-governing bodies of administrators, receivers and the like and the fast-track closure of competing insolvency structures (e.g. CIRC and CIRSU).

This may seem self-evident. However, past experience in this area has been very poor. At the level of governance, the culture of Pakistan favours taking a decade to ponder the self-evident and a similar amount of time to implement the inevitable. The unique and complex stakeholder map of Pakistan causes unnecessary complexities, difficulties and delays. Perhaps our situation is best summed up in the following verse:

And we are here as on a darkling plain,
Swept with confused alarms of struggle and flight,
Where ignorant armies clash by night.

Matthew Arnold (1822-1888)

The Philippines

LEGISLATIVE REFORM IN REHABILITATION AND INSOLVENCY CASES: ISSUES AND PROSPECTS IN THE PHILIPPINES

by

*Rep. Oscar S. Moreno*²⁸

I. Background

Corporate rehabilitation is a relatively new concept in the Philippine legal landscape. Until the mid-1970s, suspension of payments was the only remedy available to distressed corporations as provided in the Insolvency Act of 1909²⁹. It was only in 1976, with the promulgation of Presidential Decree No. 902-A, that the concept of rehabilitation as an alternative to suspension of payments was introduced. Essentially, PD 902-A³⁰ allowed illiquid corporations to apply at the Securities and Exchange Commission (SEC) for receivership or for the appointment of a management committee while they developed a rehabilitation plan.

When the Securities Regulation Code was adopted in 2000, jurisdiction over debt relief petitions was transferred from the SEC to the regular courts, prompting the Supreme Court to designate 60 (60) Regional Trial Courts (RTCs) as commercial courts and to adopt the Interim Rules on Corporate Rehabilitation. The Interim Rules, like its antecedent SEC Rules of Procedure on Corporate Recovery, implements PD 902-A. But the Interim Rules, even as it springs from the same substantive law, has introduced significant changes in the corporate rehabilitation proceedings. It removed the classification of creditors into secured and unsecured which the SEC previously made. It also contained an explicit proviso for cram-down, binding all persons, including creditors who may or may

²⁸ The author is the Chair of the Committee on Economic Affairs of the House of Representatives, Philippine Congress, which currently hears the proposed law on corporate recovery and insolvency.

²⁹ The Insolvency Act of 1909 (Act No. 1956) covered insolvency cases for both natural and juridical persons.

³⁰ PD 902-A provided an additional remedy for corporations not technically insolvent but experiencing cash flow problems. It indirectly amended the Insolvency Act in this regard. It is this legislation which the proposed law intends principally to amend.

not have participated in the proceedings or opposed the plan, to the provisions of the court-approved rehabilitation plan.

While the Interim Rules made bold changes in rehabilitation proceedings, the substantive law (PD 902-A) itself provides very limited remedies and is largely perceived to be inadequate in addressing the demands of a complicated and modern business environment. Indeed, under the existing legal framework, the only remedy available to distressed businesses is to undergo rehabilitation under the supervision of the court. This has turned off smaller and lower-capitalised businesses in distress which do not have the resources to engage in litigation with creditors, forcing them to either fold up or enter, under-leveraged, into negotiations. Moreover, such remedy is available only to illiquid juridical debtors, denying to businesses with debts greater than their assets but likely to be revitalised a shot at rehabilitation.

Also, under the present rehabilitation model, very few incentives are in place to attract investments in distressed but viable businesses. This, coupled with the general sentiment of uncertainty and the high risk associated with rehabilitation cases, has dried up financing critical to the revival of businesses and the economy in general.

II. Legislative Reform Objectives

To remedy this situation, reform has been on the legislative agenda since the previous congress. Such reform efforts focus on three major objectives, to wit: (1) inject speed and efficiency in the resolution of rehabilitation and insolvency cases; (2) adjust and balance the rights of creditors and debtors; and (3) adhere to international standards and best practices.

Speed and Efficiency. Essentially, the concern for a speedy and efficient rehabilitation is anchored on the need to ensure successful rehabilitation and mitigate its negative impact (the negative externalities arising there from).

In rehabilitation proceedings, the enforcement of contractual rights is suspended to nurse debtors back to financial health. In our proposed legislation, this period of suspension retroacts to the date of filing with the court of a petition for rehabilitation. During this period, the enforcement of any and all claims against the debtor is prohibited while all legal proceedings by and against the debtor are consolidated in the court where the petition is filed. All other proceedings are stayed, except those filed on appeal at the Court of Appeal or Supreme Court prior to the commencement date, or those filed at specialised courts/quasi-judicial agencies.³¹

This period of suspension is designed to preserve the status quo and pre-empt any attempt to further deplete the resources of the debtor which, if unabated, could result in the irreversible state of bankruptcy. It holds at bay creditors — specially those holding security — whose knee-jerk reaction is to foreclose on the security once indicators of illiquidity, more so if (much less) insolvency becomes apparent.

In so doing, however, a possible constitutional issue on the impairment of the obligation of contracts arises.³² Thus, two mechanisms are contained in the draft law to ensure that no undue interference with the parties' contractual rights and duties will occur:

³¹ The enforcement of claims arising from these proceedings is nevertheless subject to stay.

³² Sec. 10, Article III (Bill of Rights) of the 1987 Philippine Constitution provides that “*No law impairing the obligations of contracts shall be passed.*”

1. The debtor is required to meet the criterion of “substantial likelihood of rehabilitation³³” in order for it to continue to avail of the stay and other benefits in the law. The court is mandated to determine the debtor’s likelihood of rehabilitation within 90 days from the date of filing of the petition, otherwise, suspension/stay automatically expires;
2. The period of rehabilitation is pegged at a maximum of 18 months. Within this period, the court must approve a rehabilitation plan, otherwise, the proceedings are converted to dissolution and liquidation.

The requirement of substantial likelihood of rehabilitation involves the determination of at least two things: (1) the debtor’s capacity to rehabilitate itself, and (2) its good faith. The concurrence of these would more or less provide an implied guarantee to the creditor that resort to court is a genuine act on the part of the debtor to rehabilitate itself and not an evasion of its contractual obligations. Such obligations the debtor would in fact reassume once rehabilitation proves successful. On the other hand, the maximum period of 18 months for approval would seem a reasonable period within which debtor and creditors could draft and agree on a rehabilitation plan, and failure to do so within such period is taken as an indication of lack of interest in or failure at rehabilitation.

The debtor’s capacity to rehabilitate itself is an essential requisite for the court to give due course to the petition for rehabilitation. Consistent with this, our draft law accords super-priority status to what we refer to as “new money,³⁴” or credit issued after commencement of the proceedings to the debtor to keep it operational and help it achieve rehabilitation. New money is entitled to priority in payment and preferred even over secured obligations.

An adjunct issue to this capacity to rehabilitate is the question of who could best steer the distressed debtor out of its financial problem. Two choices emerge: the current management (whose acts may or may not have induced the financial problem in the first place), or an “outsider” in the person of the rehabilitation receiver (who at best could provide the much-needed change in leadership, or at worst lacks exposure – much less expertise – in the debtor’s operations). Our draft law evades this dilemma by: (1) limiting the task of the rehabilitation receiver to monitoring and oversight over the operations of the debtor during the pendency of the petition, and (2) transferring control and management of the company to the receiver only upon written consent of the debtor and the general unsecured creditors’ committee.

³³ This is found in Sec. 23(2) of the draft law which provides: “For purposes hereof, there is substantial likelihood for the debtor to be rehabilitated if the following minimum requirements are met: (1) the proposed rehabilitation plan submitted complies with the minimum contents prescribed by this act; (2) there is sufficient monitoring by the rehabilitation receiver of the debtor’s business for the protection of creditors; (3) the debtor has met with its creditors to the extent reasonably possible in attempts to reach a consensus on the proposed rehabilitation plan; (4) there are sufficient assets with which to rehabilitate the debtor; and (5) the rehabilitation receiver submits a report that, based on the preliminary evaluation: (a) there is sufficient cash flow to maintain the operations of the debtor; (b) the debtor’s stockholders, directors and officers have been acting in good faith and with due diligence; (c) the petition is not a sham filing intended only to delay the enforcement of creditors’ rights; and (d) the debtor would likely be able to pursue a viable rehabilitation plan.”

³⁴ Sec. 36 of the proposed law provides: “With the approval of the court upon the recommendation of the rehabilitation receiver, the debtor in order to enhance its rehabilitation, may: (1) enter into credit arrangements, the payments of which shall be considered an administrative expense; or XXX” Administrative expenses are exempt from the stay.

The general rule that the debtor's management retains control over the company's operations recognises not only the expertise acquired by the debtor's officers but also the need to keep intervention at the minimum in order to preserve the semblance of regularity in the debtor's operations. At any event, the debtor's management is made subject to the receiver's monitoring, and is made liable for suspicious acts – from refusal to divulge information to other acts tainted with fraud³⁵.

Finally, the draft law takes cognisance of the fact that speed and efficiency is as much dependent on the adjudicator as it is on the parties involved. Hence, as ambitious as it may sound, the establishment of commercial courts all over the country with exclusive and original jurisdiction over rehabilitation and insolvency cases and other commercial disputes is proposed. The intent is basically to promote expertise in, and hopefully expedite, the adjudication of cases in commercial law. The glaring hindrance to this proposal is of course its massive funding requirement. Thus, it is provided in our draft that the trial courts currently assigned by the Supreme Court to entertain insolvency and rehabilitation cases continue to do so in the interim.

Adjustment and Balancing of Rights. At the core of rehabilitation efforts is the thorny issue of rights, and to what extent they may be enforced or restrained. As, most often, these rights are mutually exclusive – a right granted to either a debtor or creditor diminishes and derogates that given to the other – rehabilitation appears to be a zero-sum game.

Our proposed legislation sets the parameters of such game by foremost identifying its key players – i.e. the debtor and creditors. The draft law is concerned exclusively with juridical debtors – corporations and partnerships – and their respective creditors, whether natural or juridical. Sole proprietorship-type of businesses are excluded from its application; they will have to resort to the Old Insolvency Law (along with individuals facing insolvency). The exclusion is meant to prevent the mischief of individual debtors using their business to avail of the protective shield of the law against creditors validly pursuing their claim for personal debts.

Upon commencement of the proceedings, the debtor generally obtains two things: first, relief from claims and interest on loans in order to preserve its assets³⁶; and second, the right to improve its

³⁵ see footnotes 18 and 19, p. 10 of this paper.

³⁶ Sec. 24 of the draft law provides: “Unless otherwise provided in this Act, the court's issuance of a commencement order shall: (1) vest the rehabilitation receiver with all the powers and functions provided for in this act, such as the right to review and obtain all records to which the debtor's management and directors have access, including bank accounts of whatever nature of the debtor, subject to the approval by the court of the performance bond filed by the rehabilitation receiver; (2) suspend all legal and other proceedings for the enforcement of claims of whatever nature and kind against the debtor subject to the provisions of sections 26 and 27 hereof; (3) prohibit the debtor from selling, encumbering, transferring or disposing in any manner any of its properties except in the ordinary course of business; (4) prohibit the debtor from making any payment of its liabilities outstanding as of the commencement date, except upon the approval of the court upon motion duly filed for the purpose; (5) suspend all actions to enforce any judgment against the debtor; (6) prohibit, or otherwise serve as the legal basis for rendering null and void the results of, any extra-judicial activity or process to seize property, sell encumbered property, or otherwise attempt to collect on or enforce a claim against the debtor after the commencement date unless otherwise allowed in this Act subject to the provisions of section 29 hereof; (7) serve as the legal basis for rendering null and void any setoff after the commencement date of any debt owed to the debtor by any of the debtor's creditors; (8) serve as the legal basis for rendering null and void the perfection of any lien against the debtor's property after the commencement date; and (9) consolidate the resolution of all legal proceedings by and against the debtor to the court: Provided, however, That the court may allow the continuation of cases in other courts where the debtor had initiated the suit.

chances at rehabilitation. The first is granted by the draft law by suspending actions which not only deplete the resources of the debtor but also add burdens on its property. It is meant to preserve the status quo and thwart any act or transaction which jeopardise the debtor's chances at rehabilitating itself. The second is made possible by giving the debtor the green light to: (1) contract new loans for its rehabilitation; and (2) terminate all contracts and confirm only those which are necessary for rehabilitation.

In fact, the draft law automatically terminates all contracts of the debtor 60 days from commencement date³⁷ in order to unload the debtor's burden from unnecessary contractual obligations.

Only those contracts which the debtor confirms during this period are left in force, the assumption being that those pertain to transactions critical to the debtor's continued operation and eventual rehabilitation.

The dual advantage outlined above accrues to the debtor who elects any of the three remedies for rehabilitation, to wit: suspension of payments, pre-negotiated rehabilitation and court-supervised rehabilitation.

Among the three, suspension of payments is the familiar remedy, having been provided for in the old Insolvency Law of 1909. It enables the debtor to postpone payments for 90 days from the commencement date. Thereafter, the stay against creditor claims expires automatically. To prevent the anomalous situation where a debtor would first resort to this remedy and then avail of others to prolong the benefits of suspension against claims, the draft law forfeits access by the debtor to other relief within one year from the commencement date.

Pre-negotiated rehabilitation approximates a market-driven type of rehabilitation. It grants a debtor that has worked out extra-judicially a rehabilitation plan with its creditors the relief of suspension of claims while the rehab plan awaits judicial approval. Upon approval, the cram-down mechanism³⁸ takes effect binding all creditors to the plan. Court-supervised rehabilitation meanwhile

Attempts to seek legal or other recourse against the debtor outside these proceedings shall be sufficient to support a finding of indirect contempt of court.

The court may order, through its injunctive and contempt powers, the transfer of documents, return of property, the annotation of titles and other relevant documents, or provide for other appropriate relief to address any violation of this Section or to protect the interests of creditors and stakeholders.

Individuals, including the debtor's management and directors, who refuse to accede to requests for documents or property described in this Section shall be liable for indirect contempt of court and criminal penalties, as well as all resulting costs and attorneys' fees.

³⁷ Sec. 38 of the proposed law provides: Unless specifically cancelled by a court decree prior to issuance of the order commencing proceedings, or at anytime thereafter by the court before which the proceedings are pending, all contracts of the debtor with creditors and other third parties shall be deemed to continue in force if they are necessary for the rehabilitation of the debtor, regardless of pre-commencement defaults by the debtor: Provided, That within 90 days following the commencement date, the debtor, with the consent of the rehabilitation receiver, shall notify each contractual counter-party of whether it is confirming or terminating the particular contract. Contractual obligations of the debtor arising during this period, and afterwards for confirmed contracts, shall be an administrative expense. Contracts not confirmed by the required deadline shall be considered terminated. Claims for actual damages, if any, arising as a result of the election to terminate a contract shall be considered a pre-commencement claim against the debtor."

³⁸ See footnote 13 on page 6 of this paper

subjects the whole process of rehabilitation, specifically the drafting of the rehabilitation plan, to the administration and scrutiny of the court³⁹.

In any of these cases, the debtor obtains the benefits of the law as soon as the court issues a commencement order five days upon filing of a petition sufficient in form and substance.

In cases where the juridical debtor belongs to a group of companies, the problem of free-rider arises and targeting becomes important, otherwise the law will abet the exploitation of creditors. As a general proposition therefore, the iron-clad rule is made to apply and each member of a group of companies is treated as a separate legal entity such that entitlement to the remedies of the distressed entity does not extend to other members in the group.

The Philippine context, however, requires that an exception be made to this rule. In our domestic business environment, members of a group of companies are often times so intertwined and their operations so interdependent that gains and losses are farmed out and mutually shared. Taking this reality into consideration, our proposed law permits global filing for related enterprises, or those where conditions exist that approximate such a relationship.⁴⁰

As to the creditors, the draft law has two general aims: (1) to equalise treatment among them; and (2) to safeguard their claims. The draft law bats at uniformity in the treatment of creditors, and where this is not applicable; it creates avenues to empower the under-leveraged. Thus, the prohibition against the enforcement of claims is made to apply to all creditors, whether secured or unsecured, including government financial institutions. It also binds all creditors to a decision supported by a majority, through what is popularly referred to as a “cram-down mechanism.”⁴¹ The inclusion of this mechanism

³⁹ Where rehabilitation is impossible, or where rehabilitation efforts fail (as when the rehabilitation plan is not filed on the time, or where there is serious breach in the performance of the provisions of the plan) the draft law provides for the liquidation of the company. The provision of liquidation is important because the SRC merely transferred jurisdiction over rehabilitation cases, but not insolvency and liquidation cases, to the regular courts.

⁴⁰ Sec. 8 of the draft law provides: “Each juridical entity shall be considered as a separate entity under the proceedings in this Act. The assets and liabilities of a debtor may not be commingled or aggregated with those of another under these proceedings unless the other is a related enterprise that is owned or controlled directly or indirectly by the same interests: provided, however, that the commingling or aggregation of assets and liabilities of the debtor with those of a related enterprise may only be allowed where: (1) there was commingling in fact of assets and liabilities of the debtor and the related enterprise prior to the commencement of the proceedings; (2) the debtor and the related enterprise have common creditors and it will be more convenient to treat them together rather than separately; (3) the related enterprise voluntarily accedes to join the debtor as party petitioner and to commingle its assets and liabilities with the debtor’s; and (4) the consolidation of assets and liabilities of the debtor and the related enterprise is beneficial to all concerned and promotes the objectives of rehabilitation.

Provided, finally, that nothing in this Section shall prevent the court from joining other entities affiliated with the debtor as parties pursuant to the Rules of Court.”

⁴¹ Sec. 72(1) provides that: “Approval of the plan shall discharge the financial payment obligations of the debtor unless otherwise allowed to the extent called for by the plan. Contracts and other arrangements between the debtor and its creditors shall be deemed to continue to apply to the extent that they do not conflict with the payment provisions of the plan. Any compromises on amounts payable by the debtor shall be binding on all creditors regardless of whether the plan is successfully implemented. Claims

repeals the provision in the Insolvency Act which exempts secured creditors who stay away from negotiations and proceedings from the effects of the approved rehabilitation plan.

For facility in decision-making, the creation of distinct classes or sub-groups of creditors is allowed by the draft law. But the classification is meant more to promote, and not defeat, the equalisation in the treatment of creditors. Where the draft law makes a classification based on the possession of security over a debt, it does so to undermine discrimination among creditors. Hence, it provides for the establishment of a General Unsecured Creditors Committee to give voice to creditors who hold no security over credits extended to the debtor. Unsecured creditors are usually under-leveraged, and are at the lower end of the hierarchy and preference of credits.

The creation of their representative committee is intended to increase their capacity to protect their claims. Such committee is granted certain powers⁴², among others, that of vetoing petitions for post-commencement financing requested by the rehabilitation receiver.

In general, all creditors are given a bundle of rights aimed at safeguarding their investments/claims. This includes the following rights: (1) to initiate proceedings; (2) to notice and hearing; (3) to participate in the appointment of the rehabilitation receiver; (4) to require adequate protection for property subject of their claim; and (5) to proceed against solidary guarantors, and third party or accommodation mortgagors.

The right to initiate involuntary proceedings is given to creditors with total claims equivalent to one million Philippine pesos (Php 1,000,000.00), or 25% of the total paid up capital or partners' contributions, whichever is higher. This right can only be exercised when there is, or at least there exists the imminent possibility of, default in payment by the debtor.⁴³

Understandably, the requirements for involuntary proceedings are more taxing than those for debtor-initiated proceedings because creditors are not in the best position to determine the real financial position, much less the viability of, a business enterprise. The stringent requirements are meant to ensure that the creditor will only exercise this right with the intention of rehabilitating the debtor (which, when successful, will ultimately allow him to collect his credit in full).

The creditor's right to notice and hearing is guaranteed in almost every stage of the rehabilitation process. The commencement order is required to be published twice for two consecutive weeks in a

arising after approval of the plan that are otherwise not treated by the plan are not subject to any suspension order."

⁴² Sec. 54 gives the general unsecured creditors' committee the right to: "(1) veto petitions for post-commencement financing requested by the rehabilitation receiver or liquidator; (2) authorise the rehabilitation receiver's assumption of control of the debtor pursuant to Section 42 of this Act; (3) review the rehabilitation receiver's or liquidator's records in connection with the administration of the debtor; (4) remove the rehabilitation receiver or liquidator from his position in accordance with the procedures in this Act; and (5) participate in a decision to extend the deadline for the submission of a rehabilitation plan."

⁴³ Sec. 18 provides that: "Any three creditors with total claims equivalent to either one million pesos (₱1,000,000.00), or 25% of the total paid-up capital or partners' contributions, whichever is higher, shall be entitled to initiate involuntary proceedings against a debtor if: (1) there are no genuine disputes of facts or law on their claims and the required payments have not been made for more than 60 days; or (2) creditor other than the petitioners has initiated foreclosure proceedings against the debtor that will prevent the debtor from paying its debts as they come due or will render it insolvent."

newspaper of general circulation.⁴⁴ The rehabilitation receiver is also considered as the agent of creditors as regards the receipt of pleadings and other paper filed with the court. Further, creditors having an ownership interest in a property of the debtor, or a claim against the debtor, are to be served notice of pleadings against such property or claim.

These safeguards are put in place to notify the creditor of any action that may prejudice his interest or claim, and therefore allow him to adequately prepare against such possibility.

To further protect the creditors' interest, a proposed provision in the draft law seeks not only to give creditors the right to participate in the appointment of the rehabilitation receiver but to require support by a majority of them (50% of secured and unsecured creditors) before the court could appoint a receiver. This suggestion has elicited some controversy, with some arguing that the requirement could taint the impartiality of the receiver and undermine his position as an officer of the court. There is every indication, however, that the provision will be retained, but checks on the acts of the rehabilitation receiver will be tightened in order to deter the commission of acts that prejudice parties in the proceedings.

Finally, despite the stay order, creditors are given the right to proceed against solidary guarantors and third party/accommodation mortgagors and require adequate protection for the property subject of its claim. The suspensive benefit of the commencement order is not extended to solidary guarantors and third party/accommodation mortgagors whose obligation is, by nature, subsidiary, and arises upon the failure of the debtor to perform its obligation to the creditor/s. As such, creditors are allowed to proceed with their claims against them. However, the creditor will be prohibited from doing so against third-party/accommodation mortgagors when the property subject of accommodation mortgage is necessary for the rehabilitation of the debtor. In such a case, creditor's interest becomes subordinated to the objective of successful rehabilitation.

The creditor is also given the right to petition the court to order the rehabilitation receiver to take reasonable steps to prevent the depreciation of its property in the possession of the debtor. Where this is not possible, he is given the alternative of petitioning for: (1) the foreclosure of the property; (2) the conveyance of a lien or ownership interest in a substitute property of the debtor; (3) the conveyance of a lien on the residual funds from the sale of encumbered property; or (4) the sale or disposition of the property. The court is also empowered in cases where adequate protection over a property securing a creditor's claim is lacking to order the debtor to make arrangements to insure the property, provide additional or replacement security, make payments, or to allow the enforcement of a security claim against the debtor.

The immediately preceding rights granted to the creditor, and the mandate of the court to protect creditor property, underscore the strenuous balancing of debtor and creditors' rights sought to be

⁴⁴ Sec. 23(1) of the proposed law provides: "The commencement order, which shall be published once a week for two consecutive weeks in a newspaper of general circulation in the Philippines, beginning not later than seven days after the issuance of the commencement order, shall be effective for an initial period of 90 days from the date of filing of the petition, extendible for a maximum period of 60 days for meritorious reasons. It shall automatically be dissolved without need of court action upon the expiration of said initial period or extended period, as the case may be, unless the court gives due course to the petition within said period on a finding that there is substantial likelihood for the debtor to be rehabilitated. If the court does not give due course to the petition, it shall order the dismissal of the petition or the conversion of the proceedings to dissolution and liquidation proceedings under subchapter 4 of chapter iv of this act."

achieved by the proposed law. At the fulcrum of this balancing is the principle of equity, where creditor's rights are not exhumed but in fact protected, even as rehabilitation is relentlessly pursued.

This balancing of rights inevitably alters the hierarchy and preference of credits. Expenses incurred for and in the process of rehabilitation are granted super-preferred status in order to encourage creditors to invest in revitalising distressed corporations. They are referred to as "administrative expenses"⁴⁵ and are exempt from the stay/suspension order. Related to this, there exists at the moment a strong lobby for the government to waive, or at least suspend, the collection of documentary stamp tax, capital gains tax and withholding taxes on, as well as interest on late payment of taxes by, companies undergoing rehabilitation.

This lobby, while it rests on the valid argument that government should also be made to assume part of the costs of rehabilitation, must, however, confront two major issues before it gains ground. The first is that of moral hazard. Undoubtedly, it would be bad policy for the government to assume, by way of tax waiver, rehabilitation of companies in the red due to mismanagement. That would in the end not only tolerate but reward bad management. Secondly, if ever government should share in the costs of rehabilitation, exactly how much it should assume is stamped with a big question mark.

Adoption of international standards and best practices. Modern trade and commerce spill over national borders. The adoption of certain international legal standards and best practices is meant to improve the local business environment and secure to Philippine business entities which find themselves in distressed conditions in foreign jurisdictions the same protection and relief accorded to their foreign counterparts.

One such standard pertains to cross-border insolvency⁴⁶ where representatives of a foreign corporation under insolvency proceedings in foreign countries are allowed to seek a judicial order stopping Philippine creditors from acting unilaterally with respect to assets located in the Philippines. Corollarily, the court is also given the power to provide such other relief to a foreign debtor, taking into consideration reciprocity and the rights of local creditors.⁴⁷

The draft law also increases the penalty to directors and officers, who cause, authorise or directly participate in the disposition of property fraudulently, or in a manner grossly disadvantageous to debtor and/or creditor; or those who conceal from creditors, embezzle or misappropriate any property.

⁴⁵ Sec. 3(a) defines Administrative expenses" as follows: "to those reasonable and necessary expenses: (1) incurred in connection with the filing of the petition; (2) arising from such filing of the petition in connection therewith, including those incurred for the rehabilitation or liquidation of the debtor; (3) incurred in the ordinary course of business after the filing of the petition; and (4) that are otherwise authorised or mandated under this act."

⁴⁶ Sec. 109 provides: "The court shall set a hearing in connection with an insolvency or rehabilitation proceeding taking place in a foreign jurisdiction, upon the submission of a petition by the representative of the foreign entity that is the subject of the foreign proceeding."

⁴⁷ The factors entitling a foreign corporation to relief is set out in Sec. 111 of the proposed law, which provides: "In determining whether to grant relief under this Sub-chapter, the court shall consider: (1) the protection of creditors in the Philippines and the inconvenience in pursuing their claims in a foreign proceeding; (2) the just treatment of all creditors through resort to a unified insolvency or rehabilitation proceeding; (3) whether other jurisdictions have given recognition to the foreign proceeding; (4) the extent that the foreign proceeding recognises the rights of creditors and other interested parties in a manner substantially in accordance with the manner prescribed in this Act; and (5) the extent that the foreign proceeding has recognised and shown deference to proceedings under this Act and previous legislation."

Offenders are made liable for double the value of the property, or the amount of the transaction involved, whichever is higher⁴⁸. The increased penalty seeks to deter acts that cause the deterioration of the value of the enterprise to the detriment of creditors.

III. Conclusion

The reforms currently being undertaken by the Philippine legislature seeks to update and modernise the rehabilitation and insolvency regime in the country. The inadequacy and inconsistency of the current regime are manifest in the overstretched court battles involving a few significant businesses in the country, most notably the National Steel Corporation, where rehabilitation has yet to take off.

Legislative reform efforts intend to put in place a clear and predictable set of rules to infuse order in rehabilitation and insolvency proceedings. Once passed, it is hoped that the proposed law will be able to arrest the collapse of key players in the economy, especially in times of instability, swiftly re-engage productive resources into revitalised and competitive businesses, and therefore strengthen the sinews of a fragile national economy.

⁴⁸ The liability of directors and officers is provided in Sec. 13 of the draft law which provides that: “Directors and officers of a debtor shall be liable for double the value of the property sold, embezzled or disposed of or double the amount of the transaction involved, whichever is higher, to be recovered for the benefit of the debtor and the creditors under the following circumstances: (1) if the officer or director, having notice of the commencement of the proceedings, or having reason to believe that proceedings are about to be commenced, disposes or causes to be disposed of any property of the debtor or authorises or approves any transactions fraudulently or in a manner grossly disadvantageous to the debtor and/or creditors; or (2) if such director or officer conceals from the creditors or embezzles or misappropriates any of such property.

The court shall determine the extent of the liability of a director or an officer under this Section. In this connection, the court shall consider the amount of the shareholding or equity interest of such director or officer, the degree of control of such director or officer over the debtor, and the extent of the involvement of such director or debtor in the actual management of the operations of the debtor.”

This is reiterated in Sec. 112 which extends liability to employees. Sec. 112 reads as follows: “A director, officer or other employee of the debtor who commits any one of the following acts shall, upon conviction thereof, be punished by a fine no more than one million pesos and imprisonment for not less than three months nor more than five years for each offence: (1) if he shall, either after the commencement date or prior thereto with contemplation of their commencement, hide or conceal, or destroy or cause to be destroyed or hidden any property belonging to the debtor; or if he shall hide, destroy, alter, mutilate, or falsify, or cause to be hidden, destroyed, altered, mutilated, or falsified, any book, deed, document, or writing relating thereto, or if he shall, with intent to defraud his creditors, make any payment, sale, assignment, transfer, or conveyance of any property belonging to the debtor; (2) if he shall, in any case of any person having, to his knowledge or belief, proved a false or fictitious debt against the debtor he shall fail to disclose the same to the rehabilitation receiver or liquidator within one month after coming to the knowledge or belief thereof; or if he shall attempt to account for any of the debtor’s property by fictitious losses or expenses; or (3) if he shall knowingly violate a prohibition or knowingly fail to undertake an obligation established this Act.”

PHILIPPINE INSOLVENCY LAW: REFORMS AND PROPOSALS

by

*Cesar L. Villanueva,*⁴⁹

I. The Philippine Scenario

The Philippine corporate bankruptcy system has for almost a century operated on very tenuous legal bases: (a) an antiquated 1906 Insolvency Act,⁵⁰ which essentially provided for simple suspension of payments and corporate liquidation resulting from insolvency, with no provisions on corporate rehabilitation or restructuring; and (b) the 1980 amendment⁵¹ to Presidential Decree No. 902-A, which recognised in very sketchy provisions the jurisdiction of the Philippine Securities and Exchange Commission (“SEC”), acting as a quasi-judicial body, to hear petitions for corporate rehabilitation.

The Insolvency Act did not provide for corporate rehabilitation and its automatic stay provisions did not effectively cover actions on enforcement by secured creditors. As a result the legislation was rarely invoked, and effectively fell into disuse. On the other hand, the remedy of corporate rehabilitation under Presidential Decree No. 902-A was very unfamiliar to the Philippine jurisdiction at the time the amendment was introduced in 1980, and the lack of adequate provisions to support the process prevented its application on a pervasive basis. Most of the major gaps in the law (i.e. the standing of who can avail and the issue of joinder of corporate officers bound personally to corporate debts, coverage of the stay order, the standing of creditors on the approval of the corporate plan, the ability to cram down a rehabilitation plan, etc.) had to be worked out through tedious, case-by-case decisions rendered by the Supreme Court from appeals coming from petitions being processed by the SEC.

⁴⁹The author is the Associate Dean of the ATENEO DE MANILA LAW SCHOOL, and Chairman of the Commercial Law Department of the PHILIPPINE JUDICIAL ACADEMY. He is also the lecturer on Corporate Governance of the Institute of Corporate Directors which handles the mandated accreditation seminars given to directors of banking institutions and public-listed companies in the Philippines. He is the author of books on Philippine Commercial Laws and Philippine Corporate laws, and published and delivered papers on Philippine corporate insolvency system.

⁵⁰ Republic Act No. 1956

⁵¹ Presidential Decree No. 1758, which amended Section 5 of Pres. Decree No. 9020-A, providing that the Securities and Exchange Commission shall have “original and exclusive jurisdiction to hear and decide cases involving XXX.” d) Petitions of corporations, partnerships or associations to be declared in the state of suspension of payment in cases where the corporation, partnership or association possesses property to cover all of its debts but foresees the impossibility of meeting them when they respectively fall due or in cases where the corporation, partnership or association has no sufficient assets to cover its liabilities, but is under the Management Committee created pursuant to this Decree.”

This meant that the whole framework upon which creditors and corporate debtors would be able to find comfort and familiarity with the rehabilitation proceedings took a process of almost twenty years. It was only the demands of the 1997 Asian Financial Crisis which forced the SEC to finally exercise its rule-making powers and issue in December, 1999 the “*SEC Rules of Procedure on Corporate Recovery*.”

Unfortunately, by July 2000, the Securities Regulation Code⁵² was enacted into law, which effectively removed from SEC’s jurisdiction petitions for corporate rehabilitation and transferred them to the regular trial courts (i.e. the Regional Trial Courts).

The Philippine experience on the corporate bankruptcy system has been rather spotty, and has tended to be a “patch-up” job. The imperatives of globalisation, the need of the country to attract foreign investments as one of the key components to economic development, as well as the experience and continuing repercussions of the 1997 Asian Financial Crisis, have all crystallised the need to overhaul the Philippine corporate bankruptcy system in order to comply with world standards.

II. The Interim Measures

Since the economic and financial circumstances prevailing during the economic crisis did not permit waiting for Congress to pass a modern bankruptcy law, several sectors in Philippine society felt the need to improvise by establishing an interim framework for a corporate rehabilitation system based on the country’s SEC experience. The plan of action basically followed two routes: (a) “judicial legislation,” and (b) judicial specialisation and training in corporate rehabilitation.

Using its powers under sub-section 5.2 of the Securities Regulation Code to designate the Regional Trial Court branches to exercise jurisdiction over corporate cases,⁵³ and its power under Section 5(5) of Article VIII of the Philippine Constitution to promulgate rules of procedure, the Supreme Court took the lead by:

1. designating the most qualified RTC judge or judges in each of the regional districts of the Philippines to be “commercial law judges,” to hear and decide corporate cases, including petitions for corporate suspension of payments/rehabilitation;⁵⁴ and
2. promulgating in December 2000 the “Interim Rules of Procedure on Corporate Rehabilitation,” which were largely based on the SEC Rules on Corporate Recovery.

⁵² Republic Act No. 8799

⁵³ Subsection 5.2 of the Securities Regulation Code reads: “The Commission’s jurisdiction over all cases enumerated under Section 5 of Presidential Decree No. 902-A is hereby transferred to the Court of general jurisdiction or the appropriate Regional Trial Courts; Provided, That the Supreme Court in the exercise of its authority may designate the Regional Trial Court branches that shall exercise jurisdiction over these cases. The Commission shall retain jurisdiction over pending cases involving intra-corporate disputes submitted for final resolution which should be resolved within one year from the enactment of this Code. The Commission shall retain jurisdiction over pending suspension of payments/rehabilitation cases filed as of 30 June 2000 until finally disposed.”

⁵⁴ Administrative Order No. 00-11-03-SC

Under the auspices of the Philippine Judicial Academy (“PHILJA”), which is the judicial education arm of the Supreme Court, the designated commercial law judges underwent extensive training on the various aspects of corporate rehabilitation and exposure to “law and economics” to enable them to read financial statements and understand accounting, economic, banking and commercial concepts. With funding from the Asian Development Bank, and in partnership with the Asian Institute of Management, the judges went through three-phase training modules on the management, financial and legal aspects of corporate rehabilitation or restructuring. Several sessions were also spent with the judges to familiarise themselves with existing jurisprudence governing Section 5(d) of Presidential Decree No. 902-A, as well as the mechanics and rationale of the various provisions of the *Interim Rules of Procedure on Corporate Rehabilitation*.

The salient features of the *Interim Rules of Procedure on Corporate Rehabilitation* are the following:

1. The proceedings are mandated to be *in rem*: through compliance with publication requirements, the results of the proceedings are binding on creditors and other affected persons even when they do not participate in the proceedings;
2. The proceedings are declared to be “summary”, “non-adversarial”, and “technology friendly” such that pleadings that unduly delay (motion to dismiss/reconsideration, motion for bill of particulars, etc.) are prohibited, Causes of actions and oppositions are based on affidavits attaching actionable documents when necessary. Service of pleadings may be effected by fax or e-mail;
3. The proceedings are strictly "time bound". The whole process cannot exceed 18 months; and
4. The orders of the courts are immediately executory, even on appeal, unless enjoined by the Court of Appeals or the Supreme Court.

In addition, the *Interim Rules* contained "assertive provisions" to enhance the possibility for rehabilitation of the corporate debtor, which items were completely not covered by the substantive provisions of Section 5(d) of Presidential Decree No. 902-A, namely:

1. An expanded definition of "claims" subject to the stay order to cover "claims or demands of whatever nature or character against the debtor or its property, whether for money or otherwise;"
2. Express prohibition against withholding of supply of goods and services to the corporate debtor;
3. Provision for the payment of administrative expenses;
4. Provision for relief to secured creditors whenever they have no "adequate protection;" and
5. Empowers to the court to approve the rehabilitation plan over the opposition of the majority of creditors, and does not provide for the classification of creditors.

Among some of the Philippine corporate practitioners, the *Interim Rules* were thought to constitute a bold move on the part of the Supreme Court given that some of the provisions were considered substantive law, and beyond the scope of the procedural power of the Supreme Court. Some sectors even considered the key provisions of the *Interim Rules*, such as the cram down power of the court, to lack a substantive law basis and constitute “unlawful taking” in contravention of the constitutionally protected property rights of secured creditors.

Two years after the promulgation of the *Interim Rules*, the expected rise in corporate rehabilitation cases, brought about by the continuing financial and economic difficulties being experienced in the Philippines, has not eventuated. The following reasons have been attributed to the limited resort to the *Interim Rules*:

1. The innovative provisions are really untested and practitioners are not certain how much control they can retain over the proceedings after filing a petition. Basic familiarity with the operation of the various provisions of the *Interim Rules* should see developments similar to the SEC’s initial jurisdiction over corporate rehabilitation cases — slowly through the growth of Supreme Court decisions interpreting and implementing the *Interim Rules*, commercial practitioners should gain enough confidence in the workings of the corporate rehabilitation under the *Interim Rules* and more readily seek to invoke those provisions;
2. The “substantive” provisions of the *Interim Rules* present a strong basis by which approved rehabilitation plans may be overturned on the basis of constitutional issues raised with the Supreme Court. This results in a great deal of uncertainty on whether the funds and resources spent on a corporate rehabilitation process might be wasted.

Nevertheless, the *Interim Rules*, together with the relevant jurisprudential pronouncements of the Supreme Court covering rehabilitation proceedings falling under Section 5(d) of Presidential Decree No. 902-A, provide for the existing legal framework of the Philippine corporate rehabilitation system.

Short-term Developments

There is a growing perception that the Philippine Congress will not be able to enact into law anytime soon the proposed Corporate Recovery and Insolvency Act. This has prompted some sectors in Philippine society to move ahead of the Legislature and the Supreme Court to once again take the lead by promulgating an “*Interim Rules of Procedure on Corporate Insolvency and Liquidation*” that will not only provide for a revised procedural framework to upgrade the provisions of the antediluvian provisions of the Insolvency Act and cover the process for banking and insurance sectors, but to also to innovate outdated provisions of the law under the guise of “remedial law”.

This author has opposed such a move since it would engender only further confusion and complication in the Philippine legal system. In a paper submitted to the Judicial Reform Committee of the PHILJA, this author has posited:

“The more important consideration I had in evaluating the Proposed Liquidation Rules is whether the Academy should even attempt to propose such a move to the Supreme Court, *insofar as it seeks to revise and affect certain provisions of the Insolvency Law.*”

“While there is no doubt that the Supreme Court has the power to adopt rules of procedure pursuant to its powers under Section 5(5) of Article VIII of the Constitution, the Proposed Liquidation Rules would actually embroil the Supreme Court not only on whether it is touching upon substantive matters, but more importantly on whether it should pre-empt the Legislative Department in the current move to upgrade and update our insolvency laws.

“It is accepted under current practice that bankruptcy or insolvency laws must cover both substantive and procedural aspects. And was said in the beginning, the procedural aspects of a bankruptcy law are meant to carry out more effectively the policy considerations embodied in the substantive portions of the law. It would be of public knowledge that Congress is now considering the passage of the Corporate Recovery Act, which is intended to update and upgrade corporate rehabilitation and insolvency rules at par with modern world standards. The passage of the Proposed Liquidation Rules which contains many of such modern bankruptcy practice by the Supreme Court may open it to criticism that it is pre-empting the Legislative Department on the matter.

“There is no doubt that our century-old Insolvency Law requires upgrading, but should this responsibility be taken-up by the Supreme Court, rather than the policy-determining department of our government?”

“Likewise, the passage of the Proposed Liquidation Rules by the Supreme Court touching on matters pertaining to the handiwork of Legislature, which is the Insolvency Law, may place the High Tribunal at a defensive stance on having to vindicate its own rules on determining whether they touched upon substantive matters. As has been the aphorism, the Supreme Court may be considered the “weakest” branch of the government because it does not have the means to defend itself, and its strength has continued to be based on its unsullied reputation to dispense justice effectively, being a disinterested party to any justiciable controversy that it faces. Certain substantive issues are still pending with respect to insolvency matters, preference and concurrence of credit effects, etc., some of which have been discussed above. It is only fitting that the Supreme Court resolves such serious issues in the exercise of its constitutionally vested judicial powers, rather than pre-empt such issues by the passage of the Proposed Liquidation Rules in the exercise of its constitutionally granted power to promulgate rules of procedure.”

There is no doubt that the Philippines needs to enact into law at the soonest possible time a consolidated “Corporate Recovery and Insolvency Act,” not only to supplant the antiquated provisions of the Insolvency Act and to provide for clear and full substantial law basis for corporate rehabilitation proceedings, but likewise to ensure that the Philippine system adheres to world standards in order to attract more foreign investment.

Proposed Corporate Recovery and Insolvency Act

Under the aegis of the Capital Market Development Council, bills have been introduced in both the House of Senate and House of Representatives of the Philippine Congress for what initially was called the "Corporate Recovery Act." This draft legislation was designed to cover only corporate rehabilitation, leaving the Insolvency Law intact.'

The bill has hardly received any attention in the Senate, and has been under scrutiny in the Economic Committee headed by Congressman Oscar Moreno in the House of Representatives. The current version of the bill is called the "Corporate Recovery and Insolvency Act," — a consolidated law governing the entire bankruptcy field for corporate debtors, thereby effectively abrogating the Insolvency Act and Section 5(d) of Presidential Decree No. 902-A.

Based on the perception that the Philippine judicial system tends to be very slow in its process, and that even time bound and summary mandated proceedings are subject to unreasonable delay due to the use of jurisdictional and constitutional issues in certiorari proceedings, the original version of the bill mandated "fast-track rehabilitation proceedings," which if not approved by the major stakeholders, would push the proceedings into liquidation of the corporate debtors.

The objections interposed by many practitioners to the rather harsh version of the original bill has, therefore, allowed it to evolve into a sort of "code", comprehensively governing the whole gamut of corporate bankruptcy from simple suspension of payments, to corporate rehabilitation, and insolvency-liquidation proceedings. In addition, the bill seeks to have the code adhere to world-standards by, among other things, providing for cross-border recognition of insolvency administration.

There is no doubt that the paper of Congressman Oscar Moreno would do a better job of detailing the progress that has been made in moulding the various provisions of the bill. The more useful function of this paper is to discuss the concerns that the author raised in a formal paper submitted to the Congressional committee on the overall impact of the bill on the Philippine commercial and credit transaction setting.

In that paper, the author observed that the provisions of the bill tended:

1. to be unduly biased against secured creditors; and
2. had the effect of making the corporate vehicle a less attractive medium for doing business in the Philippines, thereby making credit extensions to corporations more costly.

It was observed in the paper:

“In focusing on corporate rehabilitation, and trying to do the best job at it, the draft CRA may have become a little short-sighted on the role that corporate rehabilitation plays in the world of Philippine commercial laws. Endemic or widespread corporate financial distresses should be considered unusual events or periods, and a particular corporate rehabilitation proceeding is more the exception, rather than the rule. Corporate rehabilitation as a process is essentially an extraordinary process, that goes against normal or usual corporate and business principles, and attempts to by-pass carefully built contractual relationships.”

“The CRA should be drafted on those bases; otherwise it would become unduly invasive of the general landscape for Corporate Law and Credit Transactions, and would make overall business climate in the Philippines more expensive than need be”. To “over-do” corporate rehabilitation system would actually risk putting the CRA on very shaky ground in terms of constitutional attacks, but more importantly, instead of engendering usage of the CRA, its intrusive, and sometimes solicitous provisions, may more likely encourage a whole process of “building around it,” so that in the end CRA would only have encouraged increasing the costs of credit transactions, and would actually place the corporate medium at an unnecessary disadvantage.

The general observations were based on the following provisions of the then version of the bill:

1. Even when rehabilitation is certain not to work, Sub-Chapter 4 on “Dissolution and Liquidation” would not allow the secured creditors to pursue their remedies of foreclosure. Instead there is every attempt to provide for an equitable distribution of the proceeds to benefit the unsecured creditors.

2. The cram-down provisions do not include an assurance that the equivalent of the value of the contractual proprietary value of their security is preserved.
3. Since the bill does not attempt to be an overall Insolvency Code of the Philippines, then the current Insolvency Act will remain valid and effective insofar as individual creditors are concerned, and because the Insolvency Act has a central philosophy of leaving secured creditors to the remedies available under the contracts, the dichotomy would most likely channel many credit accommodations to the individual officers/stockholders, or commit them to joint – and several (JSS) undertaking, making the credit regime very inefficient within the Philippine commercial and legal systems.

In particular, the paper discussed misgivings on particular provisions of the bill which did not properly classify creditors, and provided for personal liability of corporate directors and officers, thus:

Decision-Making of Creditors — The simple majority rule under Sec. 9 to bind all creditors, which clearly includes secured creditors, is way to low. In most statutory provisions, on matters of importance, especially those that affect individual proprietary rights, a higher vote is required, such as two-thirds of voting equity under Corporation Code, or the double-majority rule under the Insolvency Act.

Liability of Directors and Officers — Sec. 11 makes directors and officers personally liable for any claims of creditors that remain unpaid after the distribution of the proceeds from a liquidation.

Firstly, in the absence of the qualifying circumstances under Sec. 11, then it seems that personal liability attaches to directors and officers on the instances enumerated therein based on the “fact of office” and not on whether a director or officer has participated in the acts enumerated or has knowingly allowed them to happen without registering his objection as mandated under Section 31 of the Corporation Code.

Secondly, the use of the term “when a debtor has liquidated itself under proceedings other than those described in this Act,” in paragraph (a) as a basis for liability without proper parameters is dangerous. Supposing the secured creditors of the corporation decide to foreclose based on their security contracts, which would then have the effect of commencing liquidation, would such circumstances alone, make the directors and officers personally liable for unpaid debts of the corporation? The impetus should come from the other creditors who are granted by law the standing to bring the appropriate remedies under the CRA.

Thirdly, the operative facts under paragraph (b) are not clear upon which to pin personal liability. What is the basis upon which to say that the “value of the debtor’s assets has fallen below that of the debtor’s liabilities”? The audited financial statements, a specific evaluation of assets done by a specialist on behalf of a creditor?

What would be “reasonable steps” for a director/officer? Is bringing the matter to the board for the board to take proper action sufficient?”

Fourthly, the parameters of paragraph (c) are too broad and subject to abuse. What are “reasonable and good faith efforts to participate in the proceedings”? When has there been compliance on non-compliance with the obligation to “develop and disclose a plan pursuant to the requirements in this Act?”

The essence of personal liability is fraud or personal culpability or gross negligence under the Corporation Code. Because of the broad languages of CRA on director/officer personal liability, then who would dare accept responsible positions in corporations. The overall effect of such provisions is to effectively place beyond reach qualified persons to serve a corporation; and perhaps only those who have no choice and are unqualified to serve, and consequently corporate governance suffers overall under the Philippine setting, which would then engender, rather than prevent, corporate failures.

Fifthly, the wide discretion given to the courts under the last paragraph of Section 11 allows for much corruption and use of pressure to allow certain parties to get what they want from the courts.

Finally, the basis of liability for directors and officers under Sec. 11 must legally mean a breach of the imputed obligations under the same section. Which would then mean that by being personally liable under Sec. 11, the directors and officers would at the same time be criminally liable under Sec. 103, which imposes fine and imprisonment for a director or officer who “shall knowingly violate a prohibition or knowingly fail to undertake an obligation established in this Act.”

The bill is currently undergoing debate and scrutiny within the technical committee level of the House, where not only expert representatives of the banking, insurance and other commercial sectors of Philippine society have been invited to participate, but also leading corporate and commercial law practitioners to ensure that the bill, once it becomes law, will serve the best interests of the Philippine commercial system, and assist it to become a strong participant in the global economic order.

THE INTERSECTION BETWEEN TAX & LABOUR LAWS IN CORPORATE INSOLVENCY PROCEEDINGS IN THE PHILIPPINES

by

*Manuel Yngson*⁵⁵

A. Prefatory Statement

A common policy issue that confronts those seeking to make improvements in an insolvency law system is the treatment to be accorded to tax and labour laws as they relate to insolvency proceedings.

In some insolvency law systems, labour laws, and to a certain extent, tax laws, are made superior to insolvency laws, and more specifically to the rights of creditors. In others, especially where the governing authorities have adopted the policy of extending financial assistance to financially distressed corporations, tax and labour claims are accorded subordinate status to the rights of creditors or the rehabilitation of the insolvent corporate debtor. In others, a mixture of these arrangements prevails.

B. Philippines Situation

In the case of the Philippines, this policy issue has been addressed by giving ranked preference to tax and labour claims in the distribution of the proceeds of liquidation but, at the same time, empowering the Commissioner of Internal Revenue (henceforth “Commissioner”), to enter into a compromise settlement over internal revenue tax assessments that could substantially reduce the tax obligation of the financially distressed taxpayer, to as low as only 10% of the basic tax assessed, or even lower.

Notwithstanding this positioning of tax and labour laws in relation to the insolvency law, problems arising from tax and labour claims still abound in corporate insolvency proceedings, whether for corporate rehabilitation or corporate liquidation.

C. Preference of Tax Claims in the Distribution of the Proceeds of Liquidation

Under the Insolvency Law of the Philippines (Act. 1956 as amended, “Insolvency Law”), the distribution of the proceeds of liquidation is made in accordance with the Rules of Concurrence and Preference of Credits under the Civil Code of the Philippines (“Civil Code”).

1. **Special Preference with regard to encumbered movable or immovable property.** Article 2241 of the Civil Code⁵⁶ enumerates the contractual or legal claims or liens over specific

⁵⁵Manuel Yngson is the Founding President of Corporate Recovery & Insolvency Practitioners (INSOLPHIL), Philippines

⁵⁶ Art. 2241. With reference to specific movable property of the debtor, the following claims or liens shall be preferred:

1. Duties, taxes and fees due thereon to the State or any subdivision thereof;
2. Claims arising from misappropriation, breach of trust, or malfeasance by public officials committed in the performance of their duties, on the movables, money or securities obtained by them;

movable property which are given *pari passu* and *pro rata* preference with regard to each other except for taxes, duties and fees due to the State which are given super-special preference; while Article 2242⁵⁷ enumerates the contractual or legal claims, mortgages and

3. Claims for the unpaid price of movables sold, on said movables, so long as they are in the possession of the debtor, up to the value of the same; and if the movable has been resold by the debtor and the price is still unpaid, the lien may be enforced on the price; this price is not lost by the immobilisation of the thing by destination, provided it has not lost its form, substance and identity; neither is the right lost by the sale of the thing together with other property for a lump sum, when the price thereof can be determined proportionally;

4. Credits guaranteed with a pledge so long as the things pledged are in the hands of the creditor, or those guaranteed by the chattel mortgage, upon the things pledged or mortgaged, up to the value thereof;

5. Credits for the making, repair, safekeeping or preservation of personal property, on the movable thus made, repaired, kept or possessed;

6. Claims for labourers' wages, on the goods manufactured or the work done;

7. For expenses of salvage, upon the goods salvaged;

8. Credits between the landlord and the tenant, arising from the contract of tenancy on shares, on the shares of each in the fruits or harvest;

9. Credits for transportation, upon the goods carried, for the price of the contract and incidental expenses, until their delivery and for 30 days thereafter;

10. Credits for lodging and supplies usually furnished to travelers by hotel keepers, on the movables belonging to the guest as long as such movables are in the hotel, but not for money loaned to the guests;

11. Credits for seeds and expenses for cultivation and harvest advanced to the debtor, upon the fruits harvested;

12. Credits for rent for one year, upon the personal property of the lessee existing on the immovable leased and on the fruits of the same, but not on money or instruments of credit;

13. Claims in favor of the depositor if the depositary has wrongfully sold the thing deposited upon the price of the sale

In the foregoing cases, if the movables to which the lien or preference attaches have been wrongfully taken, the creditor may demand them from any possessor, within thirty days from the unlawful seizure.

⁵⁷ Art. 2242. With reference to specific immovable property and real rights of the debtor, the following claims, mortgages and liens shall be preferred, and shall constitute an encumbrance on the immovable or real right:

1. Taxes due upon the land or building;

2. For the unpaid price of real property sold, upon the immovable sold;

3. Claims of labourers, masons, mechanics and other workers, as well as of architects, engineers or contractors, engaged in the construction, reconstruction or repair of buildings, canals or other works, upon said buildings, canals or other works;

4. Claims of furnishers of materials used in the construction, reconstruction, or repair of buildings, canals or other works, upon said buildings, canals or other works;

5. Mortgage credits recorded in the Registry of Property, upon the real estate mortgaged;

6. Expenses for the preservation or improvement of real property when the law authorises reimbursement, upon the immovable preserved or improved;

liens over specific immovable property and /or real rights of the debtor, which claims, liens etc. are likewise given *pari passu* and *pro-rata* preference with regard to each other except for taxes due upon the land or building, which are likewise given super-special preference.

2. **Super-special preferred tax claims over movable or personal properties.** Under the Civil Code, specifically Article 2243⁵⁸ in relation to Articles 2241 and Article 2247⁵⁹ thereof, claims for taxes, duties and fees due to the State with reference to a specific movable property of the debtor, is given number one preference over all the other contractual or legal claims on said movable property.
3. **Super-special preferred tax claims over immovable or real properties and rights.** Similarly, under the same Article 2243 in relation to Articles 2242 and 2249⁶⁰, taxes due upon the land or building are likewise given number one preference over other claims, mortgages and liens on said specific immovable property, or real rights of the debtor thereon.

D. Additional Special preference of taxes with regard to the unencumbered or “free portion” of the bankruptcy estate

Aside from the first preference given to taxes as legal liens over encumbered movable and immovable properties, taxes are further given special preference under the Civil Code by being included in the list of claims or credits which are preferred in the order named, with regard to the unencumbered or free portion of the bankruptcy estate. Under Article 2244⁶¹ of the Civil Code which

7. Credits annotated in Registry of Property, in virtue of a judicial order, by attachments or executions, upon the property affected, and only as to later credits;

8. Claims of co-heirs for warranty in the partition of an immovable among them, upon the real property thus divided;

9. Claims of donors of real property for pecuniary charges or other conditions imposed upon the donee, upon the immovable donated;

10. Credits of insurers, upon the property insured, for the insurance premium for two years.” (1923a).

⁵⁸ Art. 2243. The claims or credits enumerated in the two preceding articles shall be considered as mortgages or pledges or real or personal property, or liens within the purview of legal provisions governing insolvency. Taxes mentioned in No. 1, article 2241, and No. 1 article 2242, shall first be satisfied.

⁵⁹ Art. 2247. If there are two or more credits with respect to the same specific movable property, they shall be satisfied *pro rata*, after the payment of duties, taxes and fees due the State or any subdivision thereof.

⁶⁰ Art. 2249. If there are two or more credits with respect to the same specific real property or real rights, they shall be satisfied *pro rata*, after the payment of the taxes and assessments upon the immovable property or real right.

⁶¹ Art. 2244. With reference to other property, real and personal, of the debtor, the following claims or credits shall be preferred in the order named:

1. Proper funeral expenses for the debtor, or children under his or her parental authority who have no property of their own, when approved by the court;

2. Credits for services rendered the insolvent by the employees, labourers, or household helpers for one year preceding the commencement of the proceedings in insolvency;

3. Expenses during the last illness of the debtor or of his or her spouse and children under his or her parental authority, if they have no property of their own;

consists of 14 items, “taxes and assessments” due to the national government, province and city/municipality, are given preference numbers 9, 10 and 11 respectively. Under Article 2245⁶² Common Credits or those credits which are not enumerated in either Articles 2241, 2242, 2243 or 2244, do not enjoy any preference at all.

E. Authority of the Commissioner to compromise payment of any internal revenue tax

While, under the Philippine legal system, taxes are given super-special preference in the distribution of the proceeds of liquidation, ahead even of the claims of secured creditors and other lien holders, on another extreme, under Section 204 of the National Internal Revenue Code of 1997⁶³ (henceforth “NIRC”), the Commissioner may substantially reduce the taxes of an insolvent taxpayer where the “financial position of the taxpayer demonstrates a clear inability to pay the assessed tax”.

4. Compensation due to the labourers or their dependants under laws providing for indemnity for damages in cases of labour accident, or illness resulting from the nature of the employment;

5. Credits and advancements made to the debtor for support of himself or herself, and her family, during the last year preceding the insolvency;

6. Support during the insolvency proceedings, and for three months thereafter;

7. Fines and civil indemnification arising from a criminal offence;

8. Legal expenses, and expenses incurred in the administration of the insolvent’s estate for the common interest of the creditors, when properly authorised and approved by the court;

9. Taxes and assessments due the national government, other than those mentioned in articles 2241, No. 1, and 2242, No. 1;

10. Taxes and assessments due any province, other than those referred to in articles 2241, No. 1, and 2242 No. 1;

11. Taxes and assessments due any city or municipality, other than those indicated in articles 2241 No. 1, and 2242 No. 1;

12. Damages for death from personal injuries caused by a quasi-delict;

13. Gifts due to public and private institutions of charity or beneficence;

14. Credits, which without special privilege, appear in (a) a public instrument; or (b) in a final judgment, if they have been the subject of litigation. These credits shall have preference among themselves in the order of priority of the dates of instruments and of the judgments, respectively.”

⁶² Art. 2245. Credits of any other kind or class, or by any other right or title not comprised in the four preceding articles, shall enjoy no preference.”

⁶³ Sec. 204. Authority of the Commissioner to compromise, abate and refund or credit taxes.- The Commissioner may compromise the payment of any internal revenue tax when:

1. A reasonable doubts as to the validity of the claim against the taxpayer exists; or

2. The financial position of the tax payer demonstrates a clear inability to pay the assessed tax.

The compromise settlement of any tax liability shall be subject to the following minimum amounts:

For cases of financial incapacity, a minimum compromise rate equivalent to 10% of the basic assessed tax; and for other cases, a minimum compromise rate equivalent to 40% of the basic assessed tax.

Where the basic tax involved exceeds P1,000,000.00 or where the settlement offered is less than the prescribed minimum rates, the compromise shall be subject to the approval of the Evaluation Board which shall be composed of the Commissioner and the four Deputy Commissioner

F. Tax problems in corporate rehabilitation/recovery proceedings

One would think that with the Philippine law on tax claims being positioned on both extremes of the spectrum, we no longer have any problem coming from tax claims in corporate rehabilitation/recovery proceedings.

Unfortunately, we still do. For one, the discretion conferred on the Commissioner to reduce any internal revenue tax to as low as only 10% of the basic tax or even lower if approved by the Evaluation Board which is composed of the same Commissioner and his four Deputies, is so broad ranging from 100% of the basic tax plus surcharges of 25% per annum, interest of two 2% per month and penalty, down to less than 10% that the process becomes pregnant with possibilities. Moreover, while proving inability to pay the assessed tax may be easy, proving the extent of such inability which inevitably determines the compromise rate or amount, is much more difficult, "financial position" being a function of accounting principles, which latter, unlike laws, are not clearly defined nor strictly followed due to lack of legal sanctions. Furthermore, in a country where the tax collectors are, more often than not unable to meet their tax collection target due to either too high targets or too low efficiency in tax collection, compounded by an ever-increasing national budget deficit, the chances of an equitable reduction of tax payment on the part of a corporation undergoing insolvency proceedings are very slim indeed.

There are also the other provisions of the NIRC that muddle, if not exacerbate, the already problematic situation of insolvent corporations and their creditors:

1. **Authority of the Commissioner to prescribe realty values as basis for tax collection.** Under Section 6(E) of the NIRC⁶⁴, the Commissioner, in collecting taxes, has divided the Philippines into different zones or areas for the purpose of determining the fair market value of real properties located in each zone or area. These “fair market valuation” on zonal valuation are then used as basis for *ad valorem* taxes. There seems to be nothing wrong with this provision, except that once every three years the Commissioner increases the zonal valuation but even if real property values have actually gone down substantially as in the last five years, he does not correspondingly adjust the zonal valuation downwards. One has to go to court and incur litigation expenses to make the Commissioner just maintain instead of increase the zonal valuation.
2. **Capital gains tax from the sale or exchange of real property.** Then there is the 6% “capital gains tax” collected on the sale, exchange or disposition of lands and buildings which are classified as “capital assets”. Under Section 27(D)(5) of the NIRC⁶⁵, this tax is collected on the basis of the zonal valuation or the gross selling price stated in the Deed of Sale/Exchange whichever is higher. Parenthetically, despite its name of “capital gains tax,” since the tax collection is made whether capital gain is actually realised or not, this tax is actually a transaction tax, with the gain being merely presumed.

⁶⁴ Sec. 6(E) *Authority of the Commissioner to prescribe real property value.* The Commissioner is hereby authorised to divide the Philippines into different zones or areas and shall, upon consultation with competent appraisers both from the private and public sectors, determine the fair market value of real properties located in each zone or area. For purposes of computing any internal revenue tax, the value of the property shall be whichever is the higher of:

1. the fair market value as determined by the Commissioner; or
2. the fair market value as shown in the schedule of values of the Provincial and City Assessors.

⁶⁵ Sec. 27(D)(5) *Capital gains realised from the sale, exchange or disposition of lands and /or buildings.* A final tax of 6% is hereby imposed on the gain resumed to have been realised on the sale, exchange or disposition of lands and/or building which are not actually used in the business of a corporation and are treated as capital assets, based on the gross selling price or fair market value as determined in accordance with Section (E) of this Code, whichever is higher, of such lands and/or buildings.

3. **Documentary Stamp Taxes.** There are also the various documentary stamp taxes under Title VII of the NIRC which are collected not only on the sale and conversion of real and personal properties as well as shares of stocks but also on the execution of loan agreements, promissory note, leases, mortgages, pledges, etc., non payment of which under Section 201 of the NIRC⁶⁶ will bar the recording of the documents in the Registry of Deeds thus preventing the formal transfer or annotation or encumbrance of the property. The documentary stamp tax on the sale of real property is fifteen pesos (P15.00) for every one thousand Pesos (P1,000.00) of value, or 1 ½ %.
4. **Requirement of Tax Clearance.** Additionally, under Section 56(A)(3) last paragraph of the NIRC⁶⁷ in connection with the payment of capital gains tax, it is specifically provided, that:
5. “No registration of any document transferring real property shall be effected by the Register of Deeds unless the Commissioner or his duly authorised representative has certified that such transfer has been reported, and the tax herein imposed, if any, has been paid.”

Similarly, Sec. 58(E) of the NIRC⁶⁸ provides:

⁶⁶ Sec. 201 *Effect of failure to stamp taxable document.* An instrument, document or paper which is required by law to be stamped and which has been signed, issued, accepted or transferred without being duly stamped, shall not be recorded nor shall it or any copy thereof or any record of transfer of the same be admitted or used in evidence in any court until the requisite stamps shall have been affixed thereto and cancelled.

No notary public or other officer authorised to administer oaths shall add his *jurat* or acknowledgment to any document subject to documentary stamp tax unless the proper documentary stamps are affixed thereto and canceled.

⁶⁷ Section 56 (A)(3). No registration of any document transferring real property shall be affected by the Register of Deeds unless the Commissioner or his duly authorised representative has certified that such transfer has been reported, and the tax herein imposed, if any, has been paid.

⁶⁸ Section 58 (E). *Registration with Register of Deeds* No registration of any document transferring real property shall be effected by the Register of Deeds unless the Commissioner or his duly authorised representative has certified that such transfer has been reported, and the capital gains or creditable withholding tax, if any, has been paid; provided, however, that the information as may be required by rules and regulations to be prescribed by the Secretary of Finance, upon recommendation of the Commissioner, shall be annotated by the Register of Deeds in the Transfer Certificate of Title or Condominium Certificate of Title; provided, further, that in cases of transfer of property to a corporation, pursuant to a merger, consolidation or reorganisation, and where the law allows deferred recognition of income in accordance with Section 40, the information as may be required by rules and regulations to be prescribed by the Secretary of Finance, upon recommendation of the Commissioner, shall be annotated by the Register of Deeds at the back of the Transfer Certificate of Title or Condominium Certificate of Title of the real property involved; provided, finally, that any violation of this provision by the Register of Deeds shall be subject to the penalties imposed under Section 269^{of this Code.}

“Registration with Register of Deeds.- No registration of any document transferring real property shall be effected by the Register of Deeds unless the Commissioner or his duly authorised representative has certified that such transfer has been reported, and the capital gains or creditable withholding tax, if any, has been paid; x x x”

Applying the preceding tax provisions together, the effect is that a Receiver of a corporation undergoing rehabilitation or a Liquidator of a corporation undergoing liquidation cannot sell the real estate property of the insolvent debtor and pay creditors or generate funds for administrative expenses, without simultaneously paying the capital gains tax of 6% and the documentary stamp tax of 1½ % based on the zonal valuation of the Bureau of Internal Revenue or the gross selling price whichever is higher, because without such payment, there can be no tax clearance certificate and without such tax clearance certificate, the buyer cannot transfer title of the property to its name. As we will explain later this situation is even made worse, because of the compulsory transfer tax of one-half percent (½%) imposed by local taxation on the same sale of real property.

Parenthetically, the same set of tax laws, discussed above have in fact stymied even secured creditors from foreclosing on their real estate mortgage even where the Receiver or the Liquidator has already agreed to such foreclosure, because they will have to shoulder the same simultaneous tax payment. This was the experience of the bank creditors in the case of National Steel Corporation where the capital gain, documentary stamp and transfer taxes computed, if the foreclosure of mortgages were to be undertaken, amounted to over one billion Pesos (P1,000,000,000.00) out of assets valued at just over fourteen billion Pesos (P14,000,000,000.00). The secured creditors were eventually forced to settle with the insolvent debtor.

It can be argued that with the difficulties posed by these provisions, the Receiver or Liquidator can always avail of the provisions of Sec. 204 of the NIRC. Unfortunately, when an insolvent debtor goes to the Commissioner for a possible compromise settlement under Sec. 204, the process of reducing the tax is so painstakingly slow, not to mention complicated that the insolvency proceedings are often halted while awaiting the decision of the Commissioner on the compromise settlement.

Moreover, the prospect of receiving proceeds from the intended sale is often used as a reason by the Commissioner either to deny, or approve only a slight tax reduction instead of the maximum discount, because commonly, the Commissioner would interpret “clear inability to pay the assessed tax” on the basis of the available cash instead of the net worth of the insolvent entity.

There is therefore a need to revisit these tax provisions again when applying them to financially distressed taxpayers, in order to facilitate corporate insolvency proceedings in the Philippines.

G. Other tax provisions impacting on corporate insolvency proceedings

1. **Minimum corporate income tax on domestic corporations** — Sec 27(E)(1) of NIRC⁶⁹ provides for the imposition of a minimum corporate income tax of 2% of the gross income of domestic corporations, beginning on the fourth year from commencement of business

⁶⁹ Sec. 27(E)(1) Minimum corporate income tax on domestic corporations. Imposition of tax.- A minimum corporate income tax of 2% of the gross income as of the end of the taxable year, as defined herein, is hereby imposed on a corporation taxable under this Title, beginning on the fourth taxable year immediately following the year in which such corporation commenced its business operations, when the minimum income tax is greater than the tax computed under subsection (A) of this Section for the taxable year x x x x”

operations. In the case of a financially distressed corporation already reporting losses, this tax imposition adds insult to injury.

2. **Imposition of tax on fringe benefits** — Under Section 33 of the NIRC⁷⁰, a fringe benefits tax of 32% is imposed as a final tax on the grossed up monetary value of fringe benefits furnished or granted by the employer to the employee, unless the fringe benefit is required by the nature of, or necessary to the trade, business or profession of the employer, or when the fringe benefit is for the convenience or advantage of the employer. This provision effectively prevents the giving of generous incentives to Receivers and Liquidators who, after all, determine the success or failure of the insolvency proceedings.
3. **Returns of receivers and trustees in bankruptcy** — Under Section 54 of the NIRC⁷¹ receivers and trustees in bankruptcy operating the property or business of the corporation are subject to the same corporate income taxes and required to make returns of net income in the same manner and form as the corporation was before required to make. No tax concessions at all are given to bankrupt corporate taxpayers under this provision.
4. **Gain realised or loss sustained in case of distribution of the proceeds of liquidation** — Under Section 73 of the NIRC⁷², where a corporation distributes all of its assets in complete liquidation or dissolution, the gain realised or loss sustained by the stockholders, whether individual or corporate, is a taxable income or a deductible loss, as the case may be. In view of this provision of the NIRC, stockholders who can take advantage of the deduction in case of loss would normally insist on the immediate distribution of the proceeds of liquidation whereas stockholders who still stand to realise some share in the proceeds of liquidation, would want the distribution to be effected in the taxable year where they could derive the

⁷⁰ Sec. 33. *Special treatment of fringe benefit.*

(A) *Imposition of tax* A final tax of 34% effective 1 January 1998; 33% effective 1 January 1999; and 32% effective 1 January 2000 and thereafter, is hereby imposed on the grossed-up monetary value of fringe benefit furnished or granted to the employee (except rank and file employees as defined herein) by the employer, whether an individual or a corporation (unless the fringe benefit is required by the nature of, or necessary to, the trade, business or profession of the employer, or when the fringe benefit is for the convenience or advantage of the employer). The tax herein imposed is payable by the employer which tax shall be paid in the same manner as provide for under Section 57(A) of this Code. The grossed-up monetary value of the fringe benefits shall be determined by dividing the actual monetary value of the fringe benefit by 66% effective 1 January 1998; 67% effective 1 January 1999; and 68% effective 1 January 2000 and thereafter; *provided, however*, that fringe benefit furnished to employees and taxable under subsections (B), (C), (D) and (E) of Section 25 shall be taxed at the applicable rates imposed thereat; *provided, further*, that the grossed-up value of the fringe benefit shall be determined by dividing the actual monetary value of the fringe benefit by the difference between 100% and the applicable rates of income tax under subsections (B), (C), (D) and (E) of Section 25.

⁷¹ Section 54. *Returns of Receivers, Trustees in Bankruptcy or Assignees.* In cases wherein receivers, trustees in bankruptcy, or assignees are opening the property or business of a corporation, subject to the tax imposed by this Title, such receivers, trustees, or assignees shall make returns of net income as and of such corporation, in the same manner and form as such organisation is herein before required to make returns, and any tax due on the income as returned by receivers, trustees, or assignees shall be assessed and collected in the same manner as if assessed directly against the organisations of whose businesses or properties they have custody and control.”

⁷² Section 73. *Distribution of dividends or assets by corporations.*— Where a corporation distributes all of its assets in complete liquidation or dissolution, the gain realised or loss sustained by the stockholder, whether individual or corporate, is taxable income or a deductible loss, as the case may be x x x

most advantage. In insolvency proceedings, especially liquidation, stockholders pushing or hindering the proceedings could sometimes be a pest.

5. **Transaction Deemed Sale** — Under Section 106(B) of the NIRC⁷³ the following transactions are considered as sale: the “distribution or transfer to X, Y, Z creditors in payment of debt”; or, the “retirement from or cessation of business, with respect to inventories of taxable goods existing as of such retirement or cessation.” While this provision specifically applies to the payment of the ten percent (10%) value added tax on sale of goods or properties, a proposed distribution of the proceeds of liquidation in kind rather than cash may be stymied because there is now a tax component if creditors are paid in kind in the form of goods intended for sale or for use in the course of business.
6. **Summary remedies of the Bureau of Internal Revenue.**- Under Section 207 of the NIRC⁷⁴, upon failure of the taxpayer to pay the tax at the time required, the Commissioner may order the seizure and distraint of any goods, chattels, effects or personal property, including stocks and other securities, bank accounts etc. of the taxpayer, or levy on his real estate property. Under Section 218 of NIRC⁷⁵, this power of the Commissioner to distraint personal property and levy on real estate property may not be enjoined. The only remedy, therefore, is to pay the tax. Alternatively, of course, there could again be a resort to the power of the Commissioner to enter into a compromise agreement. But as discussed above, this is easier said than done.

Is examination of the foregoing tax provisions with the view of relaxing their implementation as regards insolvent corporations is perhaps in order. After all, the clear intent of the legislature under Sec. 204 of the NIRC is really to give special privilege to insolvent taxpayers in the payment of taxes.

⁷³ Section 106 (B). *Transactions deemed sale*. The following transactions shall be deemed sale:

1. Transfer, use or consumption not in the course of business of goods originally intended for sale or for use in the course of business;
2. Distribution or transfer to: Shareholders or investors as share in profits of the VAT registered persons; or Creditors in payment of debt;
3. Consignment of goods if actual sale is not made within 60 (60) days following the date such goods were consigned;
4. Retirement from or cessation of business, with respect to inventories of taxable goods or existing as of such retirement or cessation.

⁷⁴ Section 207. *Summary Remedies*. Upon the failure of the person owing delinquent tax or delinquent revenue to pay the same at the time required, the Commissioner or his duly authorised representative, if the amount involved is in excess of P1,000,000.00 or the Revenue District Officer, if the amount involved is P1,000,000.00 or less, shall seize and distraint any goods, chattels or effects, and the personal property, including stocks and other securities, debts, credits, bank accounts, and interests in and rights to personal property of such persons in sufficient quantity to satisfy the tax or charge, together with any increment thereto incident to delinquency, and the expenses of the distraint and the cost of the subsequent sale x x x

⁷⁵ Section 218. *Injunction not available to restrain collection of tax*. No court shall have the authority to grant an injunction to restrain the collection of any national internal revenue tax, fee or charge imposed by this Code.

H. Local Taxation

Aside from internal revenue laws, corporate insolvency proceedings both for corporate rehabilitation and corporate liquidation have also to contend with local taxation under the Republic Act. No. 7160 otherwise known as the Local Government Code (henceforth “LGC” for short).

Under the LGC, local government units namely provinces, cities, municipalities and barangays are given various powers to impose not only regulatory fees and other exactions, but local taxes as well.

1. Provinces

In the case of provinces, for example, one of their major powers is to collect a tax on the transfer of real property amounting to ½% of the total consideration involved or the fair market value, whichever is higher. If you recall, the capital gains tax of 6% and the documentary stamp of 1 ½ % are already collected before title to real estate property may be transferred, so you have to add another ½% to this to give a total of 8%. Under Section 135(b) of the LGC,⁷⁶ this transfer tax has to be paid before any transfer of real property may be registered with the Registry of Deeds.

2. Municipalities outside Metro Manila

In the case of municipalities outside Metro Manila, they are empowered to collect taxes on business, ranging from 37.5 % of 1% of gross sales or receipts on manufacturers, to ½% of gross sales in the case of wholesalers, distributors and dealers, as well as contractors, banks and financial institutions, to 2% on P400,000.00 or less and 1% on the excess of gross sale of retailers.

3. Municipalities in Metro Manila and Cities in general

Municipalities situated in Metro Manila are allowed to collect business taxes based on the gross sales or gross receipts up to 50% higher than the above rates allowed for municipalities outside the Metro Manila area. [Sec. 144, LGC]⁷⁷. Cities may levy the same taxes, fees and charges which may be imposed by the province or municipality at up to 50% higher rates. [Sec. 151, LGC]⁷⁸

⁷⁶ Section 135(b). *Tax on transfer of real property ownership.* For this purpose, the Register of Deeds of the province concerned shall, before registering any deed, require the presentation of the evidence of payment of this tax. The provincial assessor shall likewise make the same requirement before cancelling an old tax declaring and issuing a new one in place thereof. Notaries public shall furnish the provincial treasurer with a copy of any deed transferring ownership or title to any real property within 30 days from the date of notarisation. It shall be the duty of the seller, donor, transferor, executor or administrator to pay the tax herein imposed within 60 days from the date of the execution of the deed or from the date of the decedent’s death.

⁷⁷ Section 144. *Rates of tax within the Metropolitan Manila area.* The municipalities within the Metropolitan Manila Area may levy taxes at rates which shall not exceed by 50% the maximum rates prescribed in the preceding section.

⁷⁸ Section 151. *Scope of taxing power.* Except as otherwise provided in this Code, the city may levy the taxes, fees and charges which the province or municipality may impose, provided, however, that the taxes, fees and charges levied and collected by highly urbanised and independent component cities shall accrue to them and are distributed in accordance with the provisions of this Code. The rates of the taxes that the city may levy may exceed the maximum rates allowed for the province or municipality by not more than 50%, except the rates of professional and amusement taxes.

4. Barangay

In the case of barangays, they are also authorised to collect 1% of the gross value or receipts of stores or retailers amounting to P50,000.00 in the case of barangays in cities and P30,000.00 in the case of barangays in municipalities. [Sec. 152(a), LGC]⁷⁹

More importantly, there is a requirement for barangay clearance under Section 152(c) of the LGC.⁸⁰ Unless this tax clearance is duly obtained, no city or municipality may issue any license or permit for any business activity. It is not the amount involved therefore, but the fact of the requirement of the barangay clearance that makes it an important compliance requirement especially for a corporation undergoing insolvency proceedings.

5. Real estate or real property tax

Provinces, cities and municipalities in Metro Manila are in addition, allowed to collect real property tax on real property situated within their respective territories. This collection of real property tax is considered ordinary compared to similar taxes in other jurisdictions, except that in the LGC of 1991, the definition of “machinery” was expanded to include those “which may or may not be attached permanently or temporarily to the real property xxx, those which are mobile, self-powered or self-propelled and those not permanently attached to the real property xxx” [Section 199 (o)]⁸¹

Considering that the traditional definition of machinery to be considered as realty is that it must be “permanently attached to the land”, this definition is indeed an “expansion” that makes practically all types of machinery used in business as subject to real property tax.

The real property tax is an *ad valorem* tax assessed, levied and collected in all provinces, cities and municipalities in Metro Manila on land, buildings, machineries and other improvements affixed to the real property and not specifically exempted by law. The tax the maximum of which is 1% for the province and 2% for cities and municipalities in Metro Manila [Sec. 233, LGC], is based on the assessed value or the taxable value levied as a percentage of the value of the property located within the boundaries of the taxing governmental unit. The assessed value is the fair market value of the real property multiplied by the assessment level. The assessment level in turn is the percentage applied to the fair market value to determine the taxable value of the property; for example, depending on its fair market value as declared by the owner or determined by the local assessor, the assessment level of

⁷⁹ Section 152(a). *Taxes*. On stores or retailers with fixed business establishments with gross sales or receipts of the preceding calendar year of P50,000.00 or less in the case of cities; and P30,000.00 or less, in the case of municipalities, at a rate not exceeding 1% on such gross sales or receipts.

⁸⁰ Section 152(c). *Barangay Clearance*. No city or municipality may issue any licence or permit for any business or activity unless a clearance is first obtained from the barangay where such business or activity is located or conducted. For such clearance, the sangguniang barangay may impose a reasonable fee. The application for clearance shall be acted upon within seven working days from the filing thereof. In the event that clearance is not issued within the said period, the city or municipality may issue the said licence or permit.

⁸¹ Section 199 (o). *Machinery*. Machinery embraces machines, equipment, mechanical contrivances, instruments, appliances or apparatus which may or may not be attached, permanently or temporarily, to the real property. It includes the physical facilities for production, the installations and appurtenant service facilities, those which are mobile, self-powered or self-propelled, and those not permanently attached to the real property which are actually, directly, and exclusively used to meet the needs of the particular industry, business or activity and which by their very nature and purpose are designed for, or necessary to its manufacturing, mining, logging, commercial, industrial or agricultural purposes.

residential land is 20%), while that of commercial land is 50%. The assessment level of residential buildings and other structures ranges from 10% - 60 % of the fair market value while that of commercial and residential buildings and other structures have an assessment level of 30%-80%.

Under Section 209(b) of the LGC⁸² it is the duty of the Registry of Deeds to require every person seeking to register a document transferring or encumbering real property to submit a certificate to the effect that real property subject of the transfer or encumbrance, as the case may be, has been fully paid of all real property taxes due thereon. Failure to submit such certificate will cause the denial of such registration.

6. Community tax

Cities and municipalities may also collect a Community Tax on corporations doing business within its boundaries. The amount of taxes under Section 158 of the LGC⁸³ is P500.00 plus an additional of two pesos for every P5,000.00 worth of real property or gross earnings.

⁸² Section 209 (b). *Duty of Registrar of Deeds to apprise assessor of real property listed in Registry.* (b) It shall also be the duty of the Registrar of Deeds to require every person who shall present for registration a document of transfer, alienation, or encumbrance of real property to accompany the same with a certificate to the effect that the real property subject of the transfer, alienation, or encumbrance, as the case may be, has been fully paid of all real property taxes due thereon. Failure to provide such certificate shall be valid cause for the Registrar of Deeds to refuse the registration of document.

⁸³ Section 158. *Juridical persons liable to Community Tax.* Every corporation no matter how created or organised, whether domestic or resident foreign, engaged in or doing business in the Philippines shall pay an annual community tax of P500.00 and an annual additional tax which in no case shall exceed P10,000.00 in accordance with the following schedules:

1. For every P5,000.00 worth of real property in the Philippines owned by it during the preceding year based on the valuation used for the payment of the real property tax under existing laws, found in the assessment rolls of the city or municipality where the real property is situated. P2.00; and

2. For every P5,000.00 of gross receipts or earnings derived by it from its business in the Philippines during the preceding year – P2.00

The dividends received by a corporation from another corporation however shall, for the purpose of the additional tax, be considered as part of the gross receipts or earnings of said corporation.

Again, this tax has an impact on insolvency proceedings not so much with the amount of tax collected, but the fact that under Sections 161, 162 and 163 of the LGC each corporation is required to pay the tax and secure a Community Tax Certificate not later than the last day of February of each year with such Certificate to be used in case of notarisation of documents, receipt of licence, certificate or permit from the government, payment of tax or receipt of money from the government and other official business transactions.

7. Mayor's Permit

These local taxes, especially the Mayor's permit to operate a business is a real inconvenience because under Section 147 of the LGC⁸⁴ it is mandatory for the operator of any business to secure such permit and failure to secure the same is sufficient ground for closure and stoppage of the operations of a business or establishment.

The worst part is that under Section 145 of the LGC,⁸⁵ even if the business is terminated, the full taxes for the last year of operation including the Mayor's permit, must still be paid before the business can be considered officially retired.

8. Time of payment of surcharge and penalties

Under Section 167 of the LGC⁸⁶, all local taxes fees and surcharge shall be paid within the first 20 days of January or of each subsequent quarter, as the case may be. If the local taxes, fees or charges are not fully paid on time an interest of 25% per annum and a penalty of 2% per month is imposed under Section 168 of the LGC⁸⁷.

9. Local government lien, distraint and levy

⁸⁴ Section 147. *Fees and charges.* The municipality may impose and collect such reasonable fees and charges on business and occupation and, except as reserved to the province in Section 139 of this Code, on the practice of any profession or calling, commensurate with the cost of regulation, inspection, and licencing before any person may engage in such business or occupation, or practice such profession or calling.

⁸⁵ "Section 145. *Retirement of Business.* A business subject to tax pursuant to the preceding sections shall, upon termination thereof, submit a sworn statement of its gross sales or receipts for the current year. If the tax paid during the year be less than the tax due on said gross sales or receipts of the current year the difference shall be paid before the business is considered officially retired.

⁸⁶ Section 167. *Time of payment.* Unless otherwise provided in this Code, all local taxes, fees, and charges shall be paid within the first 20 days of January or of each subsequent quarter, as the case may be. The sanggunian concerned may, for a justifiable reason or cause, extend the time for payment of such taxes, fees, or charges without surcharges or penalties, but only for a period not exceeding six months.

⁸⁷ Section 168. *Surcharges and penalties on unpaid taxes, fees or charges.* The sanggunian may impose a surcharge not exceeding 25% of the amount of taxes, fees or charges not paid on time and an interest at the rate not exceeding 2% per month of the unpaid taxes, fees or charges including surcharges, until such amount is fully paid but in no case shall the total interest on the unpaid amount or portion thereof exceed 36 months.

Unpaid local taxes, fees and charges are, pursuant to Section 173 of the LGC⁸⁸ considered as a lien which may only be extinguished upon full payment of the delinquent local taxes, fees and charges, including surcharges and interest.

Like in the case of internal revenue taxes, in local taxation there is also the remedy of distraint of personal property and levy on real property under Sections 175⁸⁹ and 176 of the LGC,⁹⁰ respectively.

What makes the warrant of distraint and levy for unpaid local taxes, fees and charges more bothersome, is that under Section 177 of the LGC,⁹¹ failure on the part of the local treasurer to issue or execute the warrant of distraint or levy within the period set by law shall mean his automatic dismissal from service. Naturally, the local treasurer would invariably cause the service of the warrant to prevent his automatic dismissal and in such case the insolvent corporation will have very little time to negotiate for a tax concession.

10. Exemption through local ordinances

⁸⁸ Section 173. *Local Government's Lien*. Local taxes, fees, charges and other revenues constitute a lien, superior to all liens, charges or encumbrances in favor of any person, enforceable by appropriate administrative or judicial action, not only upon any property or rights therein which may be subject to the lien but also upon property used in business, occupation, practice of profession or calling, or exercise of privilege with respect to which the lien is imposed. The lien may only be extinguished upon full payment of the delinquent local taxes fees and charges including related surcharges and interest.

⁸⁹ Section 175. *Distraint of personal property*. The remedy by distraint shall proceeds as follows:

(a) Seizure — Upon failure of the person owing a local tax, fee or charge to pay the same at the time required the local treasurer or his deputy may, upon written notice, seize or confiscate any personal property belonging to that person or any personal property subject to the lien in sufficient quantity to satisfy the tax, fee or charge in question, together with any increment thereto, incident to delinquency and the expenses of seizure. In such case, the local treasurer or his deputy shall issue a duly authenticated certificate based upon the records of his office showing the fact of delinquency and the amount of the tax, fee or charge and penalty due. Such certificate shall serve as sufficient warrant for the distraint of personal property aforementioned, subject to the taxpayer's right to claim exemption under the provisions of existing laws. Distraint personal property shall be sold at public auction in the manner herein provided for.

⁹⁰ Section 176. *Levy on real property*. After the expiration of the time required to pay the delinquent tax, fee, or charge, real property may be levied on before, simultaneously, or after the distraint of personal property belonging to the delinquent taxpayer. To this end the provincial, city or municipal treasurer, as the case may be, shall prepare a duly authenticated certificate showing the name of the taxpayer and the amount of the tax, fee or charge and penalty due from him. Said certificate shall operate with the force of a legal execution throughout the Philippines. Levy shall be affected by writing upon said certificate the description of the property upon which levy is made. At the same time, written notice of the levy shall be mailed to or served upon the assessor and the Registrar of Deeds of the province or city where the property is located who shall annotate the levy on the tax declaration and certificate of title of the property, respectively, and the delinquent taxpayer or, if he is absent from the Philippines, to his agent or the manager of the business in respect to which the liability arose, or if there be none, to the occupant the property in question x x x.

⁹¹ Section 177. *Penalty for failure to issue and execute warrant*. Without prejudice to criminal prosecution under the Revised Penal Code and other applicable laws, any local treasurer who fails to issue or execute the warrant of distraint or levy after the expiration of the time prescribed, or who is found guilty of abusing the exercise thereof by competent authority shall be automatically dismissed from the service after due notice and hearing.

This situation of the insolvent corporation is made doubly difficult by the fact that under Section 192 of the LGC⁹², the only way to secure tax concession from the local government unit is through local ordinances granting tax exemption or relief. Naturally this will require a lobby for such ordinances and no corporation Receiver or Liquidator can have the time or funds for such a lobby.

11. Possible remedy

A possible remedy in the case of local taxation is a special law giving tax concessions to a taxpayer undergoing insolvency proceedings by deferring all tax payments due from it, whether national or local, to the end of the rehabilitation proceedings, or the liquidation proceedings as the case may be. If the corporate rehabilitation is successful, then the local government unit will be paid the taxes, fees and charges due it as provided in the rehabilitation plan. On the other hand, if the corporate rehabilitation fails and resort to liquidation proceedings ensues, then the local government unit will share in the proceeds of liquidation in accordance with its preference under Article 2244 of the Civil Code discussed earlier.

I. Filing fees

Filing fees are not exactly taxes, but like internal revenue and local taxes, have an adverse impact on insolvency proceedings. The amount of filing fees for a petition for corporate rehabilitation or liquidation amounting to one-half percent (1/2%) of the value of the assets of an insolvent entity, was often a stumbling block in the filing of a petition for either a corporate rehabilitation or corporate liquidation, considering that either petition is normally resorted to when the corporation is already suffering from shortage of funds. Worse, the insolvent corporation is often unable to undertake the collection of its receivables because it has also to shoulder the same rate of filing fees based this time on the amount being claimed.

The Supreme Court, which is empowered to issue the rules of procedure including the regulation of the filing fees, has partially alleviated this situation by coming up recently, with its Administrative Memorandum No. 00-8-10-SC reducing the maximum filing fee for petition for corporate rehabilitation to P100,000.00 for assets or claims (whichever is lower) of up to P100,000,000.00 charging P10.00 for every 10,000.00 in excess of P100,000,000.00. Also, the Supreme Court allowed the staggering of payment of fees in excess of P100,000.00.

J. Preference of labour claims in the distribution of the proceeds of liquidation

In the case of labour claims, Article 110 of the Labour Code of the Philippines⁹³ gives workers special preference in case of bankruptcy or liquidation of an employer's business.

This special preference when applied to the Rules of Concurrence and Preference of Credits under the Civil Code, makes labour claims number one in the list of claims or credits enumerated under Article 2244, that are given preference in the order named.

⁹² Section 192. *Authority to grant tax exemption privileges.* - Local government units may, through ordinances duly approved, grant tax exemptions, incentives, or reliefs under such terms and conditions as they may deem necessary.

⁹³ Art. 110. *Workers preference in case of bankruptcy.* In the event of bankruptcy or liquidation of an employer's business, his workers shall enjoy first preference as regards to wages and other monetary claims, any provisions of law to the contrary notwithstanding. Such unpaid wages and monetary claims shall be paid in full before claims of the government and other creditors may be paid.

This makes the listing under Art. 2244 increase from 14 to 15, with labour claims being number one in the order named.

Notably, however, this number one preference of labour claims applies only to the free portion of the insolvent's property and does not apply to the contractual and legal liens enumerated under Articles 2241 and 2242 discussed earlier, where specific labour claims are already given preference over specific movable or real property.

K. Status of labour claims during corporate rehabilitation proceedings

On the other hand, during corporate rehabilitation proceedings, where the employees of the insolvent corporation are undoubtedly important stakeholders being the first to be affected by the success or failure of the rehabilitation, employees are not represented in the proceedings. The corporate rehabilitation proceedings invariably involves only the creditors represented by the Receiver and the stockholders and corporate debtor represented by the directors and officers. Employees do not directly participate in the corporate rehabilitation because presumably, until the business is finally closed they are not yet entitled to separation pay. On the other hand, if an employee files a labour claim other than for separation pay, such claim may not also be allowed, if there is an order staying the filing of action against the corporate debtor. This is the ruling of the Supreme Court in the cases of *Rubberworld Philippines, Inc. vs. NLRC, Arellano et. al.* 305 SCRA 721 and *Rubberworld Philippines, Inc. vs. NLRC, Magsalin et. al.* 336 SCRA 433.

L. No need for change of laws on labour claims

Unlike tax laws, in the case of labour laws, considering that specific labour claims are already given special preference over specific movable and immovable real property under Articles 2241 and 2242 of the Civil Code (No. 6 in Art. 2241 and No. 3 and in Art. 2242) and labour claims in general are given number one preference in the free portion of the bankruptcy estate under Art. 2244, we believe there is no urgent need to change our present laws concerning labour claims even if the employees of the insolvent corporation do not directly participate in corporate rehabilitation proceedings, for they can always raise legal objections in case of fraud or illegal actions. Employees should not have a major say on how the insolvent corporation will be rehabilitated.

Thailand

BUSINESS INSOLVENCY IN THAILAND: REFORM AND REHABILITATION

by

*Richard F. Broude*⁹⁴

I. Introduction

This report was commissioned by the OECD to provide an independent expert background and basis for a peer discussion of the Thai insolvency regime, in the context of the second meeting of the Forum for Asian Insolvency Reform (FAIR). While the opinions expressed here do not necessarily represent the OECD or other FAIR partners, the report has been edited to reflect a balanced view of key Thai issues and reform effort, and provide a preliminary set of recommendations for the future.

The report deals, in general terms, with bankruptcy and insolvency “as a defining characteristic of a market economy; one that demarcates the limits of extending credit, confronting risk, entrepreneurial venture, and corporate self-determination; it engages all sectors of the economy; and it expresses fundamental conflicts at the heart of the capitalist political economy between labour and capital, owners and managers, debtors and creditors, and the state and the market.”⁹⁵ The manner in which a particular country deals with a failing or distressed enterprise says volumes about the value that country places upon the bankruptcy goals of preserving value, saving jobs, and allocating resources.

In particular terms, this report addresses the manner in which Thailand’s insolvency regime, formal and informal, has responded to the financial crisis that began in 1997 and affected most of the economies in Asia. It measures that system against the general goals set out above. Given the importance of a bankruptcy regime to a country’s economy, it comes as no surprise that much has been written about how the various countries in the region responded to the crises, with a particular emphasis upon insolvency regimes.⁹⁶

During the course of my investigations for this report, I was privileged to have met and spoken to many individuals in the public and private sectors who are intimately involved with seeing that Thailand deals in the best way possible with the fallout from the financial crisis. None of these individuals are identified by name in this report, and the conclusions that are drawn from these conversations are a synthesis of many views.

The focus here is upon rehabilitation, not liquidation, although Thai law provides for both. Until 1998, Thai insolvency law dealt solely with liquidation; rehabilitation was not provided for. As shall be seen, governmental agencies, along with the business and financial communities, invented informal procedures for dealing with the dislocations and failures caused by the 1997 crisis, and the legislature was not far behind. After amending Thailand’s insolvency law in 1998 to provide for rehabilitation, the legislature again amended the law in 1999. However, the current status of Thailand’s insolvency regime cannot be understood without a discussion of the events and processes that went before.

⁹⁴ Richard F Broude is a Lawyer based in New York, USA

⁹⁵ Bruce G. Carruthers and Terence C. Halliday, “*Rescuing Business*,” 1 (Clarendon Press 1998).

⁹⁶ See especially “*Insolvency Systems in Asia: An Efficiency Perspective*” (OECD 2001) (hereinafter “*Insolvency Systems*”).

PART I: AN OVERVIEW OF INSOLVENCY REFORM: SETTING THE STAGE

A. *Dealing with the Crisis*

The financial crisis that began in 1997 resulted in a number of extraordinary measures designed to stabilise Thailand's economy. Led by the International Monetary Fund ("IMF"), a number of institutions and governments agreed upon a loan programme accompanied by prescribed reforms in a number of sectors of the Thai economy. The rescue package consisted of a 34-month standby arrangement valued at US\$ 3.9 billion.⁹⁷ The current Thai government is considering repayment of the IMF loan.

As events unfolded, the government of Thailand realised that other measures were needed to deal with the dislocations caused by the trauma to economic activity. Thus, a "non-intrusive market-led strategy for debt restructuring", *Brink* at 47, was adopted, that included tax relief, changes to the laws dealing with foreign investment and ownership of real estate, out of court mechanisms for workouts, and "improvements in the country's bankruptcy, foreclosure, and secured-lending laws." *Id.*

Other reforms were instituted. These included establishment of the Thailand Financial Accounting Standards Board, strengthening the Institute of Certified Accountants and Auditors of Thailand, modernising the rules governing listing on the Stock Exchange of Thailand, attempting to modernise disclosure requirements, revising the guidelines for corporate directors, and making financial reports more transparent, among other things.

B. *Stating the Problem*

Any analysis of the efficacy of informal and formal insolvency procedures must start with the setting in which these procedures are supposed to operate. No one has set the stage any better than Judge Wisit who, after pointing out that the immediate effects of the Asian economic crisis were the flotation of the Thai baht and the consequent effect on companies that had borrowed in foreign currencies, high interest rates aimed at currency stabilisation, currency outflow, and the shuttering of 56 finance companies affecting a large group of borrowers, states:

"As in many other countries in Asia the lending practice in Thailand concentrated more on collateral rather than on an analysis of cash flows. More often than not, Thai banks and finance companies in their lending required personal guarantees from owners and directors of the borrowing entities. One of the reasons this condition was accepted by the debtors might be the precedent that personal guarantees were not normally called upon for settlement of debt. Another reason might be the difficulty in differentiating the interests of the directors and owners of the borrowing companies who were often the same persons or a closely related group of persons.

⁹⁷ Ijaz Nabi and Jayasankar Shivakumar, "Back From the Brink," 24-27 (World Bank 2001) (hereinafter "Brink"). The "rescue package" was accompanied by "financial sector restructuring," "fiscal policy," and "monetary and exchange rate policy." *Brink* at 27.

In his recent and controversial book, "Globalization and Its Discontents", by Joseph E. Stiglitz (hereinafter "Discontents"), Nobel prize-winning economist, one-time Chairman of President Clinton's Council of Economic Advisers, and formerly the chief economist of the World Bank, the author observes, at 53, that "[f]iscal austerity, privatization, and market liberalization were the three pillars of Washington Consensus advice throughout the 1980s and 1990s." Professor Stiglitz argues that, while the Consensus may work in some countries, it is not a universal panacea for, and indeed may cause harm to, others.

Another weakness in the lending practice in Thailand was the emphasis on personal relationship.”⁹⁸

These conditions are exacerbated by the fact that Thailand, in common with other countries in the region, had weak and inefficient corporate governance structures in both corporations and financial institutions as well as ineffective prudential supervision. In addition, private banks (as well as non-bank financial companies) were owned and controlled by the same families that controlled the conglomerates. The result of these conditions is that large loans were frequently made by banks to companies controlled by the same families without much attention paid to underwriting standards.⁹⁹

The financial crisis resulted in business, accounting, and legal problems seldom if ever encountered before in Thailand. This circumstance led, in turn, to the hurried development of an informal way of dealing with financially distressed businesses and to the passage, in 1998 and 1999, of significant amendments to the Thai insolvency statute, which dated from 1940. Before the 1998 amendment, that statute had provided only for liquidation; the 1998 amendments for the first time provided a method of rehabilitating financially distressed enterprises. The 1999 amendments were designed to cure some of the perceived weaknesses of the 1998 statute. A separate piece of legislation, also passed in 1999, created the Central Bankruptcy Court.

C. The Role of International Organisations in Insolvency Reform

In some not insignificant part, the legislative developments (as well as other policies adopted by the Thai government) were part of the rescue package described above. Many of the international institutions that participated in the rescues of countries in distress, led by the World Bank and the IMF, insisted that any financial aid designed to ease the effects of the crisis be accompanied by legislative modernisation, with a focus upon insolvency laws.¹⁰⁰ The so-called “World Bank Insolvency Initiative” resulted in a paper entitled “*Principles and Guidelines for Effective Insolvency and Creditor Systems*.”¹⁰¹ In 1999, the IMF published “Orderly & Effective Insolvency Procedures: Key Issues.” The Asian Development Bank, in its 1999 and 2000 annual reports, detailed at length its Regional Technical Assistance for Insolvency Law Reform project, or “RETA.” The ADB’s 1999 report, entitled “*Insolvency Law Reform in the Asian and Pacific Region*” in *Law and Development at the Asian Development Bank*, 1999 Edition, pointed to “many of the inadequacies of the legal regimes in the region, and in particular, the failings of the insolvency regimes in the Bank’s developing member countries in Asia.” *Id.* at 7.

Each of these organisations called for the enactment of modern insolvency legislation, for improvement in the judicial systems employed to enforce that legislation, and for “transparency.” Suggestions were proffered as to how these admirable goals might be attained.

⁹⁸ Wisit Wisitsora-At, “*Country Report for Thailand*,” appearing in *Insolvency Systems*, *supra* n. 1, 397, 397-398.

⁹⁹ Il Chong Nam & Soogeun Oh, “*Asian Insolvency Regimes from a Comparative Perspective: Problems and Issues for Reform*,” appearing in *Insolvency Systems*, *supra* n.2, 19, 33-35.

¹⁰⁰ *Discontents*, *supra* n. 3 at 118, argues that the IMF strategy for corporate restructuring was flawed because it led debtors to believe that real restructuring could be delayed, if not put off forever, by foot-dragging and other tactics of delay. In addition, the author states, at p. 18, that “after the 1997 Asian crisis, IMF policies exacerbated the crises in Indonesia and Thailand.”

¹⁰¹ The principles and guidelines are set out in Gordon W. Johnson, “*The World Bank’s global insolvency principles*,” appearing in *Global Insolvency & Restructuring Review* 28 (May/June 2001).

D. The Key Areas of Insolvency Reform

At a November, 1999, meeting in Sydney, Australia, sponsored by the OECD and others, entitled *Insolvency Systems in Asia: an Efficiency Perspective*; certain conclusions were reached about the importance of insolvency reform. As reported in *Insolvency Systems* at 8-16, these conclusions were:

- An efficient and effective insolvency system is pivotal for long-term economic recovery and growth.
- There is no “one-size fits all” solution.
- Notwithstanding the considerable flexibility in designing a well-functioning insolvency system, certain core features are essential to all insolvency regimes. Included within this rubric are efficiency, predictability, the realisation that not all businesses can be saved—some must be liquidated, an appropriate balancing of debtor and creditors’ rights, and dealing with shortcomings in the institutional infrastructure.
- Formal and informal mechanisms should complement and support one another.
- Insolvency reform must be accompanied by a broader set of reforms in related areas.

Focusing more specifically on statutory reform, a specific set of criteria were used in FAIR I by which one should judge the efficacy of a rescue statute. These are:

- **Access.** “Does the law enable the reorganisation process to be easily and inexpensively commenced?”
- **Automatic stay.** “Does the law provide for an immediate automatic stay?”
- **Continued Management.** “Does the law adequately provide for the ongoing management and control of an enterprise that seeks to be reorganised?”
- **Provision of new money.** “Does the law provide for a commercially sound form of priority for the on going finance funding that may be required to keep the enterprise liquid?”
- **Time frame.** “Does the law provide for a speedy but sensible time frame for the progress of a case of reorganisation?”
- **Information to creditors.** “Does the law adequately provide for creditors to receive sufficient and reliable information concerning the enterprise and the reorganisation proposal or plan?”
- **Voting rights and requirements.** “Does the law adequately provide for creditor voting rights and their exercise?”
- **Basic requirements of reorganisation plans.** “Does the law ensure that a plan of reorganisation meets some fundamental basic requirements?”
- **Supervision of the process.** “Does the law provide for adequate overall supervision of the reorganisation process?”

- **Conversion to liquidation.** “Does the law provide for conversion to liquidation if creditors do not accept a reorganisation plan or if the plan is not implemented?”¹⁰²

There can be no quarrel with the proposition that these criteria are among the hallmarks of sophisticated and workable insolvency regimes. Whether enactment of a sophisticated insolvency statute leads to a sophisticated insolvency system is, however, a different matter altogether. One must remember always, as Professor Stiglitz points out, that “one cannot simply graft the laws of one country onto the customs and norms of another.” *Discontents*, p. 237. After all, it took the United States the better part of a century, which included the Great Depression and two world wars, to arrive at present chapter 11, one of the sources of the 1998 Thai legislation. Some things, it can safely be concluded, don’t happen overnight. As has been stated:

“[W]hat is required, perhaps more urgently in Thailand than elsewhere, is an understanding of closely controlled companies. Even though they may be listed on the Stock Exchange of Thailand, a number of these organisations have what could euphemistically be termed a unique approach to financial control, corporate governance and indeed, their trading practices.”¹⁰³

An assessment of the efficacy of the Thai system need not and should not contain invidious comparisons to the administration of insolvency systems in other countries, particularly those that have had decades to develop out of court mechanisms, insolvency legislation, and a sophisticated, honest, and well-paid corps of judges, trustees, and other administrators to manage the system created by the legislature and the participants in the credit industry. It should be made in light of the Thai culture and legal system, and address the manner in which the Thai insolvency system, including the amendatory legislation, has addressed Thai needs in light of that culture and that legal system.

PART II. THE THAI INSOLVENCY SYSTEM AND ITS IMPLEMENTATION: AFTER THE ASIAN CRISIS

A. The Legislative Framework

The 1997 crisis led to reforms in both the informal and formal insolvency systems. First, the Financial Sector Restructuring Authority (“FRA”) was established to take over the operations of 58 finance companies that were suspended following the crisis. All but two were closed, and the FRA held auctions to dispose of the assets of the finance companies. However, complex profit-sharing arrangements entered into to maximise sales prices has led to difficulties in computing dividends to creditors.

Next, the 1998 and 1999 amendments to the Thai laws for the first time provided for a rehabilitation regime. The legislation has been described as “a hybrid of US chapter 11 reorganisation and the Judicial Management of the Singaporean law.”¹⁰⁴ When the 1998 legislation was found to

¹⁰² These criteria were proposed to FAIR I by Clare Wee & Ron Harmer, “*Insolvency Reform in Asia: An Assessment of Recent Developments and the Role of the Judiciary*,” pp. 6-7, 11, presented at the Forum For Asian Insolvency Reform, Bali, Indonesia, February 2001. The authors go on to address other areas of concern, such as the development of an effective and honest judiciary with adequate resources to do the job assigned it, as well as the development of enough qualified people to perform as management of reorganising debtors.

¹⁰³ Steven Miller, *Corporate restructuring and insolvency: the view from Thailand*, appearing in *Global Insolvency and Restructuring Review*, page 15 (June/July 2000).

¹⁰⁴ Wisit, *supra* n. 4 at 404.

have some gaps and deficiencies, the 1999 legislation was passed in an attempt to cure them. The reforms encompassed by the legislation can be evaluated for present purposes by returning to the criteria developed at Fair I.

- **Access.** One of the most problematic areas of the Thai law is its insistence that the rehabilitation procedure be available only to businesses that are insolvent using the balance sheet test (assets are less than liabilities).¹⁰⁵ Mandating balance-sheet insolvency as the prerequisite to qualifying for rehabilitation means, among other things, that unless out of court procedures are in place and work, by the time a company qualifies for rehabilitation it may be too late. Long delays are the usual result when an involuntary petition is filed and the debtor contests solvency. Objective standards of proof are more readily available to show failure to pay debts as they come due than to demonstrate asset valuation or discover and evaluate off-balance sheet debt. At the present time, studies are underway regarding the possible amendment of the financial standard for commencing a proceeding. It may be that the standard should be different for voluntary and involuntary petitions.
- **Automatic stay.** An immediate and broadly applicable stay of creditor – secured and unsecured – proceedings comes into effect upon the court’s acceptance of the reorganisation petition. Acceptance generally is obtained the day after the petition is filed. The stay may be modified if, *inter alia*, a creditor is not being adequately protected. The stay also prevents the initiation or continuation of a petition seeking bankruptcy. The stay remains in effect until the time for implementation of the plan expires, or the plan has been successfully implemented, or when the court takes certain actions, such as dismissing the petition.
- **Management of the Debtor.** If the petition is approved by the court, a reorganisation order will be issued and a “planner” appointed. The planner controls the assets and business of the debtor, and also succeeds to shareholders’ rights (except for the right to receive dividends). The planner must prepare a reorganisation plan within three months (subject to two one-month extensions) of being notified of his/her appointment. Because of the possibility of personal liability under certain circumstances, “the Planner tends to be a specially incorporated vehicle consisting of the debtor’s existing management, or an accounting firm, or a joint venture between management and such a firm.”¹⁰⁶ The difficulties of such a regime were pointed out by Wee & Harmer, *supra*, when they observed that suspending management power “in favour of an independently appointed manager . . . has created some tension in Thailand because of a strong cultural aversion, mainly from owners and managers of corporations, to surrendering complete control.” It seems not uncommon for the planner to be suggested by the debtor rather than by creditors or by the court. Although the creditors may choose not to accept the debtor’s proposed planner and can elect their own, this seldom occurs. On some occasions, the debtor-proposed planner may seek to extend the proceedings by proposing unrealistic or unacceptable plans.

Still another management change may occur when the plan is approved and the plan administrator, described below, takes office.

- **Provision of new money.** Businesses in restructuring frequently need new capital in order

¹⁰⁵ Other criteria are that the debtor owes at least THB 10 million and that there exist reasonable grounds and means to reorganise the debtor’s business operations.

¹⁰⁶ Nipaporn Weskosith, Steven Miller and Nicholas Poole, “*Thailand*”, a chapter in *Insolvency & Restructuring 2002*, chapter 28, at page 193.

to operate. Lenders are often willing to provide that capital, but not unless they are assured that their loans will be afforded a first priority in repayment. While Thai law permits the planner to incur debt (by way of loans, goods or services necessary to operate the business), it does not specifically provide for priority in payment except when the case is converted to liquidation. This statutory omission is ripe for remediation.

- **Time frame.** The Thai law provides rather short time limits for all stages of the procedure. As set out earlier, a planner usually has three, and at most five, months to propose a plan. However, the time frame does get extended as creditors propose amendments to the plan. It is not uncommon for nine to 12 months to elapse before a vote on the plan is taken.
- **Information to creditors.** The debtor is obliged to turn its financial and other records over to the planner. No public examination of the debtor is required, in contradistinction of bankruptcy cases, in which such an examination is the norm. Creditors must file proofs of claim with the Official Receiver. That officer rules on objections to claims, which may be filed by creditors, the debtor, or the planner. When the planner presents a plan, creditors will be asked to vote upon it. In order to vote according to their best interests, a certain degree of information about the case, the debtor and its prospects should be provided. While some details are usually contained in the plan, Thai law generally falls short in this regard.
- **Voting rights and requirements.** The 1999 law increased the complexity involved in the process of plan approval as compared to the original 1998 legislation. Creditors are placed into classes. Each secured creditor with at least 15% of all secured debts must be placed in a separate class, while all other secured creditors are classified together. Unsecured creditors may be placed into one or more classes, although the claims in each class must be similar. Subordinated creditors comprise still another class. Once the plan has been proposed, the Official Receiver calls a meeting of creditors for the purpose of voting as well as for the purpose of determining whether any amendments are necessary or desirable. A plan is approved by “special resolutions” of the classes of creditors. That means that at least 75% in value and 50% in number of those voting in each class have voted in favour of the plan. However, if not all classes approve by special resolution, the plan may still be approved if at least one class passes a special resolution, and the members of that class who voted in favour of the plan hold at least 50% of the debt of all creditors who voted on the plan. This latter method of approval is similar to “cramdown” under Chapter 11 (that is, confirmation of a plan even if not all classes vote in favour). A creditor who votes against the plan may object. Once the plan is approved by creditors, it must be approved by the court. Court approval makes the plan binding upon all creditors.
- **Basic requirements of reorganisation plans.** A plan must contain, among other things, a description of the reasons for reorganisation, a description of assets and liabilities, and a description of the manner in which classes of creditors are being treated. Thai law contains a “best interests of creditors” test; that is, to approve the plan, the court must find that creditors are receiving at least as much under the plan as they would receive if the debtor were adjudged a bankrupt. In addition, the debtor must no longer be insolvent. Many plans contemplate nothing more than a rescheduling of liabilities, postponing the day of reckoning by including an unrealistic balloon payment that comes due at the end of the term of the plan.
- **Supervision of the process.** Once the plan has been approved, a plan administrator is appointed to oversee the implementation of the plan. A creditors’ committee may be appointed by creditors after the plan is approved to monitor the plan’s implementation

process. When the plan has been successfully completed, former management and shareholders' rights are restored.

- **Conversion to liquidation.** If the rehabilitation process fails, it is not a simple matter to place the debtor into liquidation. For this to happen, there must have been a previous petition seeking liquidation pending before it was stayed by the filing of an application seeking rehabilitation.

The liquidation statute has in many respects not kept pace with recent developments, and thus is not always able to satisfactorily serve one of its most important functions – to encourage companies to use the informal or formal reorganisation process. A creditor must petition for bankruptcy and demonstrate that the debtor is insolvent on a balance-sheet basis. If that showing is made, a receiving order is entered by the court, and the debtor's assets are vested in the Official Receiver. Thereafter, a meeting of creditors is called and the debtor is examined. At this meeting, it is for the creditors to decide whether the debtor should be adjudicated a bankrupt. The debtor may make a proposal for a composition, which may be accepted by special resolution. If it is not accepted, the debtor is adjudicated a bankrupt by the court.

Thereafter, the Official Receiver collects the debtor's assets and, in addition, is empowered to set aside certain pre-petition transactions. The Official Receiver will examine claims, object to those that are objectionable, and thereafter distribute the property of the estate in accordance with the statutory priorities.

The conditions described in Part I.B above that appertained when the Asian financial crisis began seem still to apply in some degree today. Family influence and governmental intervention are believed by many to distort the reconstruction process. The ability of recalcitrant debtors to cause delay by numerous and repeated lawsuits is a continuing impediment to the efficient working of the system. The TPI saga was pointed to by many as the prime example of this phenomenon. There, at least 30 complaints have been lodged against TPI's planner and plan administrator by TPI's management, and arrest warrants have been issued against executives of the plan administrator. Most of these efforts have been dismissed but they have held up the process.

Many participants in the process fear for their safety, and bodyguards are common. Creditors are reluctant to attack fundamental business problems, preferring to reschedule debt, pushing the real problems off to some later date. This has the effect of permitting banks to put these credits back on their balance sheets as performing loans, thus hiding the severity of their own problems.

However, there have been a number of positive results, including the consolidation of the troubled steel industry.

B. Institutional Arrangements

1. The Central Bankruptcy Court

Thailand's Central Bankruptcy Court came into existence in June 1999. The court has exclusive jurisdiction over all liquidation and rehabilitation cases and over all civil proceedings related to those cases. The 21 judges of the Central Bankruptcy Court are rotated in and out of the court. The rotation process minimises the efficacy of training programme that have been designed to enhance the judges' ability to deal fairly and wisely with the matters that come before them. The court has its own procedures that are governed by the Act establishing the court as well as by Rules promulgated in 1999 pursuant to Section 19 of that Act.

The court has been assigned the task of moving bankruptcy cases through the system as quickly as possible consistent with adequate attention. One of the most important results that can come from the court will be its influence on informal restructurings. If debtors and creditors can predict with some certainty what will happen if a formal proceeding is instituted, they might be more willing to reach an out of court deal. If, on the other hand, debtors perceive that the courts are being lenient with debtors in formal proceedings (e.g. the planner turns out to be an ally of the debtor), or that delay is the norm, they will be much less reluctant to take hard positions in out of court negotiations and more willing to institute a voluntary rehabilitation proceeding.

2. *Informal Mechanisms: CDRAC*

Even though the law provided for a court-supervised rehabilitation procedure, most restructuring negotiations still took place outside the judicial system, mostly because of the delay that seemed inherent in the latter. As one commentator put it, “the pace of restructuring remained slow,” even after the legislative reform.¹⁰⁷ The need for a more expeditious out of court mechanism to effectuate corporate restructurings resulted in the creation of the Corporate Debt Restructuring Advisory Committee (“CDRAC”), established under the aegis of the Bank of Thailand in 1998. As a consequence of initiatives promoted by CDRAC, in March 1999 a number of Thai and foreign financial institutions became parties to a Debtor-Creditor Agreement and an Inter-Creditor Agreement. Many debtors, financial institutions, and other creditors signed onto the agreements. These documents provided a framework for workouts, adopting the “best practices” guidelines of various earlier initiatives, including the “Bangkok Approach,” a set of principles broadly modelled on the London Approach of the Bank of England.

The Bangkok Approach that formed the template for CDRAC’s work was summarised in the “Framework for Corporate Debt Restructuring in Thailand,” a product of numerous public and private institutions. The Framework set forth 17 principles that were to guide debt restructurings. In addition, an appendix set forth a timetable to be followed in restructuring procedures, as follows: (i) a meeting of creditors is to be held on seven days’ notice. At that meeting a creditors’ committee and a lead bank are to be appointed. (ii) Within seven days, the debtor’s management is to submit detailed financial information and, upon the request of creditors, independent experts, such as accountants, are to be engaged. During the entire process, the debtor is required to submit such further information as is requested by the committee. (iii) Within three months of the first meeting of creditors, subject to an additional two month extension, the plan is to be submitted to all creditors. Ten days thereafter, creditors may propose amendments to the plan. (iv) Finally, creditors are to decide whether the debtor should be reorganised privately, formally reorganised under the Bankruptcy Act, or liquidated.

As stated in Vassiliou, *supra*:

“These [CDRAC] agreements are binding contracts that commit the signatories to follow a framework to expedite debt restructurings. The agreements bind the creditors who signed up to the terms for all debtors that subsequently sign a Debtor Accession agreeing to be bound by the Debtor-Creditor Agreement”.

“The agreements establish a process to disclose information, prepare and approve a restructuring plan, mediate debtor-creditor disputes and arbitrate inter-creditor disputes. . . . The CDRAC process begins with a first meeting of creditors to prepare a workout schedule and appoint a ‘Lead Institution’ that helps to co-ordinate the process. A steering committee of creditors may be

¹⁰⁷ Lampros Vassiliou, *Legal Issues: Thailand*, appearing in *Guide to Restructuring in Asia 2001*, at p. 126.

appointed. The process has, in practice, been very time compliance focused with often inadequate attention paid to the quality or feasibility of restructuring deals”.

Id. at 128-129.

Once the parties have agreed upon a plan, it is put to the vote of the creditors. If there are significant holdouts or other reasons exist, the court process may be used to approve the plan in a process very similar to that by which a pre-packaged plan is approved under chapter 11.

There were numerous problems with the CDRAC approach. Creditors were seemingly unable to make the “hard” decisions, choosing instead to postpone the problem to another day. Put another way, creditors did not force the debtor to undertake substantial “left-side-of-the-balance sheet” reforms, focusing only on “right-side-of-the-balance sheet” debt rescheduling.¹⁰⁸ Conversations with a number of participants in the process confirmed this conclusion.

The latest statistics concerning CDRAC’s work, published by the Bank of Thailand in October, 2002, show that CDRAC successfully restructured 10,272 debtors involving 1,364,675 million baht, while 1,671 restructurings involving 419,851 million baht failed.

CDRAC is no longer undertaking new matters. It had a defined lifespan, which has expired. CDRAC was not renewed because the new government believed that its initiative, the Thai Asset Management Corporation, would facilitate restructurings without the need for CDRAC. It is to the TAMC, therefore, that we now turn.

3. *The Thai Asset Management Corporation*

The most significant recent development by far has been the creation of the Thai Asset Management Corporation (“TAMC”).¹⁰⁹ TAMC came into existence on 9 June 2001. In very general terms, TAMC was created to speed up the process of dealing with non-performing loans (“NPLs”). It is a state agency, all of whose shares are owned by the Financial Institutions Development Fund (“FIDF”). At some future date, TAMC may issue additional shares that could be sold to the public.

TAMC is in the business of purchasing NPLs from government-owned and private Thai financial institutions, attempting to restructure those loans but, if that proves impossible, undertaking other action in accordance with its mandates.

TAMC is managed by a board of directors appointed by the Minister of Finance and approved by the Council of Ministers.

The guidelines governing purchase of NPLs is rather detailed. The most notable points are:

- All NPLs classified as substandard in government-owned financial institutions or asset

¹⁰⁸ The same observation was made in *Insolvency Systems*, *supra* n. 1, at 9, in which it was observed that participants in the Sydney meeting referred to earlier “noted certain debtors and creditors have engaged in ‘band-aid reconstruction’ by only rescheduling debts without attempting real restructuring.”

¹⁰⁹ See, generally, the detailed analysis of TAMC prepared in October, 2001, by Siam Premier law firm that may be found at its website, www.siamlaw.co.th/publications/tamc/htm; Cynthia Pornavalai, “*Thai Asset Management Corporation: Objectives and Powers*,” *Int’l Bus. Lawyer* 174 (April 2002); and The World Bank’s *Monitor*, April 2002, at 36-37.

management companies must be transferred to the TAMC. A transferor may not pick-and-choose which NPLs to transfer.

- NPLs of privately-owned financial institutions or asset management companies that are of sub-quality can be sold to TAMC only if they are collateralised.
- Non-Thai institutions are ineligible to transfer NPLs to the TAMC.
- Certain provisions contained in the decree make it difficult for private institutions to refuse to take part in the TAMC scheme.
- The overwhelming majority of NPLs transferred to the TAMC have come from government-owned institutions. This may be due, in part, to the fact that many of the NPLs owned by private institutions had been part of the CDRAC process. Another reason is that the pricing for NPLs transferred by state-owned transferors is more favourable than that offered privately-owned institutions.
- The purchase price of the transferred NPLs is paid by 10-year non-transferable notes guaranteed by the FIDF. A formula exists with respect to sharing of any gain or loss on the transferred NPL between the transferor and the TAMC.

TAMC has been given extraordinary powers with which to enforce its mandate. It has the powers to restructure debt, reorganise the debtor's business, dispose of the debtor's assets, and may foreclose on security interests without the necessity of instituting judicial proceedings. There are very few restrictions upon the way TAMC may accomplish these tasks. The debtor's consent is not even necessary in some cases. For example, with respect to debt restructurings, TAMC may extend maturities, reduce principal or interest, convert debt to equity, receive title to the debtor's assets to reduce debt, or engage in any other transaction that is deemed appropriate.

There are some restrictions upon TAMC's ability to reorganise the debtor's business. Some of these are reminiscent of the criteria for rehabilitation under the Bankruptcy Act. These restrictions are: (1) the debtor must be a juristic person; (2) TAMC must own more than 50% of the debt; (3) there must be a reasonable prospect for rehabilitation; and (4) the debtor must consent. If any one of these facts is not present, TAMC lacks the power to reorganise the debtor's business. Any reorganisation would then have to be done under the Act, if that statute's eligibility criteria are satisfied.

If the debtor's business is to be reorganised, TAMC must follow a programme that again is quite similar to that found in the Bankruptcy Act. If a reorganisation is agreed to, a planner and plan administrator are appointed, there is a time limitation for implementing the plan, and the plan is, when all is said and done, submitted to the Bankruptcy Court for approval. In this sense, the process is similar to the pre-packaged plan found in the United States.

According to a recent press release,¹¹⁰ 800 cases having a book value of 292,922 million baht had been concluded as of the end of August, 2002. This is up from 357 cases involving 134,252 baht in book value at the end of May, 2002.¹¹¹ Of the 800 cases, 349 cases with a book value of 134,252 million baht (46%) were approved for debt restructuring, while 51 cases with 14% of book value had

¹¹⁰ The press release, No. 9/2000 (12 Sept 2002), as well as other information concerning the operation of the TAMC, may be found at <http://www.tamc.or.th>.

¹¹¹ Press Release No. 7/2002 (7 June 2002).

gone through business rehabilitation in the bankruptcy court, and 390 cases with 38.6% of book value had undergone foreclosure or receivership. Of the cases that had been concluded, 31.7% by value were in the real estate sector and 28.1% in manufacturing. One other interesting statistic, gleaned from the earlier press release, is that about twice as many cases involved single-creditor loans as opposed to multiple-creditor loans. TAMC counts among its successes the successful restructurings of Advance Paint & Chemical (Thailand) Plc, Thai Cane Paper Plc, and Thai Copper Industries Plc.

Other information contained in TAMC publications or on its website reveal that it intends to use joint ventures and special purpose vehicles, among other things, to resolve cases. Its case-by-case evaluations are made with the help of financial advisors.

Outside observers tend to have reservations about the present and future effectiveness of TAMC. There is a developing consensus that: (1) TAMC is rescheduling rather than restructuring, with the result that it is merely postponing, not solving, problems; (2) it does not yet have the personnel necessary to accomplish its tasks; (3) the published statistics tend to overstate its performance;¹¹² (4) it is rather slow; and (5) it is not transparent enough so as to gain the full confidence of the marketplace.

According to The World Bank's "*Thailand Economic Monitor*," May 2002 at 37, part of the problem faced by TAMC is that its approach of balancing the positions of creditors, debtors and taxpayers runs head on into the private banks' approach to restructuring which, according to The World Bank, seeks to maximise recoveries.

Nevertheless, TAMC has created high hopes in the restructuring community. If managed properly, TAMC could be a pacesetter, thereby increasing the ability of financial institutions to work out their own NPLs.

4. Debt Restructurings Carried Out by Financial Institutions

Not all NPLs have been assigned to TAMC. A good deal of debt restructurings are being carried out by financial institutions. According to the recent report by the Bank of Thailand, approximately 40,000 cases, involving 101 million baht, were in the process of restructuring as of 30 September 2002. Approximately 75% of the cases and two-thirds of the value involved state-owned banks; the remainder involved commercial banks. More than 650,000 cases, involving more than 3 million **trillion** baht had been completed. By far the greatest number of cases (260,000) involve what is described in the report as "personal consumption".

PART III. CONCLUSIONS AND RECOMMENDATIONS

Most experts agree that the Bankruptcy Act itself, despite some shortcomings, is a very good law what is lacking is proper implementation. This due to a multitude of factors.

First, the companies most in need of business restructuring are frequently controlled by families with the power, prestige and influence to deny governmental and non-governmental institutions the power they need to liquidate businesses that need liquidating, restructure the business of companies that need restructuring, and reschedule the debts of enterprises that have sound businesses but may have temporary cash-flow problems.

Second, as strange as it seems, these problems are not being faced in part because of the improving economy. This leads to the perception that the Asian Financial Crisis is all but over, and

¹¹² See, e.g. Pornavalai, note 18 *supra*, at 185.

that all the distressed companies need is a little more time to rise with the tide of increased sales and a booming Thai economic environment. The problem, of course, is that no economic trend goes up (or down) forever. Sick or mismanaged companies do not become healthy or well-managed just because times are better. Underlying systemic problems will have to be addressed at some point, whatever the economy is like, and many of the enterprises whose debts were merely rescheduled will predictably return for further relief. Indeed, the best time for reform is when the system is not under pressure.

That said, there is nevertheless cause for some guarded optimism. Bank underwriting standards are slowly improving, as are bank regulatory practices. A goodly number of Thais have been trained in the business of restructuring, and one can look forward to their increased participation in the next round of restructurings and rehabilitations. Company managements, while still reluctant to lay off employees or modify business practices, may nevertheless be more cautious about adding more staff just because times are better.

The Central Bankruptcy Court is one of the real bright spots in the insolvency scene. However, its own statistics reveal that a large number of cases remain pending. It still needs improvement so that it might become more efficient. More training and increased spending on technology are immediate needs. The court (and Thai courts generally) seem reluctant to act expeditiously in any event, and particularly in cases involving creditors attempting to enforce their rights. Debtors are given too much free rein to clog the system and add to the delay.

There is a broad consensus that the Bankruptcy Act needs to be modified in some important respects, as follows.

1. The type of insolvency that permits access to the bankruptcy system should be modified to include equitable insolvency (the inability to pay debts as they mature) as well as balance sheet insolvency (where assets are less than liabilities). Perhaps the standard should be different for voluntary and involuntary cases.
2. The status of post-petition debt incurred in operating a debtor's business needs to be clarified and a priority afforded. This should lead to the increased availability of capital for companies operating in a formal reorganisation proceeding and perhaps make restructurings easier to accomplish.
3. If rehabilitation fails, the ability to put the debtor into bankruptcy needs to be made easier. Perhaps conversion to bankruptcy should be automatic unless a party in interest shows cause why dismissal of the case or some other remedy is appropriate. As it is, the difficulty of converting a case to bankruptcy permits insolvent and unviable businesses to continue operating.
4. The potential that the important players in a restructuring may incur personal liability discourages many qualified people from participating as planners, plan administrators, or acting in other roles. This possibility might even extend to employees of TAMC. It certainly inhibits bankers employed by state banks from making decisions for fear that, if their decisions turn out not to have been correct, their personal estates might be jeopardised. Legislation should be enacted to restrict personal liability to grossly negligent or fraudulent conduct.
5. The recent process of licensing insolvency practitioners, starting with planners and plan administrators, has had decidedly mixed results. While many believe that licensing enhances the quality of those involved in the restructuring process, the new regulations require that

planners must be Thai and that corporations that are planners must be Thai-owned and have a prescribed majority of Thai employees. If a planner is not licensed, a substantial bond is required, a requirement not easily satisfied. This has led to the development, noted above, of debtor's becoming their own planners, because debtors need not be licensed or bonded. It is too early to reach any conclusions about the licensing process itself, because the licensing committee has only recently started its work and there have been few applications.

There is some disagreement as to whether the current law favours debtors or creditors. As it is so hard to separate out the effects of the law from the effects of the way that the law is administered, it is almost impossible to determine which side of this argument is stronger. Studies are underway to determine if a debtor-in-possession scheme should be created.

The need for a new law dealing comprehensively with secured transactions is apparent. Statutory reform is needed with respect to types of property that can be taken as collateral and with respect to the manner in which perfection may be accomplished. At the same time, immediate and comprehensive reform of the ability of secured creditors to enforce their security interests is imperative. Speedy remedies frequently force debtors to face up to their problems sooner rather than later, resulting in timely, not delayed, remediation. The World Bank's "*Thailand Economic Monitor*". May 2002 at 35 points out that "the pace of restructurings has been undermined by the backlog of cases in the Civil Courts, where mortgages are enforced." According to the *Monitor*, there are **65,000** NPL cases awaiting judgment, a process that will take *seven* years to clear up, assuming no new cases.

Substantial improvements are needed to make the debt collection process speedy and relatively inexpensive. At the present time, it is next to impossible to obtain a judgment and proceed to execution on an unsecured claim in anything approaching a reasonable amount of time.

One of the distinct trends that became evident during the author's conversations in Thailand and elsewhere is the departure of the Westerners who were instrumental in getting the system off the ground in 1997 and who trained the Thais in the restructuring business. Part of the reason for this is the normal course of events. However, some allege that the corruption endemic to the system (family influence and governmental intervention, as described above) has driven them away.

Substantial progress has been made in Thailand, which was one of the first countries in the region to tackle directly and in a bold way the issue of insolvency immediately after the Asian crisis. But more needs to be done and there is a sense that the longer these needs are not addressed the tougher it will be to address them down the line.

Whether an optimistic view of the future is warranted will be discovered only when the next round of restructurings commences, whether they be re-entry or new NPLs. Will serious attention be given to restructuring the business? Will liquidation be forced when liquidation is called for? Will fine distinctions about how to treat differently situated businesses be recognised and acted upon? Will much-needed legislation be enacted? Will the irreversibility of reforms that have already been undertaken be guaranteed in the future? These are the key questions that need to be answered in the months and years to come and upon which hinges the success of the Thai approach to insolvency reform.

SUMMARY OF PROPOSED AMENDMENTS TO THAI BANKRUPTCY LAW

by

*Surasak Vasijit*¹¹³

The Thai government intends to further amend the Thai Bankruptcy Act. The amendments suggested to date revise a number of the reorganisation provisions enacted in 1998 and 1999 as well as amending a number of the provisions relating to bankruptcy proceedings. The amendments are expected to be implemented during 2003 although the precise timing of their passage through the parliamentary approval process remains unclear. The main effect of the proposed amendments is as follows:

Reorganisation proceedings

- Registered ordinary partnerships and limited partnerships would be entitled to file for reorganisation proceedings.
- A company facing liquidity problems rather than insolvency (based on its assets and liabilities) would also be entitled to file for reorganisation proceedings.
- A moratorium of 180 days would apply in relation to the refiling of a reorganisation petition where the initial plan is not approved by either the creditors' meeting or the court.
- The stay on proceedings against the debtor applies in respect of obligations which arose before the date of the reorganisation order. Currently, the stay applies in respect of obligations which arose before the date of court approval of the plan.
- Individual guarantors would benefit from a debtor being placed in reorganisation proceedings as an automatic stay on proceedings would apply in respect of them.
- Prior to their appointment, planners would be required to declare their fees and expenses and those of parties they hire. The court would also be entitled to review the planner's fees and expenses prior to deciding whether or not to issue a reorganisation order.
- The debtor's creditors or shareholders would be entitled to petition for the removal of the planner and to institute legal proceedings against the planner.
- The court would be given power to remove a planner in certain circumstances similar to the removal of a plan administrator.
- Each unsecured creditor having a debt of not less than 15% of the total indebtedness for which a claim for repayment may be filed in the business reorganisation would be classified as a group.
- Voting on the reorganisation plan is amended, requiring a special resolution at a meeting of any one class of creditors and votes in favour of the plan from creditors holding not less than 75% (increased from 50%) of all claims voting on the plan. (A special resolution is a

¹¹³ Surasak Vasijit is a Partner with Freshfields Bruckhaus Deringer in Bangkok, Thailand

resolution passed by a majority in number holding three-quarters by value of the debts represented and voting at the meeting.) It is unclear whether the amendment will apply to cases in reorganisation proceedings at the time of its enactment. Convening separate meetings of different classes of creditors has also been proposed.

- The court could order approval of a plan where the planner and creditors who attend the court hearing to consider whether or not to approve the plan are able to agree to an amendment to the plan. Where the planner and creditors cannot agree on the amendment, the court has the discretion to approve the plan with conditions to protect disadvantaged creditors.
- Where a plan is not approved by creditors, the court has the discretion to order the absolute receivership of the debtor. Currently, the court can only cancel the reorganisation order permitting any stayed bankruptcy proceedings to continue.
- The order terminating the business reorganisation has the effect of releasing the debtor from all debts, irrespective of whether the reorganisation is successful in accordance with the plan. The debtor remains liable for those debts which have not yet been repaid in accordance with the plan. This confirms the position where the debtor is released from reorganisation proceedings.
- The Supreme Court rather than the Chief Justice of the Central Bankruptcy Court would be the party to decide whether or not appeals may be made against court orders regarding a business reorganisation.
- Debts incurred by the official receiver, planner, plan administrator and interim plan administrator would have preferential ranking if they are incurred in good faith.

Bankruptcy proceedings

- The amendments revise the provisions dealing with the filing of claims in bankruptcy cases and, among other things, grant the official receiver the power to approve or dismiss claims, subject to the right of an interested person to file an objection with the court.
- The official receiver may apply to the court to interrupt the three year period after the date of the bankruptcy judgment to prevent certain bankrupt individuals from being released from bankruptcy.
- The fees payable in respect of the collection and disposal of assets in a bankruptcy and on a composition of debts have been reduced.

The provisions set out above may be modified prior to their implementation.

European Union

THE EUROPEAN UNION APPROACH TO CROSS-BORDER INSOLVENCIES. THE EUROPEAN INSOLVENCY REGULATION

by

*Sijmen de Ranitz*¹¹⁴

I. Introduction

On 31 May 2002, the European Insolvency Regulation (“EUIR”) came into force. This regulation is the result of more than 30 years of discussions on the European approach to cross-border insolvency issues. This paper is intended to provide some background to the EUIR and information on its applicability, its system and its structure.

II. Practical information

The official name of the EUIR is Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings. Please note that for a proper understanding of the EUIR it is important to read its 33 preambles and for explanatory notes see the Report on the Treaty on Insolvency Proceedings, written by Virgos and Schmit, and published in 1996¹¹⁵.

III. History and background of the EUIR

For the non-European reader it is important to realise that Europe has for centuries consisted of a varying number of more or less independent empires, kingdoms, states, duchesses, city-states and other forms of local or territorial power, and that many countries as we know them today have only existed in their present form for often less than two centuries. Wars and revolutions have played an important role in Europe and have taken their toll. Sovereignty and territoriality were key factors in the political and legal thinking of that time. It is only after the two major wars of the last century that Europe made with serious efforts toward co-operation and harmonisation, efforts that have now lead to the European Union.

¹¹⁴ Sijmen de Ranitz is a Managing Partner with DeBrauw, Blackstone Westbroek, based in the Netherlands

¹¹⁵ The EUIR is a direct binding regulation for all EU countries as from 31 May 2002, with the exception of Denmark, where the EUIR is not applicable for the time being. The EEX has been replaced by the EEV (European Execution Regulation (“EER”) as per 1 March 2002, also except for Denmark (EEX applicable). Further note that for some non-EU-countries similar rules related to the recognition and execution of foreign judgements apply under the EVEX (Fe. Norway, Poland, Switzerland, Iceland).

In the legal field, the first important step ahead was made in 1968 when the European Execution Treaty (“EEX”) came into force. Under this treaty important rules, often overriding national rules, were accepted in the areas of jurisdiction (competent court) and execution (enforcement in other EU countries of civil judgements). The EEX exempted all legal issues that were insolvency-law related. The view was that as insolvency laws in the various European jurisdictions were too different, it would take more time to prepare a treaty on European insolvency law issues. After many years, and some failed attempts, in 1995 a Treaty on European Insolvency Proceedings was drafted. It is in relation to this treaty that the Virgos/Schmit report was written. For political reasons, unrelated to any insolvency issue, this treaty never came into force. But its contents are now almost fully and identically reflected in the EUIR.

III. Scope of the EUIR

The EUIR has limited applicability. It will only be applicable if the centre of main interests of the insolvent debtor is located within the EU. If that centre of main interests is located outside the EU the EUIR is not directly applicable and each member country of the EU may apply its own rules of private international law or international insolvency law on cross-border issues. If no bilateral or other treaty applies, it is likely that most EU jurisdictions will seek guidance from the EUIR when addressing non-EU cross-border insolvency issues. The scope of the EUIR is also limited to certain types of insolvency proceedings. The EUIR is applicable to all EU collective insolvency proceedings, which entail the partial or total divestment of the debtor and the appointment of a liquidator (Art. 1). The insolvency proceedings on which the EUIR is applicable are all listed in Annex A to the Regulation.

Further, the EUIR is not applicable on insolvency proceedings of insurance companies, credit institutions and (collective) investment undertakings. For these types of insolvencies see EC Directives 2001/24/EG and 2001/17/EG. The EUIR is only applicable on insolvency proceedings opened as from 31 May 2002 and insolvency related issues arising thereafter.

IV. The system of the EUIR; universality vs. territoriality; harmonisation

In an increasingly international business world where, from the commercial point of view, borders are just a nuisance and not very relevant, and an “open market approach” is often economically necessary, one would be inclined to ultimately aim at harmonisation of insolvency laws and the universal effect of insolvency proceedings. The tremendously increased speed of transport, travel, information and the interdependence of economies would certainly justify such harmonisation and such universal effect. But the European Union is not ready for such change, due to social, cultural, legal and political differences within the EU. This is reflected in Preamble 11 of the EUIR:

“This regulation acknowledges the fact that as a result of widely differing substantive laws it is not practical to introduce insolvency proceedings with universal scope in the entire Community. The application without exception of the law of the state of opening of proceedings would, against that background, frequently lead to difficulties. This applies, for example, to the widely differing laws on security interests to be found in the Community. Furthermore, the preferential rights enjoyed by some creditors in the insolvency proceedings are, in some cases, completely different.”

As a consequence, the EUIR does NOT harmonise the national insolvency laws. The insolvency law of France will remain quite different from the insolvency law of Germany, which again differs substantially from the Dutch insolvency law. This is not changed by the EUIR.

Also, the EUIR does not impose an unlimited universal effect of insolvency proceedings. The system allows for a limitation on the universality principle.

What is the systematic view of the EUIR?

The first principle is that “Main Insolvency Proceedings” (see Art. 3.1. EUIR) can (only) be opened in the member state where the debtor has his centre of main interests. Once opened in the EU, these Main Insolvency Proceedings have universal scope (of course: within the EU) and aim at encompassing all of the debtors assets.

The second principle is that the Main Insolvency Proceedings have a direct and immediate effect all over the EU.

The third principle is that the insolvency law of the member state where the Main Insolvency Proceedings have been opened is applicable all over the EU.

But to protect local/national interests, Secondary Insolvency Proceedings can be opened in any member state where the debtor has an establishment (as defined in Art. 2h EUIR). Secondary Insolvency Proceedings are limited to the assets located in that member state where these Secondary Proceedings are opened. The insolvency law of that member state is applicable on the Secondary Proceedings. The universal effect of the Main Insolvency Proceedings is therefore basically frustrated in the jurisdiction where Secondary Proceedings are opened. But some effects of the first principle remain (see: art. 33. 1 EUIR).

If Main Insolvency Proceedings have been opened in a member state and assets of the debtor are located in another member state, but in that member state no Secondary Proceedings can be opened due to the fact that these assets do not create an “Establishment” as defined in the EUIR, the Main Proceedings are effective in that member state. The insolvency law of the Main Proceedings is applicable in such member state. But to protect certain interests (rights in rem, set off, retention of title, real estate, labour agreements, patents, nullity actions) the EUIR provides for specific rules: art. 5-15 EUIR. These specific rules limit the application of or consequences of the insolvency law of the state of opening of the Main Proceedings.

In brief, Main Proceedings are directly effective all over the EU, and the insolvency law of the state where the Main Proceedings have been opened are applicable all over the EU, but Secondary Proceedings limit this universal approach in the case of an establishment in another member state, and for some legal relations/rights the EUIR has specific rules limiting the consequences of the applicability of the insolvency law of the Main Proceedings.

V. No consolidation

To avoid any misunderstanding, one should realise that the EUIR is applicable on the insolvency proceedings of just a debtor. The EUIR does not create or promote the principle of consolidated insolvencies. In brief, if a company is declared bankrupt in France (Main Proceedings) and that company has a subsidiary in Italy, that subsidiary is not (directly) affected by the French proceedings. If that subsidiary is insolvent under Italian law and has its centre of main interest in Italy, it is the Italian court that may open Main Proceedings of the Italian company.

VI. Main, Secondary and “Secondary without Main”

As described above, the starting point of the EUIR is that, in case of insolvency of a debtor, Main Insolvency Proceedings are to be opened in the member state where that debtor has his centre of main interests. Only to protect local/national expectations, Secondary Insolvency Proceedings can be opened in a member state where the debtor has an establishment.

There is a third type of proceedings though. Only under very limited circumstances Secondary Proceedings can be opened if no Main Proceedings have been opened. If so, these “Secondary without Main” proceedings have again territorial effect only. Finally, the issues referred to above are all to be found in Chapter I of the EUIR: “General Provisions”.

VII. Chapter II Recognition and Fair Treatment

The principle of recognition of insolvency proceedings is laid down in article 16-26: without further formalities the judgement opening the Main Proceedings shall have effect all over the EU (unless Secondary Proceedings are opened). The court appointed liquidator may exercise his powers all over the EU. Decisions of the court that has opened Main Insolvency Proceedings and which concern the course and closure of the proceedings, including compositions, are also directly recognised all over the EU without further formalities.

Clearly, the EUIR aims to have as much direct recognition, without time-consuming formalities, in order to allow for effective Main Insolvency Proceedings.

In order to achieve, within the framework of Main and Secondary Proceedings, fair treatment of creditors, some rules were needed. One of these rules is the Imputation Rule of Art. 20.2 EUIR.

A creditor who has, in the course of insolvency proceedings, obtained a dividend on his claim shall share in distributions in other proceedings only where creditors of the same ranking have, in those other proceedings, obtained an equivalent dividend.

VIII. Chapter III Secondary Proceedings

The opening and conduct of Secondary Proceedings is further described in this chapter. These proceedings are territorial and have limited scope. The liquidators in the Main and Secondary Proceedings are duty bound to co-operate, but the liquidator in the Main Proceedings has more power in some respects (see art. 33 and 37).

IX. Chapter IV Information and the filing of claims

First principle: any creditor may file his claim in any insolvency proceedings, whether main or secondary. This includes filings of claims of tax authorities and social security authorities. These types of claims were often not recognised on the basis of the sovereignty principle, but this view has now been overruled.

Second principle: also the liquidators may, and shall file, the known claims of creditors in other insolvency proceedings of the same debtor, in order to achieve, as much as possible, equal treatment of creditors.

Third principle: in order to alert creditors so that they can file, the competent court or the competent liquidator shall inform all known creditors in the EU (this is slightly discriminating) of the opening of the proceedings.

X. Conclusions

The harmonisation of insolvency laws within Europe is still a dream. The EUIR only has limited provisions of substantive law. Also, the universal approach (within the EU) of the EUIR can be limited in case of secondary proceedings (if there is an establishment in another member state).

Nevertheless, the EUIR is a first step in the right direction. It aims at effective insolvency proceedings under one insolvency law, or a limited number of insolvency laws (secondary proceedings), it creates direct recognition within the EU, it urges for co-operation and it implies that a certain amount of trust between the jurisdiction of the EU.

Far from perfect, but far better than the former territorial, sovereign approach.

Korea

INSOLVENCY LAW REFORM OF KOREA: A CONTINUING LEARNING PROCESS

by

Prof. Soogeun Oh¹¹⁶

I. Legislative History of Insolvency Law

40 Years' Experience in Insolvency Law and Practice

The year 2002 marks the 40th anniversary of the enactment of three insolvency laws: the Corporation Reorganisation Act, the Composition Act, and the Bankruptcy Act. The insolvency laws, however, were an *ad hoc* adoption of Japanese statutes that did not reflect the particular situation in Korea. Though there was no urgent need at the time in the market or in society, these laws were selected under the New Enactment Project in 1962. Without any in-depth research, corresponding Japanese statutes were translated into Korean. Even after the enactment, no serious study was conducted to help understand the provisions of the insolvency laws. As a result, legal rules in the insolvency laws were not properly learned by lawyers.

¹¹⁶

Soogeun Oh is a Professor at Ewha Womens University, Seoul, Korea

Until the late 1990's, insolvency procedures were not applied frequently as the following table shows:

Year	Bankrupt Firms	Bankruptcy	Composition	Corporate Reorganisation
1983	*	*	2	65
1984	*	*	2	52
1985	*	11	0	40
1986	*	26	0	26
1987	*	20	0	30
1988	*	21	2	26
1989	*	37	0	27
1990	4,107	27	0	15
1991	6,159	16	0	64
1992	16,769	14	0	89
1993	9,502	26	0	41
1994	11,255	18	0	42
1995	13,992	12	13	79
1996	11,589	18	9	52
1997	17,168	38	322	132
1998	22,828	467	728	148
1999	6,718	733	140	37
2000	6,693	461	78	32
2001	5,277	842	51	31

Source: Bank of Korea, Court Administration Office

Attitudes towards the Debtor

Traditional Korean law had a provision for penal punishment against insolvent debtors. Upon the sudden adoption of the western legal system in the early 1900s, insolvent debtors were no longer treated as criminals. Public sentiment, however, could not follow the change of legal principles. Until the 1950s, Korea was an agricultural society and it did not suffer from serious economic depression even after Korea entered industrialisation in the 1960s. As a result, Koreans had no experience dealing with massive insolvent debtors in a purely economic way. The insolvency laws did not properly reflect public notions on the bankrupt. It was not until 1999 that the court first rendered a decision to discharge a bankrupt, though it was when the Bankruptcy Act was enacted in 1962 that the notion of discharge was first introduced.

Another important factor is negative opinions and mistrust towards the management of failed firms, especially those of large companies. There was a Korean saying in the 1970s that “the Owner/CEOs are not bankrupt even though their companies go bankrupt.” It was partially because the government did not strictly prosecute corporate crimes. Moreover, during the period of rapid economic development, unjust profit-making led to negative public opinion against corporate management.

In the midst of economic turmoil after the crisis in 1997, Koreans came to recognise that the bankrupt individual could be innocent. Some bankrupt individuals have asked to be given a fresh start and liberal lawyers have proposed pro-debtor provisions in the law in spite of probable moral hazard.

The Infrastructure of Insolvency Law and Practice

Entering industrialisation based on free competitive market principles in the 1960s, Korea had a relatively underdeveloped market of assets, capital, and companies, and a reliable accounting system that was not firmly established. These weak infrastructures have hindered corporate restructuring both in and out of court procedure.

However, compared with the economic market, the judicial system has been much more reliable. Performing within the public sector, judges have demonstrated professional excellence and freedom from corruption. The public has respected the court system.

It is worthwhile to note that the claim collection procedure in the Korean civil process has an open structure to all type of creditors. When a creditor files a compulsory execution claim against a debtor’s property, other creditors can join the distribution of proceeds according to the ranking of priority of their claims. Thus, other creditors do not have to apply for collective relief under the bankruptcy procedure as in many other jurisdictions.

II. Economic Background of Insolvency Law

Government Intervention in Corporate Exit Mechanisms

Korean industrialisation started with a Five-Year Economic Development Plan. The government selected an industry that the nation needed in the light of the industrial policy, provided resources through loans to the selected industry and chose the firms that could manage the selected industry under the Plan. In this vein, every large firm had direct or indirect support from the government.

When some of those firms went insolvent, it was not only a matter of business failure, but the government had to take political responsibility for the partial failure of the industrial policy. Therefore, it intervened in corporate failures and performed a central role in rehabilitating large firms through such instruments as:

- Arrangement for Ailing Firms in 1969
- August 3 Presidential Emergency Economic Decree to freeze every outstanding debt
- Industrial Rationalisation Measure from mid 1970s through 1980s
- Co-operative Loan Scheme in 1997
- Deferred Non-payment Declaration Accord (Anti-budo Accord) in 1997
- Workout Accord in 1998
- Corporate Restructuring Promotion Act in 2001

Such interventions by the government created a myth of “too big to fail.” Whenever large firms were in extreme financial distress, the government worried about the impact of their failure on the whole economy. Rescue loans were frequently mentioned when a big firm or an industry in general suffered from financial difficulties and the public got the notion that a big company could not fail. As a result, the moral hazards of creditor banks as well as debtor firms were inevitable.

Government-led Banking

There are two aspects to the government relationship with banks — the largest shareholder and the regulator. The government regarded banks not as a profit-making industry but as a tool providing resources according to its industrial plans. The government did not want banks to compete with each other but rather to be subservient to economic and political purposes.

The government nominated CEOs of banks even after the second privatisation, when the government was no longer the largest shareholder. CEOs were more concerned with government policy and political intentions than the profits of banks. Thus, banks had not performed their normal functions in the money market as risk assessors and resource distributors.

III. Economic Crisis and Reform Projects

The Transparency Issue in the 1998 Amendment

The strongest complaint before the economic crisis of 1997 concerned the unclear criteria for the commencement of corporate reorganisation. At that time, the court applied the so-called public interest test for commencing the procedure, which was concerned with whether saving the failing firm was good for the public interests or not. As the public interest test depended on judges’ discretion instead of detailed clear rules, it lacked, at least to some extent, transparency.

In order to improve transparency in the reorganisation procedure, economists developed an economic test that compared liquidation value with going concern value. They preferred mechanical decision-making without reference to the courts' discretion. The 1998 amendment, completed three months after the crisis, fully adopted the economic test. If the liquidation value exceeded the going concern value, the court would terminate the reorganisation procedure and adjudge the firm bankrupt even though the majority of the creditors wanted the reorganisation procedure to be continued.

The Issue of Expediency in the 1999 Amendment

During the 1997 crisis, the government promised international financial institutions that it would streamline the insolvency laws. The major issue became that of expediency. Although the actual time span in the reorganisation procedure of Korea was not bad in comparison with other countries, there were still many who believed that the Korean procedures were too slow.

To expedite the reorganisation procedure, the 1999 Amendment provided that the commencement decision should be made within one month from the application. For that purpose, the commencement criteria shrunk to nominal requirements.

The Workout Issue in the 2001 Amendments

Even though the Ministry of Economy initiated insolvency law reform, it still had doubts about entrusting large ailing firms to the discretion of the courts. Concerned about the domino effect caused by the failure of large firms, the government forced financial institutions to establish an accord for out of court workout processes in June 1998.

The legal nature of the Workout Accord raised two onerous issues for the government. First of all, as the Workout Accord was a contract among domestic financial institutions, most foreign creditors tended to hold out. Foreign creditors were asked for larger repayments than those of domestic creditors. Secondly, the Workout Plan could not be enforced as a reorganisation plan in the reorganisation procedure. If a workout company was put into the reorganisation procedure, the whole process, including filing of claims and drafting of the plan, had to be repeated. Moreover, new money injected in the course of the workout did not receive any priority in repayment.

To solve these problems, the Ministry of Finance and Economy (MOFE/ the successor of the Ministry of Finance) tried to amend the Corporate Reorganisation Act. Its intention was to make the workout plan a corporate reorganisation plan upon the application for the procedure and secure a higher priority for new loans. MOFE, however, faced strong criticism. Lawyers could not tolerate the application of contracts to third parties and retrospective application of legal rules.

The final result following this criticism was to facilitate the ability of the creditors to submit the workout plan as a reorganisation plan in the corporate reorganisation procedure. The law now provides that agreements among the creditors made in advance of corporate reorganisation will remain effective among those parties in the corporate reorganisation procedure.

The Consolidation Issue in 2002 Reform

Continuous demand from domestic and international circles has increased momentum for a consolidation of the three insolvency laws into a single one. Although insolvency practice has been much improved since 1998, negative estimations have prevailed not only because observers were not aware of recent changes but also because they did not know the underlying reasons for alleged inefficiencies such as delayed process, unprofessional handling of cases and low rehabilitation rates. At any rate, the government made an undertaking to international organisations that it would fundamentally reform the insolvency laws.

Different views have been expressed about the reform project. Most economic policymakers, politicians and journalists blame archaic and the inadequate insolvency laws for the problems they identify. They seem to believe that insolvency law reform is all that is needed for successful restructuring. Lawyers, however, generally do not agree with the criticisms. They find the real cause of inefficiency is the disinterest and poor judgment of creditors. Lawyers are angry about frequent amendments to legislation — four times in five years.

There can be three options for consolidation as far as the nature of statutes is concerned: (1) separate statutes on rehabilitation and liquidation; (2) a single statute with multiple procedures on rehabilitation and liquidation; and (3) a single statute with a single procedure that is neutral towards rehabilitation and liquidation. In theory, option (3), a “chemical” merger, has been advanced as the best solution. But there is a strong demand for posting rehabilitation as the basic role of the consolidated insolvency law. It was observed that many ailing firms would hesitate to apply for the single procedure, as they would fear of being adjudged liquidation instead of rehabilitation. Drafters are not ready to persuade the legislators to enact a single-track system, so a multiple track under the one statute is now the proposed solution.

The draft is at the final revising stage in the Ministry of Justice, which is in charge of insolvency law drafting. The new draft is scheduled to be proposed to the Congress soon.

IV. The New Draft of the Consolidated Insolvency Law

Basic Structure

The legislative goal of the new draft, though not yet officially endorsed, is to produce an insolvency law that is easy-to-use, hard-to-cheat and restructuring-friendly. It makes one single rehabilitation procedure out of the current separate corporate reorganisation procedures and the composition procedure. The bankruptcy procedure is, by and large, left intact as in the current Bankruptcy Act. Special consideration has been given to consumer bankruptcy and cross-border insolvency.

Composed of 658 Articles, the draft has five chapters:

1. General Provisions
2. Rehabilitation Procedure
3. Bankruptcy Procedure
4. Individual Rehabilitation Procedure

5. Cross-border Insolvency Procedure

Each procedure has its own door, so applicants can choose the procedure they prefer. Conversion from one procedure to another is also possible.

Rehabilitation Procedure

Current rehabilitation procedures in the Corporate Reorganisation Act and the Composition Act are merged into one in the draft: the rehabilitation procedure. It is open to any legal entity — corporations, natural persons and unincorporated organisations.

For successful restructuring, drafters believe that early application of the procedure is central. To induce early entry into the rehabilitation procedure, the new draft makes some important changes. Though it maintains the trustee system instead of adopting a debtor-in-possession (DIP) system, it enlarges the possibility for incumbent management to maintain control over the firm.

It also reduces emphasis on the economic test, which compares liquidation value with going concern value. Under the current law, the court discontinues the rehabilitation case in the middle of a reorganisation procedure whenever the court finds that liquidation value is greater than going concern value. Moreover, when dismissing the rehabilitation case for that reason, the court should declare the applicant bankrupt. Under the draft, this economic test, however, is applied strictly only when the court approves the reorganisation plan, which means the going concern value should be greater than liquidation value for the court to approve the plan. The court provides mandatory bankruptcy adjudication only when the rehabilitation case is dismissed after the approval of the plan.

After heated discussions, the automatic stay has not been adopted because there are technical problems, including the drafting of exceptions and the scope of the stay, and conflicts with bounced check regulation. Another obstacle is that there are few comparative examples of other countries. The draft also reflects negative public sentiments that debtors can be legitimately protected from non-payment by their simple application for relief under the rehabilitation procedure.

Individual Rehabilitation Procedure

Many nations must cope with consumer bankruptcy problems, to which Korea is no exception. Two typical factors make the situation worse than in other countries. One concerns personal guarantees for the debts. It has been a long tradition in Korea to endorse private loans for friends and family members without any compensation. The other concerns credit cards. As credit card companies have issued credit cards to those with unstable financial status, more and more young consumers go bankrupt. Drafters have felt strong needs for the establishment of rehabilitation scheme for individual debtors with excessive debts.

This individual rehabilitation procedure is focused on the debtors with regular incomes. Applicants for the individual rehabilitation procedure should have regular incomes. After examining their financial situation, the court can directly approve a rescheduled payment plan without the consent of creditors. The payment plan, which can be as long as five years, should provide creditors with more than what they would get in liquidation. After the successful implementation of the plan, the debtor is discharged completely.

There are, however, strong criticisms against this scheme. Opponents have based their criticisms on moral hazard. First of all, they insist society should punish the extravagant. It is unfair, they argue, to discharge some debtors from their unpaid debts while forcing other debtors to repay their all debts.

They also raise the issue of constitutionality over the lack of creditors' consent in the individual rehabilitation procedure. Deliberation at Congress might make some changes on these matters. It would be an appropriate opportunity for the nation to think over the issues of the bankrupt and especially their fresh start with a view to working towards a new consensus.

Cross-border Insolvency Procedure

The draft bases its cross-border insolvency procedure on the UNCITRAL Model Law. It discards the current principle of territoriality. In in-bound foreign insolvency cases, the foreign insolvency representative can apply for the recognition of foreign insolvency procedures to the Insolvency Division of Seoul District Court (it has exclusive jurisdiction on the cross-border insolvency cases). The new draft, however, does not make legal effects automatically rendered upon recognition as in Article 20 of the Model Law.

At the same time, or after the application for recognition, foreign representatives can also apply for a temporary protection order or support for recognised foreign insolvency procedures, which include stay of any legal actions against debtors' property, receivership over the debtors' property, realisation and distribution.

In outbound, cross-border cases the new draft empowers the court-appointed trustee to act on behalf of the debtor in foreign courts. For co-ordination between courts and trustees (or representatives), it provides direct communication with foreign courts and/or foreign trustees. If necessary, the court can allow the trustee to make an accord with foreign trustees. The court will consider what a creditor has received in foreign insolvency procedures when it decides the amount of distribution.

V. The Long Learning Curve

Though Korea had insolvency laws for the first time in 1962, they were not really of Korean, because they were not the products of Korean's necessity and deliberation. They were just strange written letters. Few lawyers paid attention to the insolvency laws because there were so few cases.

The Korea Development Bank was an exceptional entity that was relatively well-acquainted with the laws because it had business in corporate reorganisation procedures as a big lender. Generally, however, only a handful of practicing lawyers handled insolvency cases, and judges, on average, saw one insolvency case only during their tenure until the 1980s. In the 1990s, when the public criticised the improper handling of insolvency cases and realised the importance of them, the Supreme Court increasingly paid attention to insolvency cases and improved the court practice.

Generally speaking, we ardently learn when we have an urgent need. We can learn effectively when we experience problems in actual situations. We learn most easily when an issue is just a step away and not far off. These principles of learning can be applied when a nation learns and develops insolvency law and practice. This general observation can be supported also in the area of insolvency law by the legislative history all over the world, which shows that insolvency laws most often grow during economic depression. It is because that is the time when learners see an urgent need and suffer from actual problems. Without serious internal struggles, something meaningful cannot be accomplished. It is not a 'good answer' or a 'right answer' presented by learned outsiders that is necessary for the one in distress. It can be a 'good answer' or a 'right answer' when it is acquired after faithful attempts to solve problems.

Insolvency law is no longer a set of strange written letters. It is now a living legal rule discussed not only by lawyers but also by journalists, politicians and even ordinary citizens. The draft would be the first insolvency bill deliberated by the Congress under such public scrutiny. Consensus building, which is essential to make policy choice, seems to be possible at this stage. At the next stage, we may concentrate purely on legal issues more than policy issues.

Though the contents of the new draft might still be a little way from good answers or right answers, it is the product of “our” agony and struggle. Our journey of learning about insolvency laws does not end and will never end. The new draft is a project report submitted by drafters to the people and international society in the midst of our journey of learning.

United Kingdom

PROPOSALS FOR UK INSOLVENCY LAW REFORM: THE ENTERPRISE ACT 2002

by

*Stephen Adamson*¹¹⁷

Sixteen years ago, the insolvency law and practice in the United Kingdom was radically changed with the Insolvency Act 1986 which, with other supporting law introduced the role of administrator. This person, who had to hold a licence, is an insolvency practitioner who is appointed by the Court and under the current law required an *ex-parte* independent report (“the 2.2 report”) to show that the process was capable of achieving one or more of four purposes. Three of these were for rehabilitation purposes, i.e. going concern sale or one of two types of compromises with creditors. The fourth purpose was to achieve a better outcome for creditors than would be achieved in a winding up (i.e. liquidation).

A moratorium was created which allowed the administrator time to prepare proposals and present them to creditors, to whom he/she was responsible.

This process should not be regarded as the same under Chapter 11 of the US Bankruptcy Code as, in the latter, the debtor stays in possession and has the exclusive right to prepare a plan. In the UK, the administrator takes complete control of the assets, can trade the business, remove directors, etc. The difference between the two processes was highlighted by the innovative Protocol which was developed in the case of Maxwell Corporate Communications PLC.

By and large, the administration process has been successful as it allows the practitioner considerable scope in achieving rehabilitation. It was never designed to replace the right of a lender with a floating charge to appoint an administrative receiver.

Some of the largest collapses in the UK have involved corporates which were too large to have granted security and were successfully dealt with by the administrator.

The Cork Committee, under Sir Kenneth Cork, which had reported in 1982 on the first full scale examination of UK insolvency law for 50 years, expressly approved the efficiency of receiverships but it recommended an alternative process to deal with corporates which had not granted floating charges and would otherwise have gone into a liquidation process.

However, all of this thinking and process are now to be radically altered under the provisions of the Enterprise Act of 2002 which only received Royal Assent on 7 November of this year.

In its White Paper, “Productivity and Enterprise: Insolvency – a Second Chance”, the government presented its proposals to modernise and reform current UK insolvency laws. Invitations to comment on the proposals were invited, culminating in the final provisions.

It is envisaged that these provisions will come into effect in 2004. However, the processes will be deeply affected by new Insolvency Rules which have not yet been published.

¹¹⁷ Stephen Adamson is a former President of INSOL International and the Insolvency Practitioners Association (UK)

It is relevant to consider what prompted the government to bring forward these proposals. A particularly favourable view on the state of entrepreneurship in the United States led the UK government to conclude that the insolvency regime did not favour businesses being rescued when they fell into trouble. Also, the government felt that the use of receiverships by lenders cause premature collapse. To a practitioner who has observed how carefully the secured lenders have used their powers, the latter view is definitely challengeable. The workout lenders have been careful in making such appointments.

There are six principal areas where reform has been introduced. Of these, two relate to individual bankruptcy and are not dealt with in this paper. The remaining four are:

- Administrative Procedure
- Administrative Receivership
- Crown Preferential Status
- Insolvency Services Account

The Act can be viewed on www.insolvency.gov.uk.

In summary, the changes that are proposed will affect not only practitioners, but also institutions which extend credit to UK corporates.

The administration process will be significantly changed from that described at the beginning of this paper.

Holders of floating charges will not be able to appoint an administrative receiver except in relation to capital market transactions and for those floating charges in existence at the date that the Act becomes law.

Crown preference (taxes such as income tax, VAT) is abolished and unsecured creditors will be apportioned a sum (as yet undecided) out of the funds that would have been available to the Crown.

Summary of the Changes to Insolvency Included in the Enterprise Act of 2002

THE LAW AS IT IS	THE LAW AS AMENDED
<p>1. <u>Administration</u></p> <p>Court procedure: An application by directors, company or creditors; one of four specified purposes with no hierarchy; administrator's proposals and meeting of creditors called within three months; no time limit as to duration, but court may require reports at various stages; moratorium.</p>	<p>Court procedure: An application by the company and/or directors and/or creditors; Out of Court: appointment by the holder of a qualifying floating charge or the company or the directors; three purposes (hierarchical); emphasis on the rescue of the company (not the business); the administrator to perform his functions in the interests of the creditors as a whole; administrator's proposals within 28 days, creditors' meeting within 6 weeks; time limit of 3 months which can be extended by creditors' consent to 6 months, but further extensions require court sanction; moratorium.</p>
<p>2. <u>Administrative Receivership</u></p> <p>The holder of a floating charge over the whole (or substantially whole) of a company's property may appoint an administrative receiver. The administrative receiver generally only has duties to his appointer; realises company assets to satisfy the charge of his appointer.</p>	<p>Appointment of an administrative receiver prohibited in relation to post-Act changes, except for capital market transactions, public/private partnerships, utility projects, project finance, financial markets and registered social landlords.</p>
<p>3. <u>Crown Preferential status</u></p> <p>HM Customs & Excise and Inland Revenue rank ahead of floating charge holders in relation to realisations of the company's assets.</p>	<p>HM Customs & Excise and Inland Revenue preferential status abolished; a portion of the company's assets ring-fenced for the benefit of unsecured creditors.</p>

A fundamental change is that administrators can be appointed both in and out of court. However, the administrator will always be an officer of the court. Out of court appointments can be made by the holder of a qualifying floating charge or by the company or its directors provided that proper notice has been given.

Court appointments will be made in a similar way to the present regime but will not require the expenses of preparing an independent 2.2 report (see above). Some criticism has been made as these reports have become "over engineered" and hence the costs of entering administration have been too high.

The purposes of an administration have been reduced from the present four under Section 8(3) IA 86 to three. Under paragraph 3 of Schedule 16 to the Act:-

"The administrator of a company must perform his functions:

- with the objective of rescuing the company, or
- where it is not reasonably practicable to rescue the company, with the objective of achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or
- where it is not reasonably practicable to rescue the company or achieve the result mentioned in paragraph (b), with the object of realising property in order to make a distribution to one or more secured or preferential creditors.”

A part of the fundamental thinking behind the new Act is that the company should be saved if at all possible as opposed to its business. Under the administrative receivership regime, the lender would have the right of almost immediate appointment upon a default. The administrative receiver could then take charge of the business and sell the assets from out of the company and, with certain obligations to the unsecured and preferential creditors, attempt to repay the lender its debt.

The administrator is required to act in the interests of the creditors as a whole or, where realising a secured asset, he/she has to avoid unnecessarily damaging the interests of the creditors as a whole.

The holders of a qualifying floating charge may apply to the court to have a specified person as administrator if the company or its directors (who have to give five days written notice) intend to appoint an administrator of their choice out of court.

The administrator must now convene a meeting of creditors within eight weeks as opposed to currently having to hold a meeting within three months.

Administrations will automatically cease after a limited period but with the consent of all the secured creditors and more than 50% of the unsecured creditors, the administration can be extended for three months; the court must approve any further extension.

The Act prevents the holders of a floating charge from appointing an administrative receiver, except in cases involving capital market transactions, or where the floating charge in question was created prior to the new Act coming into force.

As stated above, the Crown will give up its preferential status in relation to PAYE (Income Tax) and VAT when the Act comes into effect. An amount, as yet undecided, will be ringfenced for the unsecured creditors and will be taken out of the funds that would otherwise have been payable to the Crown. Employees will continue to have preferential status.

The Insolvency Services Account has long been a *bête noire* of insolvency practitioners in that the law required, in certain insolvencies, for funds to be paid into this account which is maintained by the Insolvency Services Agency, a part of government. Creditors of the insolvent estates have effectively had to suffer the fees charged by the Agency. Full details of the new charges are not available but the intention is to simplify the process.

Whether it is right or not, the government believes that administrative receiverships did not assist the rehabilitation of companies and were not sufficiently “transparent” or acceptable to creditors.

The government also believes that administrative receivership causes the unnecessary failure of companies, does not maximise economic value and is not transparent and accountable to all creditors. The new streamlined administration procedure is intended to address the perceived shortcomings of administrative receiverships, but at the same time reassure lenders that they have some form of protection in the event of default and maintain a stable cost of lending by matching the flexibility and cost effectiveness of an administrative receivership with the inclusiveness of an administration. The government believes that the new procedure should ensure:

- a better alignment of incentives;
- survival of viable companies;
- better returns for creditors;
- the preservation of value in the economy.

Full consideration of the checks and balances, which must always be present to ensure equity between the various classes of creditors, the directors and the shareholders, can only be given when the supporting legislation to the Enterprise Act 2002 is published. Experience tells me that when altering one part of the process, there is usually an unforeseen and adverse effect. However, it is to be hoped that the new Act will achieve the aims of its promoters in preserving value for creditors and giving a troubled corporate every chance to be rehabilitated.

The author is indebted to John Verrill of Lawrence Graham, London, for the use of the tables shown above and attached.

Summary of the Insolvency Provisions of the Enterprise Act

	SECTION IN NEW ACT	PROVISIONS	HOW PROVISIONS AFFECT EXISTING INSOLVENCY LEGISLATION
1	s243-244; Sch16; Sch 17	New administration procedure and requirements.	Replaces Part 2 of the Insolvency Act 1986 ("IA86") in its entirety; inserts Sch B1 after Sch A1 of IA86.
2	s245; Sch.18	Prohibits the appointment of administrative receivers except in certain circumstances.	Inserts Chapter IV in Part III of IA86; inserts Sch 2A in IA86
3	s246 and s247	Abolition of Crown preferential status and the ring-fencing of a part of the assets of the company for the benefit of unsecured creditors.	Paragraphs 1, 2, 3 to 5C, 6 and 7 of Sch 6 of IA86 cease to have effect.
4	s251 to s255; Sch 19; Sch 20; Sch 21	Reduces the automatic discharge period from 3 years to 12 months; introduces bankruptcy restriction orders.	Replaces s279 IA86; Inserts s281(a) IA86; substitutes s289 IA86; amends s310 IA86; inserts s310(a) IA86; Inserts Sch 4A IA86.
5	s256	Generally the bankrupt's interest in his home ceases to be part of his estate three years from the date of the commencement of the bankruptcy.	Inserts s283A IA86; amends s313 IA86; inserts s313A IA86.
6	s259; Sch 22; Sch 23	The Official Receiver may be the nominee and/or supervisor of an individual voluntary arrangement proposed by a bankrupt using the fast track procedure;	Substitutes s261 IA86; inserts s263A-G IA86; inserts s389B IA86.
7	s265 to 267	Reform of the Insolvency Services Account and the fees charged thereon.	Inserts s415A IA86; inserts paragraph 16A in schedule 8 IA86; inserts paragraph 21A in schedule 9 IA86; s405 IA86 ceases to have effect; substitutes s408 IA86.
8	s268 to 276	Supplementary provisions dealing with interpretation; consequential amendments; commencement and short title.	

PART II

CROSS BORDER INSOLVENCY

Regional Overview

INFORMAL WORKOUTS IN THE ASIAN REGION: A CROSS-BORDER OR REGIONAL PERSPECTIVE

by

*Richard Fisher*¹¹⁸

I. Background

- The ADB under TA 5975 –REG is seeking to promote regional co-operation in the development of insolvency law reform.
- One aspect of Technical Assistance is concerned with informal workout practices.

II. Rationale

- The rationale for that aspect of the Technical Assistance is as follows:
- “Formal insolvency processes are not the only way to deal with the financial problems of a debtor. Many creditors (particularly banks and other financial institutions) and other stakeholders will prefer, in certain circumstances, to have the opportunity of dealing with the financial difficulties of the debtor outside of formal processes. This is why such an approach is generally referred to as an “informal” process. The banking and finance sector has been responsible for the development and promotion of this technique and the principles and methodology that support it are now widely accepted and practised in many countries. Because of the significant growth in the “global” nature of lending and financing, it is highly desirable that informal workout techniques be promoted and developed on a regional and global basis, hopefully such that the principles and methodology become accepted and applied internationally. Thus, the focus in the area of informal workout practices will be upon the regional development of informal workouts”.

Progress of Technical Assistance

- An Issues Paper has been prepared which is accessible on the following Internet site: <http://adb.bdw.com/>.
- A Conference was held on 30 September and 1 October last in Manila at which the Issues Paper was considered.

Issues affecting the adoption of a Cross-border Approach to Informal Workouts

The Issues Paper identifies the following matters:

- To what extent might it be necessary to distinguish between informal processes that are established to deal with a systemic problem in the banking and finance sector and informal processes that are established as part of banking sector "culture"?

¹¹⁸ Richard Fisher is the Chairman of Partners at Blake Dawson Waldron based in Sydney, Australia.

- Are influences (in the sense of central bank pressure or "credible threats") necessary or, even, desirable for the promotion of an informal workout process?
- Is it desirable to develop and employ a set of "rules" to govern the process to which both creditor institutions and a debtor would be required to subscribe in order to commence or initiate the process?
- How are issues concerning "breakaway" members of a banking syndicate, bondholders and debt traders best addressed in the context of an informal process?
- Is it necessary or desirable to provide for a possible requirement of "mediation" as part of the informal process?
- What is needed to provide a "regional" or "global" approach to informal workouts?
- Would a "domestic" workout process benefit from the possibility of a "fast track" conversion mechanism to a formal reorganisation?
- Would it be possible to provide for a "fast track" conversion mechanism in a cross-border case?

Results of the Manila Conference

The Conference in Manila concluded that there was sufficient commonality amongst the current informal workout processes operating in the selected countries (Indonesia, Korea, Philippines and Thailand) for co-operation in setting guidelines for informal workouts on a regional basis to be a realistic goal. The Conference also concluded that there were certain issues which should be addressed when considering the effectiveness of the existing informal workout regimes operating in the selected countries. These issues were also relevant to consideration of a regional approach to informal workout, and included:-

- Difficulties between creditors resulting from a lack of trust
- Differences in approach to provisioning and bad debt write-off amongst financiers and other creditors, particularly between "international" banks and "domestic" banks
- Many creditors not engaging in the informal workout process at a high enough level, resulting in people attending meetings who did not have the capacity to make decisions
- Difficulty in getting the debtor to meet the costs necessarily incurred in the process, resulting in time delays; and
- Restructuring proposals being prepared on the basis of assumptions as to future events which prove to be unrealistic.

Other issues identified during the Manila Conference included

- The necessity for there to be a strong, and easily initiated, formal insolvency process to operate in conjunction with the informal workout process and act as a credible threat to all parties thereby ensuring, to the maximum extent possible, the co-operation of all parties with the informal process:

- Difficulty for borrowers under restructure to readily obtain working capital. This was considered to be an issue brought about by such working capital having no formal priority over pre-existing debt; and
- The desire for there to be a simple and quick process for enabling a negotiated workout to be referred for approval and adoption within the formal insolvency process, thereby ensuring its application to all creditors

Issues Paper

by Ronald Harmer and Richard Fisher

This paper sets out a number of issues that are considered relevant to promoting insolvency law reform and development in the Asian region in three areas of regional co-operative interest cross-border insolvency, informal workouts and the intersection of secured transactions/insolvency law regimes. It is published in connection with the above technical assistance conducted by the Asian Development Bank to raise interest, promote discussion and to seek submissions from interested persons and bodies on the issues arising in relation to the three areas.

Part One: A Unique Initiative

1.1 *Regional co-operation*

Through this regional technical assistance, the Asian Development Bank (“ADB”) seeks to achieve something quite unique – regional co-operation in three areas of insolvency law and practice.

It is a unique initiative because the technical assistance does not relate to the improvement of the insolvency law and practice of any particular country nor is it a survey or a comparative study of insolvency laws and practices of a group of countries. Rather, it seeks to achieve the wider goal of regional co-operation, a challenging assignment that, apart from politically welded organisations, few institutions have attempted or would contemplate attempting.

1.2 *Focus on three areas*

The three areas that the technical assistance concentrates on are international or cross-border insolvency, informal workout practices and the intersection of secured transactions and insolvency law regimes.

These respective areas are now briefly introduced.

1.3 *Cross-border insolvency*

Cross-border insolvency is concerned with an insolvency case that has been commenced in one jurisdiction but which is relevant to another or other jurisdictions. The relevance will arise if, for example, there are assets, creditors or business activities of the insolvent debtor located in another jurisdiction. In the absence of a law or legal process that enables the insolvency administration to be recognised in the other jurisdiction it may be difficult or impossible to ensure that the affairs of the debtor are dealt with as a whole and in a co-ordinated way. The essential regional focus in the area of cross-border insolvency is thus on the promotion and development of appropriate enabling legislation in as many countries as possible.

1.4 *Informal workout practices*

Formal insolvency processes are not the only way to deal with the financial problems of a debtor. Many creditors (particularly banks and other financial institutions) and other stakeholders will prefer, in certain circumstances, to have the opportunity of dealing with the financial difficulties of the debtor outside of formal processes. This is why such an approach is generally referred to as an “informal” process. The banking and finance sector has been responsible for the development and promotion of this technique and the principles and methodology that support it are now widely accepted and practiced in many countries. Because of the significant growth in the “global” nature of lending and financing, it is highly desirable that informal workout techniques be promoted and developed on a regional and global basis, hopefully such that the principles and methodology become accepted and applied internationally. Thus, the focus in the area of informal workout practices will be upon the regional development of informal workouts.

1.5 *Intersection between secured transactions and insolvency law regimes*

These two areas of commercial law and practice are allied to one another. If both regimes are reasonably strong and effective they combine to promote credit discipline and debt responsibility. If one or both are weak much of that discipline is lost and results in an absence of a credible threat to encourage, provide the incentive or impose the need for positive action upon a debtor that is in financial difficulty. Moreover, such weaknesses act as a disincentive to lending and investment generally. Thus, it is in the interests of both creditors and debtors (and of a country generally) to support a strong and effective secured transactions law regime. This will involve considerations concerning the creation, registration and enforcement of secured transactions. Beyond those broad considerations there are more particular considerations where one regime might legitimately intrude upon the other. This is particularly relevant when, for example, an attempt might be made to reorganise (or “rescue”) an insolvent debtor. To provide the necessary environment for that to occur, it is generally considered appropriate to subject a secured creditor to a stay or suspension of the enforcement rights and powers of the secured creditor. Further, in relation to a rescue attempt, it will invariably be necessary to ensure that a debtor has access to continuing finance so that its business activities might be preserved and continued. This may require the creation of a special “priority” entitlement to repayment. That, in turn, raises issues concerning the “priority” of existing secured creditors’ rights. If some common ground can be reached on some of these (and other) areas and countries can be encouraged to develop a more “universal” approach to them, a region may benefit from a relatively certain and predictable credit environment.

1.6 *Consideration of trade, commerce, investment and economic justifications for the promotion of development in the three areas*

The justification of the promotion and development of the three areas might ultimately rest on investment and economic benefit issues. Or, to put it in the form of a question: “How do these areas, taken individually or collectively, promote a better investment environment and greater economic benefit for a country?” This paper seeks to explore that issue, not “en masse”, but rather, by raising issues of investment and economic benefit in relation to each respective area.

1.7 *Selected countries*

This technical assistance would not be possible without and has been greatly assisted by the agreement of four countries to participate. The countries are Indonesia, Korea, Philippines and Thailand. They are collectively termed the “selected countries”. Their involvement is most important. Their varying experiences, state of development (three of the countries are presently contemplating

substantial reform to their respective insolvency systems and another proposes complete reform of its secured transactions legal regime) and diversity will provide considerable information in relation to the three subject areas. It might, even, facilitate the application of a “litmus” test in relation to the three subject areas and the issues that arise from them. However, it should be kept in mind, as mentioned earlier, that the technical assistance is “regional” and is not concentrated on one or more of the selected countries.

1.8 Work programme and methodology

The technical assistance is a long-term project. It commenced in April 2002 and is due to be completed in March 2004. The programme for the technical assistance (which also serves to describe the work methodology) is as follows:

- Inception meetings. In April 2002 two of the international consultants (Messrs. Harmer and Fisher), together with Ms. Clare Wee, Senior Counsel, OGC, ADB (in Manila) and Mr. Victor You, Counsel, OGC, ADB (in Korea), visited each of the selected countries with the valuable assistance of the local consultant and the local offices of PricewaterhouseCoopers in each country. Meetings were held with key government officials, judges, representatives from the banking and finance sector, academics and professionals. In addition, an informal discussion meeting was arranged in each country, the participants in which came from the banking and finance sector, judges, professionals and academics. The inception meetings were particularly valuable because they provided the opportunity to explain the nature of the technical assistance, introduce the three subject areas, seek the involvement and support of key officials and others and to gather important information and views on the three areas. As a result, the consultants were far better informed on the more important issues relevant to the three subject areas. Much of the content of this paper reflects the benefit of the information and experience obtained from the inception meetings.
- Issues paper. The principal purpose of this paper is to provide background and detail to the technical assistance, introduce each of the three subject areas in some detail, raise and discuss the more obvious and important issues, provide a basis for the conduct of the first meeting and, most importantly, provide a contextual base for a considerable amount of relevant and important material that will be posted to the technical assistance website.
- Conferences, meetings and workshops. The technical assistance provides for a number of meetings, conferences and workshops that will be convened as the work under the technical assistance progresses. The first of these will be held in Manila at the ADB headquarters 30 September – 1 October 2002. At this meeting it is intended to hold parallel sessions of particular interest groups that, to a degree and with inevitable overlap, will largely correspond to the three subject areas. Following those sessions, a plenary session will be held to discuss and debate the more major issues that confront progress in the three subject areas. As far as possible, it is intended to encourage participation from as many countries as possible in the conferences and workshops that are held as part of the technical assistance. As mentioned above, the purpose of the technical assistance is to encourage regional promotion and development in relation to the three subject areas, not just among the selected countries.
- Advisory group. This first conference will also result in the selection of an advisory group of participants from the selected and other countries to assist in the technical assistance for information purposes and to advise on means to develop and advance the project.

- Country reports. Drawing on the benefit of the discussions at the first conference, the next stage of the technical assistance requires that the respective local consultants prepare reports relevant to their respective countries on each of the three subject areas (and any relevant related area). These reports will identify particular issues that might confront or impede the promotion and development of regional co-operation in the three subject areas. The country reports will, thus, provide a valuable resource and will be presented and used for the basis of discussion at the first workshop.
- First workshop. The first workshop is programmed for 19-21 March 2003 in Singapore as part of and in conjunction with an International Insolvency Conference being organised by the Insolvency & Public Trustees Office, Ministry of Law, Singapore. The workshop will enable the country reports to be presented, deliberated and discussed and is expected to enable vital issues to be more clearly identified and discussed.
- Discussion paper – proposals and recommendations. Following the first workshop the consultants are required to prepare an interim report (it is intended that this will take the form of a discussion paper) that will contain draft proposals and recommendations for the promotion and development of the three subject areas. The discussion paper will form the basis for discussions and debate at the second conference.
- Second conference. This will be held around September 2003 at the ADB headquarters in Manila (possibly in conjunction with the annual OECD/ADB Forum for Asian Insolvency Reform) and will primarily involve discussion of the proposals and recommendations.
- Second workshop. This is scheduled for late 2003. It is presently proposed that this workshop will concentrate on essential practices in relation to the three subject areas. This will involve, amongst other things, co-operation between courts, use of protocols in multinational insolvency cases and informal workout practices.
- Draft final report. A draft final report containing draft final proposals and recommendations will be prepared at this stage of the technical assistance.
- Third conference. The final conference will be held in Manila in the early 2004. This will provide the opportunity to present the draft final report for discussion.
- Final report. The final report containing final proposals and recommendations is scheduled for completion in March 2004.

1.9 *The technical assistance website*

BDW will build an internet site that will provide access to relevant information. This online repository will be created for the specific purpose of enabling interested parties to view the issues paper, from anywhere at anytime. Users will be able to view relevant documents and link between documents via hyperlinks within documents. This facility will assist in streamlining project management by providing instant access to key project information. Parties with minimal technical knowledge will be able to use it easily.

- The internet site will be available by 1 September 2002 and accessible via the following internet address: <http://adb.bdw.com/>

1.10 Building on the work of other organisations and earlier ADB work

The technical assistance will benefit from the work of a number of other international organisations that is highly relevant to the three subject areas. There is a considerable body of such work, including:

- the work of UNCITRAL on cross-border insolvency, completed in 1997 with the publication of the Model law on Cross-Border Insolvency (which, of course, is highly relevant to the cross-border insolvency area);
- the current work of UNCITRAL in relation to the preparation of Model Legislative Guidelines for an Insolvency Law (this, for example, will feature a suggested legislative guideline for the conversion of an informal workout to a formal reorganisation);
- the current work of UNCITRAL in respect of

Model Legislative Guidelines for a Secured Transaction Law (this will be particularly significant in relation to the interrelationship of secured transactions and insolvency law regimes);

- the work of INSOL International in respect of Principles for a Global Approach to Multi-Creditor Workouts;
- the work of the European Bank for Reconstruction and Development in respect of “Core Principles for a Secured Transactions Law” and a “Model Law on Secured Transactions”;
- the work of the Organisation of American States in respect of a “Model Inter-American Law on Secured Transactions” for the creation and development of a secured transactions regime among its member states;
- the work of the American Law Institute in relation to the harmonising of the insolvency laws of the three NAFTA countries (USA, Canada and Mexico);
- the work of the World Bank in relation to Principles and Guidelines for Effective Insolvency and Creditors’ rights Systems.

The ADB itself brings to the technical assistance the benefit of its earlier work in relation to insolvency law and secured transactions law. There are three relevant publications resulting from that work:

- Insolvency Law Reforms in the Asian and Pacific Region (Report on RETA 5795);
- The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms (Law and Policy Reform at the Asian Development Bank, 2000 Edition, Vol. 1); and
- Secured Transactions Law Reform in Asia: unleashing the Potential of Collateral (Report on RETA 5773)

1.11 *Involvement of other organisations*

The ADB has been able to secure the involvement and support of both UNCITRAL and INSOL International in the technical assistance. The involvement of these organisations and representatives from them will provide invaluable information and assistance in relation to each of the three subject areas. UNCITRAL will bring the benefit of its work as mentioned above. In addition, it is probable that its work in relation to model legislative guidelines for both insolvency and secured transactions laws will be completed during the course of this technical assistance. It will thus be possible to observe and take account of the progress of that work. INSOL International represents some 70 organisations and some 7000 members in various disciplines from 66 countries that have a fundamental interest and involvement in insolvency law and practice. INSOL has been prominent in all of the relevant work of UNCITRAL and, in its own right, has done some considerable work in relation to informal workouts through its lenders group.

It is also intended that this technical assistance will work closely with organisations such as the World Bank, OECD and other relevant organisations, bodies and groups in the Asian region.

1.12 *Case studies*

It is intended that case study methodology (particularly, actual cases from the selected and other countries) will be a feature of the conferences and workshops.

1.13 *Focus on debtor corporations*

It is suggested that in the three subject areas the focus in this technical assistance should be on cases of insolvent corporations, not of insolvent individuals.

In relation to cross-border insolvency the reasons are that, firstly, a corporation cannot physically escape its place of incorporation nor, at a material time, its centre of main interests. Secondly, unlike in the case of an individual in some jurisdictions, there is normally no transfer (notional or otherwise) of the property of a corporation upon insolvency to a trustee, syndic or administrator. All that might occur is that the legal representative of the corporation changes (the person who is empowered to represent the corporation), but the property of the corporation remains with it.

This is not, of course, to say that cross-border insolvency is irrelevant to individual bankruptcy. In many cases it will be highly relevant because debtor individuals are still in the habit of fleeing the jurisdiction, having first transferred funds and other property from that jurisdiction in an attempt to defeat their creditors. But individual debtors will rarely be involved in cross-border trade and commerce, certainly not to anything like the same extent as corporations.

In relation to informal workouts it will be apparent that this form of process is suited only to medium/large corporations.

Finally, in relation to the intersection between secured transactions and insolvency regimes, the areas of tension will be mainly found in relation to attempts to reorganise a corporation.

It is the element of international, regional and bilateral trade and commerce that gives the impetus for this technical assistance and since that is primarily conducted through corporations, it is suggested that the focus in relation to the three subject areas should be on insolvent corporations.

Part Two: Cross-Border Insolvency

2.1 Introduction

From time immemorial some debtors have sought to hide or flee from their creditors. Before the advent of the “legal person” company, debtors were individuals. Sometimes they sought to escape their creditors by travelling to another country. Early insolvency laws reflected this activity, in part. The earliest of the English bankruptcy statutes [the 16th century Statute of Elizabeth], recited that one purpose of the law was to take account of debtors who flee the jurisdiction taking with them the proceeds of the goods and property of other persons or their proceeds of sale. The law sought to address that issue by, amongst other things, providing that a debtor committed an act of bankruptcy by fleeing the jurisdiction, thus enabling the debtor to be declared bankrupt even though the debtor had purported to change their place of domicile, and providing penalties for leaving the jurisdiction. These provisions sought to ensure that, notwithstanding that a debtor might have gone “abroad”, the debtor might still remain subject to and capable of being dealt with by the domestic bankruptcy law of England.

Those types of provisions did not, however, address the prospect that the affairs of a debtor might have “extra-territorial” implications, in the sense that the debtor may have both assets and creditors in more than one jurisdiction. Another provision in the same enactment went further and did attempt to, at least, touch upon this. It provided that the property of a debtor included property “wherever situated”. By this was meant property located anywhere in the world – in the jurisdiction or out of it. The intention was that any such property was subject to the bankruptcy regime of England. The implication was that a domestic law might extend its effect beyond the borders and reach out and command effect beyond those borders (and, consequently, beyond the usual of sovereign legislative competence).

Now, more than half a millennium later, governments, although no doubt still concerned about an individual debtor who absconds, are more concerned with the modern day implications of international trade and commerce and the reality of “cross-border” insolvency cases arising from that.

2.2 Cross-border cases

Cases of cross-border insolvency can range from the simple to the complex. A case may involve, for example, the presence of foreign creditors who have dealt with the debtor from a distance. All that this really involves are issues such as the right and the ability of those foreign creditors to participate in the insolvency administration (by, for example, being notified of the insolvency, providing the right to lodge a claim of the debt or other liability for which the debtor is responsible, possibly voting on various issues in which their interests might be affected, and being included on the same basis as local creditors in the distribution of any debt payments).

A more complex case might involve a corporation that has established subsidiary (or branch) offices in a number of other countries or one that has assets in a number of other countries. Here the issues can be considerably more complex, such as the right or power to control and deal with the foreign activities or assets, the possible power of creditors in those other countries to seek payment out of local assets, and the extent to which it might be possible to pool assets and creditors together notwithstanding international boundaries, different systems of law and so forth.

Quite clearly, none of these issues can be addressed (or properly addressed) by a mere assertion to the effect that property of the debtor includes property in any part of the world (as mentioned earlier in relation to the early English bankruptcy law). That does not even answer the simple case of what

rights foreign creditors are to be accorded in the bankruptcy of the debtor's "home" country and goes no way toward endeavouring to deal with complex issues such as, for example, a possible "global" reorganisation of a debtor enterprise. Further, a claim to extra-territorial property rights will not be effective unless that claim is recognised by another sovereign state.

Until recently, very little endeavour has been made to solve the problems presented by cases of cross-border insolvency. Although the problems had long been identified, the law was unequipped to answer or deal with the issues that have arisen from the huge increase of international trade and commerce.

2.3 *Survey of approaches to cross-border insolvency*

A survey of attempts at dealing with cross-border insolvency issues may be grouped as follows:

Application of the principle of "comity"

In countries that follow the "common law" tradition (which had its genesis in England and is a tradition observed in the USA and, for the most part, in countries that followed or adopted English law), the principle known as "comity" may sometimes be availed of (usually in and because of the absence of any enabling cross-border legislation) to recognise and give assistance in the administration of an insolvency case that has been opened in another jurisdiction. The doctrine of "comity" is not underpinned by easily identifiable criteria for its application – for the very reason that it is a judge-made doctrine and is not supported by legislation. It is more of a principle that has guided common law courts in their consideration of whether (and to what extent) to recognise the judicial acts of courts in other countries. As it was described in an American case: "...it is the recognition which one nation allows within its territory to the... judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens, or of other persons who are under the protection of its laws." [Hilton vs. Guyot, 159U.S. 113, 163-64 (1895)].

The two main benefits of comity are that a court can apply it in the absence of a convention, a treaty or domestic legislation and a court can tailor the level and extent of recognition and assistance according to the particular circumstances of each specific case. The limitations, however, are that it is unpredictable in its application, it is clearly not well-suited to civil law jurisdictions and, because it is uncertain, may result in the expenditure of valuable resources (including time) to fund and conduct an application for assistance from the foreign court which has no certainty of success.

The process known as "exequatur"

In many civil law tradition countries, recognition of a foreign insolvency case may be possible by utilising local civil law to obtain an "enabling order" (an "exequatur"). In effect, this is like recognition of a judgment. This type of legislation will usually enable access to a court to possibly obtain recognition of the opening of a foreign insolvency case in respect of the debtor. Possible, however, does not mean probable. In many cases an enabling order will not be granted in respect of an insolvency proceeding because it does not conform to a recognisable foreign judgment. And most "successful" attempts at exequatur do not necessarily bring about the desired result. More often than not they result in the opening of a local insolvency proceeding, to the exclusion of the foreign proceeding.

Reciprocity of judgments legislation

Legislation providing for the recognition of foreign judgments may be considered, in one sense, a reflection of the fact of the conduct of trade and business between persons located in different countries. Trade and commerce is based on contractual relationships that, in turn, give rise to debts for which payment is pursued. It is also a reflection, to a lesser degree, that debtors abscond and take assets with them. In a practical sense, therefore, reciprocity of judgments legislation has something to do with insolvent debtors. However, the application of this form of legislation is, like *exequatur*, usually reserved to enforcing judgments in “one on one” cases and not to insolvency “judgments” that are more in the nature of collective proceedings. Reciprocal judgments legislation is also more directed at enforcing specific judgments or orders (for example, requiring a party to pay money). Judgments or orders declaring or making a person bankrupt are not of the type that may be “enforced” without further orders – they are more usually a declaration of status and by themselves do not command that something must be done or not done. Finally, many insolvency proceedings are not “commenced” by a court order or judgment (in some countries the mere filing is sufficient to “commence”, in some other countries commencement results from administrative actions). Thus, although in some jurisdictions it may be possible to effect some type of recognition of foreign insolvency proceedings as the functional equivalent of a “judgment”, this form of legislation cannot realistically deal with cross-border situations.

Unilateral discretionary legislation

The use of unilateral legislation is the most predominant means of providing for recognition and assistance in relation to cases of cross-border insolvency. This type of initiative is no doubt the result of the perceived limitations surrounding reliance on comity, *exequatur* legislation and reciprocity of judgments legislation. The form of such legislation varies but, in general, it will provide the authority for a court to recognise and provide assistance in respect of a foreign insolvency proceeding originating in any country; it will set out certain conditions (or “tests”) that must be fulfilled or applied before recognition may be granted; it will provide for the procedure or process to be followed in making an application for recognition; and it may prescribe the nature and extent of assistance that can be provided. It will be apparent however that it only facilitates “in bound” cases and there can be no assurance or guarantee of reciprocal recognition in respect of “out bound” cases. Further, most of this legislation is “discretionary”, in the sense that the relevant court, although it must usually apply certain “tests” of eligibility, has an overall discretion whether to recognise or not (see the next section for an example of “mandatory” unilateral legislation). Despite its shortcomings, however, it offers a relatively high degree of certainty and predictability, the legislation is usually short and simple, it is reasonably efficient and non-cost-intensive and it is suitable as “stand alone” or as an expansion to *exequatur* legislation. Examples of countries that have this form of legislation are Australia, Canada, England, USA, India, Ireland and New Zealand. Extracts from the relevant legislation of some of those jurisdictions has been posted to the technical assistance website.

Unilateral mandatory legislation

The relevant legislation in Australia is a rare example of the above type of legislation that contains an inbuilt requirement for mandatory recognition and assistance. This is not, however, universal, because mandatory recognition is only required of cross-border cases originating in certain prescribed countries. In the case of all other countries, recognition is discretionary, and to this extent the Australian legislation is similar to all other unilateral discretionary legislation. A copy of the relevant Australian legislation (together with the list of “prescribed” countries) is posted to the technical assistance website).

Bilateral legislation

Some countries have concluded bilateral arrangements. An example is that between Singapore and Malaysia in relation to cases of individual bankruptcy. The relevant bankruptcy laws of those countries [see, for example, Section 104(3)-(6) Bankruptcy Act 1967 (Malaysia)] provides for mandatory mutual recognition and assistance in such cases. Relevant extracts from that legislation are posted on the technical assistance website.

Multilateral or regional treaty legislation

Treaty or convention legislation has been rare and largely confined to countries that share a common system of law and institutions. The most notable convention legislation is the “Nordic Bankruptcy Convention” of 1933, the signatories to which are Sweden, Norway, Denmark, Finland and Iceland. It has been described as a “*good example of a multilateral convention intended for a limited group of countries having very close mutual relations and a great deal of confidence in each other’s legal system*” (Professor. Michael Bogden).

The legislation provides for a full automatic recognition in all contracting states of a case of bankruptcy that is opened in one of them (universal reciprocity). The law of the state in which the bankruptcy is opened determines all issues concerning the bankruptcy, except as regards some special rules in relation to particular property (for example, rights in relation to land are determined by the law of the state in which the land is situated; the rights of secured creditors in respect of property secured in another contracting state are determined in accordance with the law of that other state). Each state is obliged to provide assistance and relief. No formal recognition procedure is required. It has been observed that “*the experiences with the convention are good. The absence of case law suggests that it works smoothly and does not give rise to any complication*” (Bogden).

Another example of a multilateral treaty is the Treaty of Montevideo (1940), which involves the South American countries of Argentina, Bolivia, Paraguay and Uruguay. The treaty includes a number of provisions for dealing with cases of cross-border insolvency involving two or more of those countries (see Articles 40-41 and 45-48), but these provisions have been rarely followed in practice.

Economic union legislation

The only example of a truly “regional” (that is, linking countries without regard to whether their respective systems of law are similar – cf. the Nordic convention) approach to cross-border insolvency is between the member states of the European Community (with the exception of Denmark). This is the EC Council Regulation 1346/2000 on Insolvency Proceedings that came into force on 31 May 2002. It applies only to and within the member states that acceded to the regulation (namely Austria, Belgium, Finland, Germany, Greece, France, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom). Cross-border cases originating in other countries have to be dealt with under the domestic law obtaining in the country in which the relevant application is made.

Although it has been a considerable time since the possibility of such a regional cross-border approach was initially conceived (the initiative for it dates back to the very foundations of the EC in 1960), the resulting legislation is a very significant and important development, if only for the reasons that it embraces countries of both common law and civil law tradition, it involves countries in which there are considerable differences in their respective insolvency law regimes and it covers such a considerable number of countries. In that sense it may be described as truly regional. Moreover, it is also truly reciprocal.

Very generally, it operates on the basis that if an insolvency proceeding is opened in a member state (normally this would be the state in which the debtor has its domicile or centre of main interests), recognition (without formality) of that proceeding is automatic throughout the other member states; the law of the state in which the proceeding is opened applies; the insolvency representative may exercise all its powers and rights throughout other member states; and the relevant courts and institutions of other member states are required to render assistance and provide relief as may be required. The opening of other (competing or secondary) proceedings in respect of the same debtor is thus restricted and the general or overall result in most cases should be that there would be only one proceeding in respect of the debtor throughout the EC member countries. Another feature of the regulation is that it goes some way toward dealing with (or at least addressing) conflicts of laws issues, particularly as regards the applicable insolvency law and also property and security rights and claims. The regulation is posted to the technical assistance website.

Global “model law” legislation

Finally, there is the product of the work of UNCITRAL that was conducted from 1994-1997, resulting in the Model Law on Cross-Border Insolvency.

The model law was approved by a general resolution of the General Assembly of the United Nations in December 1997. It is the product of the work of a working group of the member nations of the United Nations Commission on International Trade Law.

Before reviewing the content and thrust of the model law, it should be appreciated that it is not a treaty or a convention. This has two important consequences. The first is that the model law will only become effective if a country legislates for it (or a version of it) as part of its domestic legislation. The second consequence is that it will not, by itself, result in reciprocity. Thus it operates unilaterally. The effect of reciprocity may, however, be achieved between those countries that adopt the model law, provided they do not introduce more limited reciprocity qualifications into their domestic version of it.

The broad scheme of and the basis on which the model law is intended to operate is as follows:

- It applies to an insolvency proceeding in which the debtor is subject to the control or supervision of a foreign court for the purposes of reorganisation or liquidation;
- It applies to both “inbound” and “outbound” requests for recognition and assistance, but obviously concentrates on “inbound” applications;
- It provides access to the courts (or other relevant institutions) of an enacting state for a “foreign representative” (a person or body who is authorised in a foreign proceeding to administer the reorganisation or liquidation of a debtor) to apply for recognition and assistance;
- An application for recognition and assistance may be made without unnecessary formality or procedure;
- A decision on recognition should, in most cases, be quickly decided and amount to not much more than a formality;

- Depending on the nature of the foreign proceeding and the extent of assistance that is required, automatic immediate relief and assistance will follow from recognition. The main relief is in the form of a stay or suspension of actions and proceedings against the property of the debtor located in the enacting state.
- The model law provides for the possibility of co-operation between office holders and courts and judges in the various jurisdictions that might be involved.

A copy of the model law and the explanatory memorandum accompanying it has been posted to the technical assistance website.

The production of the model law and its endorsement by the United Nations has been regarded at least as significant and important (or possibly more so) as the EC cross-border regulation, primarily because it is attempting a “global” approach to the issue, unimpeded by local or regional differences. The model law offers every country in the world a system to effectively promote and govern access, recognition and assistance in cases of cross-border insolvency.

Obviously, because of its unilateral character, its effect will be greatly enhanced by the number of countries that ultimately adopt it. Thus far, adoption has not been extensive. But there are sufficient and encouraging signs to believe that adoption may soon become much more widespread

The model law has been largely adopted by Mexico (as part of its domestic insolvency law regime) and South Africa (through the Cross-Border Insolvency Act 2000). Japan enacted a modified version of the model law in 1999 (the “Law on Recognition and Assistance of a Foreign Insolvency Proceeding”). Other countries such as the United States, New Zealand, Australia and England have made provision for or proposed the adoption of the model law.

Of interest is the fact, as mentioned in more detail later, that some of the above jurisdictions have created their own version of the model law. South Africa, for example, has a provision that requires reciprocity. The Japanese legislation concentrates solely on “inbound” requests for recognition and assistance. This suggests that policymakers may wish to consider adoption in a way that best suits the particular circumstances of their country.

2.4 Treatment of cross-border insolvency in the Asian region

There are very few countries in Asia that, it might be said, have adopted a modern and efficient approach toward cross-border insolvency.

The following is a brief analysis of the current position:

- **Countries that continue to maintain a strict “territorial” approach:** In this category are Thailand, Korea, PRC and Chinese Taipei
- **Countries that might apply the “comity” principle:** Countries that have a common law heritage, such as Singapore, Malaysia, India, Pakistan and, possibly, Hong Kong, China, are in this category.
- **Countries that have enacted unilateral legislation:** In this category are Japan, Singapore and Malaysia (but only in relation to cases of individual bankruptcy and subject to reciprocity in the case of Malaysia).

- **Countries that have bilateral arrangements:** As mentioned earlier, Singapore and Malaysia have reciprocal legislation for recognition and assistance in relation to cases of individual (non-corporate) insolvency.

With the exception of Japan, where it might be said to have adopted a modified version of the UNCITRAL model law (and, to a limited extent, Singapore and Malaysia), no Asian countries have embarked on a modern cross-border approach. There are, however, some proposed or possible developments in some countries. The draft “Law of Enterprise Bankruptcy and Rehabilitation” of the PRC, for example, contains a provision for recognition and assistance of cross-border cases (see draft law, January 2001 version). This is a welcome change of approach since previous drafts adhered to the territorial principle. The Philippines draft Corporate Reorganisation Law (“CRA”) also contains a provision on cross-border insolvency. This appears to be largely modelled on the existing cross-border provisions of the US Bankruptcy Code (see proposed Section 80 CRA, cf. Section 304 US Bankruptcy code). India has signalled an intention to adopt the UNCITRAL model law. The possible adoption of the UNCITRAL model law has been discussed in Hong Kong, China and, also, in Nepal.

2.5 *Issues that arise*

Having provided something of a map of the possible ways in which to give effect to recognition and assistance in cases of cross-border insolvency and a guide as to the present position in the Asian region, it is now necessary to identify and explore the more major policy and other issues that might confront a country in its consideration of the area generally.

It is suggested that the more major of these might fall into the following categories:

- Sovereignty;
- Reciprocity;
- Protection of local creditors;
- Economic benefit;
- Ability of an existing domestic insolvency law regime and the institutional capacity to apply a cross-border law; and
- Areas of practical application.

These are now discussed in more detail.

2.6 *Sovereignty*

It was made clear during the inception mission that there is an obvious and understandable concern in opening a country up to recognition and assistance legislation. This concern is possibly most evidenced by reference to the number of countries that do not provide for reciprocity of judgments recognition and enforcement (for example, Thailand and Indonesia do not recognise foreign judgments, although Thailand is a signatory to the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards).

In essence, the concern reflects the apprehension that exposing the citizens of, say, country A to the processes and decisions of courts of another country (when those citizens are physically present in

country A and not that other country), detracts from the independence of country A and its sovereign entitlement to regulate the affairs of its own citizens.

2. *Reciprocity*

This is another significant issue. Many policymakers might take a view on this by asking why should inbound requests and applications for recognition and assistance from other countries be provided for or encouraged when there is no guarantee or obligation on another country to return the favour? The absence of a requirement for reciprocity could result in “one-way” traffic. That is certainly true if a request or application is made from a state that has no legislation or other facility for recognition and assistance. A possible answer is to limit the application of a cross-border law to countries that have either similar laws or, more extreme, to negotiate bilateral or multilateral arrangements. Policy may thus dictate that the application of any cross-border law should be subject to at least a real prospect, if not a guarantee, of reciprocity. In this context, it is perhaps relevant to note that the South African adoption of the UNCITRAL model law specifically provides for its application only in cases where the country from which an application for recognition and assistance is made has reciprocal law. And, in the same vein, the recommendation of the Law Commission of New Zealand on the issue of the possible adoption of the UNCITRAL model law suggested that New Zealand should delay enactment of the model law until it was clear that some of the major trading partners of New Zealand would adopt the model law.

2.8 *Protection of local creditors*

Another way of raising this issue is to ask the question, “Does cross-border recognition and assistance benefit creditors, local or foreign?”

Judged by reference to pure money terms, the answer is that it depends. It depends, for example, on whether, if local assets were quarantined and made available for sharing between only local creditors, they would receive more than if local assets were used to swell the “global” pool and the “pool” was then made available to all creditors. Obviously, in some cases local creditors would receive more and in other cases less. And although this may be a relatively easy question to decide in a liquidation context, it may be a difficult question to judge in case of reorganisation. So it is very much a case of “swings and roundabouts” – what might be lost in one case, will be made up in another.

If it is a case of a reorganisation, another issue that might affect creditors is the prospect of a continuing market, for example, of supply. This can have a marked effect on, for example, employee creditors and trade creditors. The measure may be not just how much will they receive if local assets are quarantined but, rather, might there be a continuing market place for the supply of future goods and services if local assets were not quarantined and the debtor enterprise was reorganised.

In effect, therefore, it is impossible to make out a case on this issue one way or the other. There are possible benefits and detriments. By the same token, however, and because the issue will always give rise to uncertainty, it might be unwise to make a policy decision on a cross-border insolvency law by endeavouring to reckon whether local creditors might be better off or not.

Certainly many countries guard against the possibility of “double dipping”, particularly by foreign creditors, by providing a rule (sometimes known as the “hotchpot” rule) that before any distribution may be made to a creditor, the creditor must bring to account the fruits of any other sources of payment.

It is understandable that a country will be concerned for its nationals and the prospect that local creditors might be worse off in a particular case where a “global” reorganisation was facilitated by application of a cross-border recognition law (worse off, in the sense that had foreign involvement been excluded, local creditors would have enjoyed sole rights of participation in local assets). There is no answer to this dilemma. It might be best addressed by accepting the observation that, in a system of inter-country co-operation, any loss to local interests in one case will be roughly balanced by a gain in another case. What is clear is that there is no conclusion of universal application in the sense, as noted at the outset, the commercial result of every liquidation and every reorganisation will depend upon their own circumstances. It is certainly the case that, for example, if local assets were quarantined for the benefit of local creditors, those local creditors would not necessarily be in a better position.

2.9 *Economic benefit considerations*

As a general “a priori” proposition it may, it is submitted, be stated that trade and commerce benefits from the application of predictable rules. If relevant laws and commercial practices are relatively certain and predictable, the more likely it is that trade and commerce is encouraged and facilitated. Trade and commerce covers not only the marketing and supply of goods and services but also investment through, for example, provision of finance and equity capital. Without seeking to promote or debate the benefits or otherwise of the so-called “global economy” or globalisation”, it would seem to follow that foreign trade and investment is likely to be more attracted to countries that, at least, take account of “foreign” interests and involvement in the local economy. In the context of cross-border insolvency, this must ultimately require a consideration of whether, if relevant financial difficulty supervenes, particularly from abroad, local laws and institutions discriminate against foreign interests and whether they are capable of responding to wider “international” considerations. An appropriate cross-border insolvency law should answer those concerns and issues.

2.10 *Ability to apply*

A further issue concerns the state of the existing domestic insolvency law and its application in practice. During the inception mission it was often observed that moving to the possibility of having to deal with cases of international insolvency might be a bridge too far because there are enough difficulties being experienced in dealing with domestic cases. Sometimes this might be attributed to deficiencies and weaknesses in the existing domestic law and institutions. For example, the absence of or significant weaknesses in a domestic reorganisation process might make it extremely difficult or impossible to assist in a reorganisation attempt that results from a sophisticated reorganisation process of another country. Further, the inability or failure of local judges to be able to properly apply domestic insolvency law might mean that it would be beyond their capacity to deal with a case of cross-border insolvency.

Beyond these considerations, where comity is a relevant consideration for gaining recognition of a foreign insolvency proceeding, it needs to be established that, in its essential features, the insolvency regime under which the foreign proceeding has been established corresponds to the regime in the country to whose courts an application for recognition has been made.

2.11 Practical issues

It might be all very well for a country to enact a law relating to cross-border insolvency, but the essence of its workability lies in the ability to apply it. For example:

- what formalities might be required to commence an application for recognition;
- what court should be involved;
- will a foreign insolvency representative have direct access to the courts or will some form of cost and time intensive formality be required (for example, through diplomatic, judicial or other channels);
- what “evidence” will be required of the commencement of an insolvency case in a foreign jurisdiction;
- what should be the effect of recognition;
- what assistance might be provided;
- what controls may be exercised over a foreign representative?

All of these issues were, of course, raised, considered and debated during the development of both the EC Regulation and the UNCITRAL model law. It may be suggested that the product of those respective works contains or endeavours to provide the answers to such issues. That is not to say, however, that either the stipulations to be found in that regulation or that model law or, indeed, the absence of some stipulation, will be determinative for all jurisdictions. In some jurisdictions, for example, there may be perceived to be a requirement for reciprocity.

But there are other practical issues. A major issue concerns coordination and co-operation between the various jurisdictions that are involved, particularly if the case involves a reorganisation of an enterprise that has significant interests in two or more jurisdictions. Such a case of cross-border insolvency will sometimes require courts in different countries to act in unison, so that effective orders may be made simultaneously. This might necessitate simultaneous hearings in the courts that are involved. Some of the elements to consider in relation to this include:

- **Communications between the courts.** This involves not only issues concerning the means of communication (telephone, fax, email, video link), but more importantly, at what level and in what circumstances may any such communication occur. It is reasonably clear, for example, that direct “private” communication between judges concerning a cross-border insolvency case should not be encouraged. Any communication of that nature should only occur in the presence of the relevant parties to the case and/or their respective advisors. It would be thus desirable for a set of acceptable “rules” to be developed and agreed to govern this area.

- **Language and interpretation difficulties.** Quite clearly, this can present a considerable barrier. This does not just refer to the means that might be employed. It must also take into account that laws and practices and procedures may (will) be markedly different. It is therefore necessary that there is a clear and unambiguous understanding of what one jurisdiction may be attempting or implementing. Issues such as this may only be overcome by the employment of skilled and reliable translators.
- **A common understanding of concepts.** Underpinning both any communications between courts of different countries as well as the management of any language and interpretation difficulty is the need for all participants (judges, parties and their representatives) to have a common or mutual understanding of the pertinent concepts that apply, either generally or in a particular case.
- **Time differences.** Trite though it may be, the observation should at least be made that any requirement or need for simultaneous court hearings in two or more countries will have to wrestle, on occasions, with the fact that there will be a considerable difference in time zones.
- **Practice and procedure generally.** The substantive law is one thing, but account must also be taken of differences in practice and procedure between the courts of different countries. As an example, consider an application for interim urgent relief in a cross-border case. Practice and procedure in country A may facilitate an expedited hearing without notice to parties who may be possible affected. In country B expedition and proceedings without notice may be quite restricted or impossible.
- **Use of “protocols”.** The overall administration of cross-border insolvency cases may be considerably assisted and advanced if the relevant parties in the jurisdictions involved in or affected by the case can agree on some basic and fundamental things. Often this involves a number of broad administrative matters, such as the future conduct of business interests of the debtor, who will administer particular assets or property, the disposal of assets, who will conduct such a disposal, what will be done with the proceeds, etc. But agreement may also be required on more substantive matters, such as who should be responsible for particular actions, jurisdictional issues concerning court supervision or control, the pursuit of actions for recovery of property and so forth.

In an endeavour to reduce the confusion and complexity that might otherwise obtain and provide for greater expedition and efficiency, a practice has arisen of the use of a “protocol” when the circumstances of a cross-border case appears to require it. The protocol records, in effect, an agreement between the relevant parties on issues such as those mentioned above. In most circumstances it will be necessary and advisable for such a protocol to be formally approved or recorded by the relevant courts in the relevant jurisdictions. Although any such “approval” or “record” might fall considerably short of a formal court endorsement or sanction of the matters contained in the protocol, a protocol that has been approved or recorded provides much needed clarity and guidance for the participants, including the courts.

Part Three: Informal Workouts

3.1 Introduction

As mentioned in the introduction to this paper, the device or mechanism of the informal workout was developed as an alternative (or, possibly, a substitute) for formal insolvency processes. The

concept is not, of course, new or unique. Informal arrangements between a debtor and creditors would have preceded even the earliest in time of formal insolvency laws.

Most insolvency laws do not forbid nor seek to prohibit a private compact between debtors and creditors, although some may state that an “arrangement” between a debtor and creditors that does not comply with the formal requirements of the law relating to “arrangements” or “compositions” is invalid or void (as, for example, in Section 213 of the Bankruptcy Act of Australia). But the essence of such a provision is really to prevent abuse (for example, in a case where a debtor and only some creditors agree on some form of payment arrangement between them but leaving nothing to be paid to all the other creditors). So, provided that an “informal arrangement” is agreed to by all creditors affected by it and no other creditors are prejudiced or adversely affected by it, such an informal arrangement will be just as effective as any “formal” arrangement because no one would have any real basis for complaint.

The informal workout is, thus, founded on two main elements – first, a private contract or consensual agreement between the debtor and those creditors that are party to the workout and, secondly, ensuring that other creditors are not adversely affected (for example, providing for them to be paid their debts in full).

As noted in the “Statement of Principles for a Global Approach to Multi-Creditor Workouts” (the “INSOL Statement”), published by INSOL International), during the last 15 years or so, financial institutions, assisted by regulatory and official authorities, have been encouraged to co-operate with one another when dealing with debtors to whom they have been collectively exposed. Although, as mentioned in the INSOL Statement, such co-operation has been most apparent in periods of economic recession, there has been more general acceptance for its application in any economic circumstances. This is primarily because a co-ordinated response gives time to help manage the impact of debtor defaults and create an opportunity to explore and evaluate the options for consensual agreement outside a formal insolvency process.

Once the informal workout process had become generally accepted by the financial sector in countries that led its development and application (for example, the U.K. and the U.S.), some areas of potential problem and tension arose. For example, in relation to a syndicate of banks involved in a financial facility with a defaulting debtor, it was sometimes the case that one or more members of the syndicate might refuse to agree to a proposed workout, hold out for a greater return or seek to assign their part of the syndicate debt to a person outside of the syndicate. There was also pressure to let other, not strictly financial institutions, such as insurance companies and bondholders, into the workout process, to which there was some reluctance and resistance because their attitudes and goals might differ quite markedly from banking sector participants. Further, the quite substantial development of markets in “secondary debt” has introduced the prospect of a workout that might initially involve just bank “primary” debt holders but is then suddenly composed of debt traders who have acquired debt from some of the banks. To some degree these tensions have been able to be accommodated through the employment of one means or another. For example, peer pressure in the case of recalcitrant bank syndicate members. And it is now generally accepted that insurance institutions, bondholders and debt traders will need to be included or in some way accommodated in any informal workout process. However, these and other like issues are left to be resolved, as relevant creditors consider appropriate in each case.

3.2 *Advantages of informal workouts*

There are usually material advantages for both debtors and creditors in pursuing an informal or “contract based” rescue or workout. Some of the main advantages are said to be that:

- The possible cost, possible complexity, possible uncertainty, and possible extensive time of formal insolvency processes are reduced;
- Because the number of creditors involved is relatively small, there is greater efficiency and less need for formalities;
- A degree of greater secrecy and confidentiality may be possible (in the sense that there is no “advertisement” or publication that the debtor is in financial difficulty);
- There may be greater flexibility and less rigidity in determining a plan of action for the resolution of the financial difficulties of the debtor since the participants are not bound by constraints that might be imposed by an insolvency reorganisation regime;
- An informal workout that is sustained by an agreement between the debtor and its financiers provides a more sympathetic regime in which to reorganise the debtor’s affairs than is usually the case in a formal insolvency administration.

3.3 *Development of workout principles*

A workout process normally involves a corporate debtor whose greatest level of liability is in bank and other financial institution debt (often as high as 90% or more). It is usual to exclude other (for example, trade) creditors from the process on the basis that their interests will not be adversely affected and may even be enhanced. Thus, funding will normally be available to such other creditors or to permit payment of their claims to ensure, for example, a continuity of trade supply and, if a workout proves successful, these other, non-affected, creditors will probably be paid in full (even though the affected banking and finance creditors may not).

The modern workout has to accommodate the amount, number and variety of financial sector debt. To do this a body of broad principles has been developed (of which the leading example is contained in the INSOL Statement mentioned above), together with “rules” to govern the process. The application of principles and rules gives the informal workout process a structure, without which the process would probably be unmanageable and ineffective.

A short summary of the principles contained in the INSOL Statement is as follows:

Principle 1: If a debtor is in financial difficulty and agrees to participate in the informal process, all relevant creditors should be prepared to co-operate with each other and the debtor to give sufficient time (referred to as the “standstill period”) for:

- the debtor to supply all relevant financial information;
- the creditors to assess the financial information; and
- the preparation and assessment of a proposal for resolving the financial difficulties of the debtor.

Principle 2: During the standstill period, all relevant creditors should agree not to enforce claims against the debtor or the assets of the debtor.

Principle 3: During the standstill period, the debtor should agree not to sell, transfer or otherwise deal with the assets of the debtor, except in the normal course of the business activities of the debtor.

Principle 4: It is necessary that, where relevant, the creditors must take a co-ordinated approach toward the debtor. A co-ordinated approach will be most facilitated by the selection of a small creditor committee; the engagement, if necessary, of professional advisers to assist the committee; and for negotiations with the debtor to be undertaken by the committee.

Principle 5: During the standstill period, the debtor should provide all relevant financial information to the creditors concerning the assets, debts, business and future prospects of the debtor and to give the creditors access to that information.

Principle 6: A proposal for resolving the financial difficulties of the debtor should show that under the proposal the creditors would not be disadvantaged (for example, that the creditors will receive at least as much as they would if the debtor became bankrupt and the assets of the debtor were liquidated).

Principle 7: Information provided by the debtor and proposals for resolving the financial difficulties of the debtor should be made available to all participating creditors but should be treated as confidential.

3.4 *Incentives to participate*

Submission to such principles and rules by a debtor and creditors is, of course, purely voluntary – an attribute that characterises an informal workout. However, to describe the process as “voluntary” overlooks an essential feature that normally must be present if the process has any likelihood of support and involvement. This feature may be best described as “pressure”. It is “pressure” of one kind or another that provides the incentive for both debtor and creditors to commence and then endeavour to negotiate an informal workout. Usually the “pressure” will be found in the hovering shadow of the possible application of an insolvency law regime and/or, depending on the circumstances, the enforcement provisions of a secured transactions law regime. It is the prospect of the speedy and effective application of one or both of these regimes that will usually compel both a debtor and relevant creditors to join in the informal process.

As regards a debtor (and, to some extent, creditors), the presence of this “pressure” is absolutely vital. It is commonly described as the real presence of a “credible threat”. For relevant creditors, however, pressure might also come from other sources (for example, the type of persuasion that might be applied by an association of banks, a central bank or ministry of finance to encourage a bank or other financial institution to participate or, indeed, take a leading role in promoting a workout). Alternatively banking sector participants might agree amongst themselves to participate in workouts generally, if certain criteria or conditions are met. An example of such an agreement is the Financial Institutions Agreement for Promotion of Company Restructuring undertaken by the Korean banks and financial institutions to which reference is made in 3.5 below.

In general, however, the aim of this technical assistance is to promote and develop the “stand alone” informal workout, influenced only by the “credible threat”. In that context, the technical assistance will necessarily be concerned with the accessibility to and efficiency of those tribunals that can impose formal insolvency administrations upon debtors who are not prepared to negotiate an arrangement under which an informal workout of its financial affairs can be pursued. Additionally, beyond the exercise of government or central banks of their “persuasive” powers, a further issue will be the availability under local insolvency laws of procedures that can be invoked to impose the regime of a formal workout on all creditors in the event that a small number of them are not prepared to agree to an informal workout.

3.5 *Development of informal workout processes in the Asian region*

The real impetus for the development and deployment in the Asian region of the techniques associated with informal workouts came with the Asian financial crisis in 1997. Indeed, prior to that crisis it may be generally stated that informal workouts of the type under discussion in this paper were relatively unknown and not practised in the Asian region.

A significant aspect of the Asian financial crisis was that the loan portfolios or receivables of many banks operating in the Asian region were significantly depreciated in value. As a consequence, the integrity and stability of the banking system in various countries in the region was severely threatened. Absent some form of intervention by governments or central banks, there could have been a complete collapse of the financial sector.

That intervention resulted in two streams of “informal workout” development.

“Structured” workout processes

The first consisted of initiatives led by either the central banks or the commercial banks themselves to establish what might be best described as “structured” informal workout processes. This resulted in the establishment of organisations or agencies such as CDRAC in Thailand, CDRC in Malaysia, the “Jakarta Initiative” in Indonesia and the less structured Financial Institutions Agreement in Korea. These organisations or agencies promoted an environment to enable banks and corporate debtors to come together in an attempt to broker a settlement of debts owed to the banks that, in the great majority of cases, meant that the debtor was required to develop a reorganisation proposal. This process was “structured”, in the sense that certain criteria had to be met before a corporate debtor was eligible to participate (for example, bank or financial institution debt in excess of a certain percentage of the debtor’s total liabilities), eligible debtors were required to submit to a set of “rules” and, in some cases, strict rules applied to the type of agreement or arrangement that banks might reach with a debtor regarding payment or settlement of financial sector debt (such as, for example, prohibiting or limiting debt-for-equity swap as part of the overall reorganisation of the debtor). To some degree, therefore, the processes were aimed at protecting the banks, rather than accommodating insolvent debtors. The relevant details of these initiatives are as follows:

- Korea: Here the initiative was known as the Financial Institutions Agreement for Promotion of Company Restructuring, the subscribers to which were Korean banks and other financial institutions.
- Thailand: The informal process is formally known as the Framework For Corporate Debt Restructuring in Thailand. The Board of Trade of Thailand, the Federation of Thai Industries, the Thai Bankers Association, the Association of Finance Companies and the Foreign Banks” Association jointly initiated it.
- Indonesia: The initiative in Indonesia became known as the “Jakarta Initiative” and was promoted by a “Task Force” appointed by the President.
- Malaysia: In Malaysia the informal system was promoted by the central bank, Bank Negara Malaysia, through the Corporate Debt Restructuring Committee.

Less-structured and more flexible initiatives were also taken in Hong Kong, China where the initiative was largely that of the Hong Kong Association of Banks with the endorsement and support of the Hong Kong Monetary Authority, and also in Singapore.

Asset management workouts

The other development came by way of organisations that, in effect, liquefied the receivables of many banks, to the extent that those receivables represented non-performing loans, by acquiring them. Those organisations then dealt directly with the corporate debtor in an endeavour to resolve the debt (which, in many cases, meant a reorganisation of the debtor under an informal workout arrangement). Such organisations included the Indonesian Bank Restructuring Authority (IBRA) in Indonesia, the Danaharta inspired statutory corporation in Malaysia and the Korean Asset Management Corporation (KAMCO) in Korea. More recently the Thai Asset Management Corporation (TAMC) was established in Thailand to undertake a similar activity.

Although these two streams of development have greatly contributed to the evolution and development of the informal workout processes in many Asian countries, the fact that they were a direct consequence of the financial crisis and were developed in that environment has probably produced a skewed form of informal workout process because the essential thrust of the processes were geared toward saving banks and re-establishing the integrity of the banking sector and system. By comparison, the environment with which this technical assistance is more concerned is one that is not overshadowed by banking sector instability, an environment in which banks and financial institutions are not so much concerned for themselves but are more concerned to rescue or reorganise a borrower who is in financial difficulty.

3.6 *Differences in approach in the Asian region*

Part of the work involved in this technical assistance is to explore the achievements and experience of the initiatives mentioned above, consider the results that have been obtained and, in particular, to promote the continued development of the informal process through the banking and financial sectors of countries in the region. There is a degree of variation (and resulting comparison) to be made between these processes. The comparative issues include the following:

- First, among the influences that encourage the development, some have been clearly influenced by government and/or central bank policy (for example, Malaysia, Indonesia and Thailand). That influence was, however, probably required because the informal workout had not been practised in those countries and a development of that nature was required to deal with significant problems in the banking sector as a result of the regional financial crisis. In other countries the process has largely developed through the initiative of the banking and financial sector itself (for example, Singapore, Hong Kong, China and, possibly, Korea). To this extent, the development reflects recognition on the part of participants in that sector (both within the Asian region and beyond) that the informal workout process often yields a better commercial result when applied to the reorganisation of the affairs of a debtor than is the case with formal insolvency processes.
- Secondly, with respect to the coverage, some essential differences can be noted. In Korea, for example, the extent of coverage depends upon which banks and financial institutions subscribed to the Financial Institutions Agreement involving the banks. An attempt at an informal workout could only be conducted in respect of the affairs of a debtor of one of the subscribing banks and in circumstances where the liabilities of the debtor to the subscribing banks represented at least 90% of its total liabilities. A further limitation arose because foreign banks were largely excluded from the process. In Thailand, the “eligible” debtors were, in effect, either nominated by a bank or other financial institution or volunteered for the process.

- Thirdly, there are differences in the process. Under the Thai process, the banks were required to subscribe to an agreement governing the process and a debtor who sought to participate was required to “accede” to the agreement. This provided a contractual base for the process. Under the Thai, Indonesian and Malaysian processes, a facilitator was provided in the form of a quasi-government agency. No such agency is involved in Singapore or Hong Kong, China. In Korea, the banks appointed a “Company Restructuring Committee” to act as facilitator.

3.7 *Issues for consideration*

The most important of these may be shortly stated as follows:

- To what extent might it be necessary to distinguish between informal processes that are established to deal with a systemic problem in the banking and finance sector and informal processes that are established as part of banking sector culture? As mentioned above, many of the informal processes in the Asian region were promoted and developed as part of a response to severe problems within the banking sector as a result of a general economic crisis. They have been “tailored” to fit that circumstance. Although they have been no doubt valuable and productive for the banking sector (and, possibly, for bank debtors), an issue arises about their applicability in “non-crisis” circumstances and to what extent banking sector involvement in such processes has “moulded” a view or habitude on informal workouts that needs rethinking and possible redesign. For example, some informal processes (that of Thailand, for example) contained prescriptions on the manner and type of “deal” that a bank might be authorised to conclude with a debtor (such as a limit on the amount of any debt write-off or a limit/ban on the amount of debt conversion to equity and so forth). Presumably, those types of dictates should not be applicable in “normal” circumstances or might the influences of central bank/ministry of finance be such as to “regulate” banking participation in informal workouts, even in “normal” circumstances?
- Are influences (in the sense of central bank pressure or “credible threats”) necessary, or even desirable, for the promotion of an informal workout process? This refers both to the banking and financial sector itself and the debtor. As regards the banking sector, the issue is whether “encouragement” of one form or another might be required to propel, or even compel, banking and financial institutions to participate in an informal process. A further option, which is considered below, is the availability of a formal process if a significant majority of a debtor’s creditors are prepared to agree to a workout but a few are resistant to the proposal. Such “encouragement” might come, for example, from a central bank and might take the form of a simple endorsement of the process or a directive. It might be more appropriate if encouragement comes from within the sector itself, through, for example, an endorsement of an informal process by an association of banks or an agreement amongst banks themselves (as, for example, under the Korean process).

As regards a debtor, “encouragement might come from a chamber of commerce or a trade association, but, in reality, the “encouragement” that is required for a debtor will usually be found in the “credible threat” notion – for example, the prospect of enforcement of secured property interests and/or the application of formal insolvency processes. The same persuasion might also be used to induce creditors to participate (else the debtor or majority of creditors might seek a formal remedy under the insolvency regime). So a further issue that arises in this context is whether, in the absence of such “credible threat”, there is any other basis upon which to encourage creditor/debtor participation in the process?

- Is it desirable to develop and employ a set of “rules” to govern the process to which both creditor institutions and a debtor would be required to subscribe in order to commence or initiate the process? Such rules would go beyond a set of “principles”. They would set out actions to be taken, obligations to be performed, time limits to be observed and so forth. Rules of that nature might give a workout process a desirable structure and impose some discipline upon the participants. Questions that arise in this context include whether a set of rules of universal application might be developed and whether any such rules might begin to “formalise” the process and undermine the essential “informality” of the process.
- How are issues concerning “breakaway” members of a banking syndicate, bondholders and debt traders best addressed in the context of an informal process? These types of issues are raised in the introduction to this part of the paper. In relation to “breakaway” banks, should this be addressed by the terms of the syndication agreement or peer pressure or, even, “friendly” central bank intervention? Issues concerning bondholders, debt traders and the like essentially involve the possible intrusion of “non-banks” with different attitudes and different agendas. How can they be best accommodated in the informal process?
- Is it necessary or desirable to provide for a possible requirement of “mediation” as part of the informal process? Despite the best intentions of the participants, deadlock between creditors and the debtor or between creditors or groups of creditors themselves is always possible and may ultimately frustrate the informal process. In some countries that established a quasi-structured informal process, the possibility of the intervention of a representative of a committee or agency to mediate on deadlocks was provided for. Perhaps, then, the issue is whether the “principles” or “rules” governing an informal process should include provision for the possibility of mediation (and, if so, by whom) or left to the interested parties to determine on a case-by-case basis.

- What is needed to provide a “regional” or “global” approach to informal workouts? The acceptance of broad principles (as, for example, the principles developed by INSOL International) would no doubt be a first step as establishing some common “international” ground. Leaving aside the acceptability of the INSOL principles (a copy has been posted to the technical assistance website for discussion), the question arises whether it might be appropriate or desirable to seek the endorsement and promotion of such a set of principles by, for example, central banks or associations of banks in individual countries. Are there other steps that might be taken to advance this issue further?
- Would a “domestic” workout process benefit from the possibility of a “fast track” conversion mechanism to a formal reorganisation? This issue contemplates that an attempt at a workout has proceeded and reached a point where a majority of participating creditors and/or groups of participating creditors has signalled their satisfaction with the terms of an informal reorganisation plan. However, there are dissentients and without their involvement the plan may be incapable of implementation. The “majority” of those in favour is such that it would be sufficient to comply with the requirements of creditor approval under the relevant formal reorganisation process and the effect of that, when coupled with the overall effect of the plan, would be to bind (or result in a “cram down”) of dissentient creditors or groups. One way of dealing with that circumstance (so that a positive result would be achieved from the informal process) would be to provide for a “conversion” mechanism within the formal insolvency law regime to effectively transpose and subject the result of the informal process to the effects and sanctions provided under the formal reorganisation process. In effect, such a mechanism would provide a “fast track” into the formal insolvency regime and would avoid having to undertake a large part of the procedure required under the formal law. As has been noted above, it might also provide or impose an additional persuasive element on dissentient creditors to join the majority.

The concept and the type of legislation that might be required to implement the concept is part of the work being developed by UNCITRAL in its work on legislative guidelines for insolvency law. A draft of that development (together with some explanatory material) has been posted to the technical assistance website. It should provide a useful basis for discussion of the concept.

- Would it be possible to provide for a “fast track” conversion mechanism in a cross-border case? A further issue that arises is whether a conversion mechanism might be similarly developed to deal with a cross-border informal workout case. Might this be provided for in a cross-border insolvency law?

Part Four: Intersection of Secured Transactions and Insolvency Regimes

4.1 Introduction

Most insolvency and secured transactions regimes have been created independently of one another. It is probable that they have been created at different times to one another. It may also be the fact that different ministries or departments have had responsibility for each regime with little or no consultation between the two. It is often the consequence that one regime has not properly taken account of the other. Although this should not normally produce any serious clash, it can result in unnecessary and, at times, unwanted tension and conflict.

The possibility of tension and conflict between the two regimes has really emerged with the development of the modern “reorganisation” or “rescue” remedies that are now a feature of most formal insolvency regimes. The “rescue culture”, as it is sometimes described, is based primarily on the proposition that, from an economic and commercial perspective, not all insolvencies are bad and not all insolvent traders should be immediately removed from the market place. To the contrary, there is economic justification to endeavour to save or rescue an insolvent trader because it is capable of producing better commercial (higher returns to creditors), market (supply markets might be preserved) and social (less unemployment) results.

However, to promote and encourage a rescue culture it is necessary to curb and restrict the legal rights of creditors, particularly those creditors who have a significant interest in some part or all of the assets and property of a trader and who would otherwise be entitled to take and dispose of those assets – for example, a secured creditor who holds a security interest in such assets. This has resulted in insolvency laws that place significant restrictions on the ability of a secured creditor to enforce rights over the assets of a debtor. So, whereas before the advent of the modern “rescue” legal process insolvency laws contained little or no restriction on the enforcement rights of secured creditors (because the business of the trader would normally be immediately shut down there was no point in applying restrictions), now the law has to intervene and provide for restrictions in an endeavour to give effect to rescue “policy”.

As will be seen, it is in this area that there is effective and real tension between secured transactions and insolvency law regimes.

4.2 *Common ground between the two regimes*

Despite the possibility of tension, there is now a growing recognition that there is some considerable common ground between the two regimes. Each is concerned with debt, with relationships between debtors and creditors and with enforcement. Individually (but, more importantly, in tandem) they are capable of exercising a considerable degree of indirect influence on corporate governance and they should also underpin credit discipline by providing the spectre of the “credible threat” (a concept that provides an incentive for an insolvent debtor to become pro-active about the financial position of the debtor).

4.3 *Independent approaches*

However, they diverge in their approach to these areas and in the values they seek to uphold, as might be appreciated from the following:

- Each postulates a different approach to debt. An insolvency regime endeavours to deal with the circumstance in which debts cannot be paid, whereas a secured transaction regime endeavours to assure that a secured debt will be paid.
- Each endeavours to uphold different rights. An insolvency regime is concerned with preventing a destructive race between individual creditors, but a secured transactions regime is concerned with maintaining enforcement rights of individual creditors.
- Each has a different stakeholder constituency. An insolvency regime looks to maximising value for the benefit of all creditors. A secured-transactions regime looks to maximising value for individual creditors.

4.4 *The interest of one regime in the other*

Although the principal area of possible tension and conflict will occur at the point where a debtor becomes subject to a formal insolvency administration, there are some points of less, but nonetheless important, areas of intersection. These are in respect of creation and registration (or “perfection”) of a security interest.

4.5 *Creation*

It may be submitted that as regards the creation of a secured property interest, an insolvency regime has an interest in supporting a secured transactions regime that clearly identifies the nature and type of “security interests” that are permitted and covered by the latter regime. That greatly assists and makes identification of security interests much more certain. In turn that assists in the administration of an insolvent debtor because the property of that debtor that is subject to a security interest may be more easily identified and recognised.

4.6 *Registration or perfection*

A registration system for secured property interests that is all embracing and provides a certain, cost effective and efficient “search base” would also benefit an insolvency regime. Such a search base would provide the insolvency representative of a debtor enterprise with the facility to identify secured property and the holder of such security with relative speed and certainty. It would also assist an insolvency representative to determine the *prima facie* validity and enforceability of such security interests and to determine priority between competing security interests over the same property.

4.7 *Enforcement of secured property interests*

It will be apparent from the above that the areas of creation and registration cause little or no tension between the two regimes. Indeed, one should support the other. However, at the point where a debtor becomes subject to a formal insolvency administration and a secured creditor is poised to enforce a security interest there is a probability of tension and possible conflict. This point is the real “intersection” between the two regimes.

A number of areas may be usefully explored.

First, the stay or suspension of enforcement rights and powers of secured creditors. It may be anticipated that when a formal insolvency administration is opened in respect of a debtor, the insolvency regime will provide for a stay or suspension of actions and proceedings in respect of the property of the debtor. The stay may be immediate and automatic or may be ordered by a court shortly after the opening of the insolvency case. It is usual for this stay to include and thus embrace secured creditors. The justification for the stay in the early or initial stages of the insolvency administration is that it is necessary to keep the insolvency estate intact and together and to prevent dismemberment to enable a decision or course of action to be decided upon about the choice of remedy in respect of the debtor (which usually reduces to a choice between liquidation or reorganisation). This is certainly true of an insolvency regime that features a single entry system, because under that form of regime the debtor is under supervision during the decision process. Other regimes may, however, provide for a dual entry system, which normally means that there is an elective choice whether to file for reorganisation or liquidation. Under this system the opening of a reorganisation case can result in an immediate automatic stay for a considerable period of time. So there may be a greater issue under such a system. But this can be revisited.

Provided the early initial stay is relatively time bound, the prospect of causing damage or prejudice to the interests of a secured creditor is relatively minimal.

But then the issue becomes more debatable. Secured transaction protagonists would say that once a liquidation remedy is decided upon there should be no stay on secured creditors, because the usual consequence will be that the business of the debtor is closed down and its assets dismembered. There is thus no continuing justification to continue any interference with secured creditors' rights. That is a generally accepted proposition and is reflected by probably the majority of insolvency regimes. But there are some who would argue that "liquidation" should not necessarily mean that the business of a debtor cannot be sold as a going concern. They would argue that the stay should continue to apply to secured creditors until either the business is sold or it is determined that the business should be closed. Some insolvency law regimes follow this course and justify the continuation of the stay accordingly. The issue is thus somewhat dependant on the nature of the attitude taken to "liquidation" under a particular insolvency regime. There appears, however, to be common agreement that once a liquidation (closure of any business) has been decided upon, there is no justification to continue a stay on secured creditors.

There is general acceptance that if (either by election or decision) a reorganisation is to be pursued, the stay on secured creditors should remain until at least a decision has been made to either abandon the attempt (and possibly convert to liquidation) or that a reorganisation should occur. The issues that appear to be important here are that the stay should be time bound; that the length of the stay should be reasonably short; and that there should be a process for the possible lifting of the stay. The latter raises issues of the criteria to be applied.

There are some considerable differences in approach on this general issue of the stay or suspension. The insolvency laws of a number of countries (for example, the U.S., Australia, Singapore, Thailand) employ "automatic" stay provisions that take effect immediately upon the commencement or "opening" of an insolvency case without the requirement for any court order. In some other jurisdictions the automatic stay may be considerably delayed pending a decision on whether to open a case (for example, Japan, Korea and Taipei China), but there is a power to make an interim stay order. In yet other jurisdictions the stay is not automatic, but may only be imposed by court order. There are also differences on such things as the length of the stay (180 days in USA compared with up to 35 days in Australia, for example), the basis and conditions upon which a stay may be lifted on the application of a secured creditor and so forth.

These differences are relevant and important within the context of this area of study under this technical assistance because, for example, the longer the period of a stay on secured creditors' rights, the greater prospect there may be of adverse effect on that creditor. Thus, although it is not a principal purpose of the technical assistance to promote guidelines for a "standard" stay provision, discussion and development of the issue is important.

The next issue concerns the categorising of secured creditors into a class (or more than one depending on the nature of the various secured interests). Most insolvency regimes provide for secured creditors to be regarded as a separate class (an exception appears to be in the insolvency law of Indonesia). Some categorise "secured creditors" into different "sub" classes within the broad category (such as those with mortgages over land, chattel securities, lease finance securities, retention of title securities and so forth – see for example the insolvency regimes of Thailand and the U.S.). Other important issues for consideration in this context are such things as the extent to which any such "class" might be able to intervene and effectively block a reorganisation proposal that has the requisite majority support of other classes or of creditors generally (again, insolvency regimes differ

considerably on this issue) and the prospect of binding a class (through what is sometimes described as “cram down”) to a reorganisation.

A final issue concerns the provision of post-commencement finance to enable a debtor to either continue to operate a business, to protect/maximise the value of certain assets, or to survive generally. This issue is capable of affecting established secured property interests because it will normally be necessary to, in effect, assure or guarantee repayment to a provider of post commencement finance. There are two considerations. First, it is necessary for the law to permit or sanctions the borrowing of such finance (the Korean and Thai insolvency laws provide examples of such a legislative sanction). Secondly, it is necessary to “guarantee” or, at least, provide for the realistic possibility of repayment. Here the methodologies vary. An insolvency regime might create a simple “priority” for repayment of such finance (as in Singapore under its judicial “management” law) or a “super priority” payment entitlement ahead of all other claimants, including secured creditors (as, for example, under the USA Bankruptcy Code). It might permit the creation of a security over property that has effective priority over existing security interests over the same property. Other variations are possible. The issue, however, is what criteria and conditions should govern the provision and repayment of post-commencement finance insofar as the secured property interests of existing secured creditors might be affected.

4.8 *Other areas to consider as providing possible tension*

Apart from the above areas, there are three other aspects to be considered in relation to the two regimes.

The first concerns the application of the “antecedent transactions avoidance” provisions of an insolvency regime. This refers to the reasonably commonplace policy of an insolvency law that seeks to avoid or invalidate certain types of transaction concerning the property or financial position of a debtor that occur in a period before the commencement of a formal insolvency administration. The most usual form that such policy takes is to avoid transactions that enable a creditor to obtain an advantage over other creditors (commonly referred to as “preferential” transactions), transactions involving property of a debtor that are made at an “undervalue”, and transactions that are made with the intention of defeating or delaying creditors of a debtor (sometimes referred to as “fraudulent” transactions).

It is not intended here to debate the merit of such provisions but, rather, to recognise that they are likely to be found in most insolvency regimes. The issue that arises is whether secured transactions should be subject to these “avoidance” provisions. It is submitted that this “issue” is not likely to raise controversy. Most insolvency regimes would not exempt secured transactions from the antecedent avoidance provisions. Some examples might be of assistance.

In relation to “preference” provisions, a relatively common type of preference occurs when an unsecured creditor to whom a debt is due but unpaid seeks to secure the debt by requiring the debtor to create a security in favour of the unsecured creditor. If that type of transaction were effected the result would be that the creditor would obtain an advantage and be placed in a better position than other creditors and, consequently, there would be less to share among the other unsecured creditors.

In relation to fraudulent transactions, it should be apparent that there is almost unlimited scope for the use of secured property interest devices to defeat or delay creditors. For example, if a debtor were to create a secured property interest as security for a “sham” (non-legal) debt.

It is suggested, therefore, that there is no apparent policy or other reason to exempt a secured transaction from the application of the avoidance provisions of an insolvency regime.

The second area concerns the possibility that an insolvency regime may seek to invalidate a secured property interest that is not registered in accordance with the requirements of the registration provisions of a secured transactions law (as an example, the insolvency regime of Australia provides that an unregistered security over personal property (chattels and other like tangible and intangible movable property) that is required to be registered, is invalid and of no effect against the insolvency representative). Again, there should not be any great controversy about such a provision. The argument in favour of it is that it adds an additional incentive to register and publicise a secured property interest. If that is in line with the overall policy of a secured transactions regime or does not unnecessarily intervene upon or clash with such policy, the insolvency regime may be regarded as an ally of the secured transactions regime.

The third area concerns the application of the priority payment rules of an insolvency law to the proceeds of the realisation of secured property interests. An insolvency regime might provide, for example, that the claims of certain creditors must be paid out of the proceeds of secured property before any payment to the secured creditor. Taxation and employee claims are often “prioritised” in this way. A secured creditors’ lobby would argue strongly against such an intrusion on the grounds that it breeds uncertainty and unpredictability. Others might contend that there is “social” justification for such provisions and, to counter the issues of uncertainty and unpredictability, suggest that such liabilities should be capable of a reasonable prediction by a secured creditor.

4.10 Issues

The main issues that appear to arise for discussion and debate centre on the following areas:

- Is any benefit likely to flow by endeavouring to “harmonise” (by, for example, bilateral or regional co-operation) the response to issues concerning the intersection between secured transactions and insolvency regimes?
- Should secured property interests be subjected to the stay and suspension provisions of an insolvency law generally?
- Should any such stay be severely limited in the event of a liquidation of the debtor?
- What are the optimal conditions under which to subject secured property interests to such a stay in the event of a reorganisation attempt?
- What criteria should govern the lifting of a stay?
- What classification criteria should apply to dividing secured creditors into “classes” and what rules should govern the conduct of a class, both as regards its members and in its relationship with other classes?
- Under what conditions should the secured creditor members of a class be subject to a “cram down”?
- Should an insolvency regime intrude upon the enforcement of secured property interests by, for example, enabling the office holder to realise secured property?

- Should secured property interests be subjected to the payment of “priority” debts from the proceeds of the sale or disposal of the secured property and, if so, what “priority” debts?
- How, in relation to existing secured property interests, might it be best to provide or create a “super priority” in respect of “new money” borrowing?

INFORMAL WORKOUTS – OUT OF COURT RESTRUCTURING

by

*Terry Bond*¹¹⁹

I. Definition

The phrase “informal workout” which has almost assumed international currency, is used sufficiently frequently that it seems not to need definition, and regularly appears in all manner of learned papers and legal publications. Before entering in to a discussion on techniques and mechanisms, and the problems associated with this system, it would probably be best just to pause and reflect upon what exactly is meant by the term itself.

In fact, the term is used to cover a myriad of practices, and in examining further how best to achieve a successful workout, one perhaps needs to be more definitive, and indeed narrow, in deciding what exactly comprises recovery/workout and restructuring. The only common denominator between the many types is the fact that they are “informal” or out of court, they are by mutual arrangement between a debtor company and its various creditors. Once the company enters into the legal process, then the word informal drops away, and it becomes a formal insolvency in one form or another.

The following is just a selection of the different practices that have all fallen under the heading of “informal workouts”:

- A realisation of sufficient assets by a company to pay off its main financial creditors, the creditors having given time for this process to take place.
- Rescheduling of the debt – the financial creditors extending their loans over a longer period of time, often with a more lenient repayment structure in the earlier years.
- An agreement whereby the main financial creditors forgive some of their debt, and/or waive interest, in exchange for formal security over the balance.
- An agreement whereby the main financial creditors forgive some of their debt, in exchange for equity, or equity-based instruments.

There are various others, but this indicates the variety of practices that are called “informal workouts”. Some may, depending upon the laws of the country concerned, ultimately require a formal court approval, but if that is merely the last step, then the phrase “informal” is still valid. However, all of these options may just be based around achieving recovery for the lenders and there may be little change within the company itself.

¹¹⁹ Terry Bond is the Lending Services Director at Barclays Bank Plc., consultant to Insol and Vice-Chairman of the Insol Lenders Group.

The views expressed in the above are the personal views of the author and should not be taken to represent the official views of either Barclays Bank PLC or Insol. Insol is the International Federation of Insolvency Professionals, details of the Insol Global Principles can be accessed on www.insol.org

II. Restructuring

Most of the examples above are geared around the recovery of money for lenders. However, increasingly, the terms “turnaround” and “restructuring” are being used to describe rather more than merely the recovery of money. It is the basis of this paper that one really should be looking at full out of court “restructuring” rather than merely “workout”. This is a much more positive approach, looking not just at recovery for lenders, but also saving businesses, including both the preservation of present economic value and the maximisation of future value.

The real benefit of the out of court process is the opportunity that it gives to make the many significant changes that will be necessary in a business that is in difficulty, without the full glare of publicity, formal mechanisms, delays and costs that tend to accompany a full court process. As one simple example, consumers may be less ready to buy product from a company that is known to be in a formal insolvency process, than from a company that is still trading. Too often, the adverse publicity, that is attendant upon the formal process, destroys business value before a turnaround can be achieved. The informal process provides time for the restructuring to be done outside court, with the intention of creating much greater value for the future from a business that has successfully turned its fortunes around. “Turnaround” would be a word much preferable to “workout”. Clearly, this can only work where a business is inherently capable of being turned around from distress to a viable entity.

There is another phrase that needs clarification. The word “restructuring” is much used, but the same word is used to cover a number of different situations. Too often it is used only to describe the financial restructuring. This paper argues that for the most effective overall restructuring to take place, there have to be two integral elements. These are corporate restructuring and financial restructuring.

Whilst occasionally the financial difficulties of a company in trouble may be the result of purely external forces, the cause more usually lies with its own internal shortcomings, often its management. If there is to be a successful turnaround or restructuring, these internal issues will need to be addressed. It matters not whether it is the company’s product quality, production capability, marketing strategy, acquisition strategy, or whatever, the likelihood is that there is usually something wrong, other than bad luck, which has led the company into difficulty. The fact is, that unless these issues are addressed and appropriate changes take place, then the company will continue not to be competitive or successful in its market place. There therefore needs to be some form of internal change or corporate restructuring for the company to once more become fully viable and regain market position. This may range from management change to the sale of divisions or subsidiaries or even overall change in policy and strategy.

The second part is the financial restructuring. With the corporate restructuring issues properly addressed, the financial restructuring helps to reposition the company’s finances so as to enable the benefits of the corporate restructuring to be achieved. This can include lenders agreeing to rearrange their facilities, write off debt and accept debt equity swaps amongst other options.

All too often, what is called a restructuring is in fact only a financial restructuring and little change actually takes place within the debtor company itself. This is often the case with pure rescheduling, which usually only involves loans being extended over longer periods and repayment being softened. This is questionably termed a restructuring. Very often, nothing changes within the business, all that happens is that the problems have been put back another year or two. However, a successful restructuring requires all parties to “bite the bullet” in respect of what they each need to do to create sufficient change that the company can re-establish viability.

Even where there is a financial restructuring, it often does not actually achieve the intended result in due course. If a company is to go forward into the future and compete successfully, it needs to have an appropriate balance sheet, appropriate level of debt and appropriate capital structure so that it can compete equally in the market place with its other challengers. As just one example, it needs to be able to obtain supplies on the same terms as its competition, or better. Too many supposed financial restructurings merely do the minimum that the lenders can get away with, still leaves the company with too much debt, too much interest burden and with a balance sheet that still looks weak, and therefore leave the company in an uncompetitive situation when compared to its rivals. Realistically, how does this help the company to stride forward and thrive in the future?

For the purposes of the remainder of this paper, “out of court restructuring” will refer to full restructuring, including both elements, and “informal workout” will be interpreted this way.

III. The Insol Global Principles

Formal insolvency systems differ dramatically around the world. Whilst increasingly there is some conformity, there is huge variation, not only in laws themselves, but in their interpretation and application, and, indeed, in their overall efficiency. The situation is even worse with out of court restructuring, where there are usually no rules or guidelines at all, and in many countries no experience or background in this process. The Insol Global Principles for out of court restructuring (which were developed alongside a World Bank initiative on formal insolvency systems), seek to address this, but it is acknowledged that they will take considerable time to achieve worldwide acceptance. They were devised following consultation with no less than 150 bodies worldwide and thus represent a broad spectrum of views and practice. They are very much based upon the principles of equity and sound common sense between the various parties. Designed to facilitate the rescue of viable businesses, with a particular aim to achieve preservation of economic value, they provide a set of guidelines to assist those wishing to do informal or out of court restructuring. They do, however, acknowledge that not all businesses can be saved.

IV. Basic Requirements

In looking at countries where these principles may work, attention must be paid to three different background requirements:-

1. A set of formal insolvency laws that is reliable, predictable and efficient.
2. Some form of policing, not as strong as enforcement, which encourages the participants to play by the rules.
3. A fallback formal court option, for use when the out of court system is working, but is about to fail because of the actions of one or two individual players. The informal process needs to be able to move swiftly in to this and have a rapid outcome.

Examining these in more detail, (1.) is crucial, as without this, there is really no pressure upon a debtor company to come to the table. The fact that creditors' rights are acknowledged and upheld, that the creditors have power to take action and this action will be enforced by the courts, is a very powerful persuasion to debtor companies and their directors to come to the table and negotiate. If there is no reliable, formal system, or it is either extremely protracted, as is so often the case, or ineffectively enforced (if at all), then the directors of the debtor company are able to delay or even ignore the need to negotiate solutions with the creditors.

With regard to (2.) and (3.), it is increasingly important that at least one of these is available, alongside (a), to support the process. The need for such support always comes up when the possible adoption of the Insol Global Principles is under discussion.

For (2.), in England, the Bank of England played a pivotal role in the success of the London Approach. In times of difficulty, their quiet intervention was usually able to help break the deadlock and achieve a successful resolution of seemingly impossible positions. One can see other institutions worldwide which are held in similar respect, and which can usefully play a similar role, one thinks of the HK Monetary Authority in Hong Kong.

As for (3.), it is extremely useful to have a fallback into a quick formal legal system where a process is moving forward positively, but where it is necessary to deal with small dissident minorities. Because the out of court process is consensual, and, at the end of the day, needs to achieve 100% support, it is always open to minority players to grandstand and hold the deal to ransom. The term "green mailing" has been used to describe this. In the US, there is a very effective "pre-pack" system using Chapter 11, where most of the work can be done outside the legal process, and then the deal is taken through the legal process to achieve a binding solution, including members who would seek to spoil the deal. Interestingly, the existence of this option, since it is known to all the players, creates the result that players who are effectively holding a deal to ransom will often moderate their behaviour towards the end of a negotiation, knowing that if they go too far, they will end up in a formal proceeding in which they will be "crammed down".

V. Successful Restructuring

There are a number of factors that will lead to a successful out of court restructuring. Firstly, there must be trust by the debtor company that it can actually talk openly and freely with its financial creditors. If there is suspicion that as soon as there is a problem certain financial creditors will rush in, grab assets and head for the hills, then a debtor company is unlikely to be willing to initiate any discussions. There has, therefore, to be an environment created by the financial creditor group within which the company feels encouraged to discuss issues and problems. Secondly, the financial creditors themselves must be prepared on occasion to moderate their own views, in order to achieve consensus for the greater good. Clearly, that is much easier said than done.

The primary condition is that there must be a belief held by all parties that there is a viable business that can be preserved. If there is no belief that this is the case, then an out of court restructuring is very unlikely to work. If there is a belief that there is something worth rescuing, then it requires the financial creditors to be prepared to standstill for a period of time, whilst the position is properly examined and reported upon. This in its turn requires the debtor company to be prepared to make available all the information necessary to facilitate this process. The doubts, suspicions and background culture in so many parts of the world make this an extremely difficult issue.

The real reason that financial creditors will be prepared to go forward in a support programme is enlightened self interest. It is all about the preservation, and hopefully the maximisation, of economic value. If financial creditors can be persuaded that there is a better value return to them in being supportive and helping a struggling business to recover and stride forward rather than merely realising the present assets, then there is a big pressure upon those creditors to act sensibly. The whole key to this issue is the assessment of where economic value lies, whether in fact it can be preserved, and how it can be maximised. There are no prizes for lenders who support “dead ducks”, but equally there are significant rewards to those lenders who are prepared to support a turnaround operation which ultimately delivers very good value. This perhaps illustrates one of the major problems in cross-border or international restructurings, namely the alignment of the interests of the debtor company with those of the creditor group. On a purely internal basis, this is usually more easily achievable, although again more so in some countries than others. However, on a cross-border basis, with the international differences in culture, laws, background experience and practice this can be extremely difficult.

VI. Problems

There are no doubt problems going forward. Globalisation expands and even medium-sized companies now have international connections, whether it be through customers, suppliers, international divisions, subsidiaries/associates or foreign lenders.

From the lenders’ perspective, there are increasingly different levels of players. This was not so many years ago when there was a fairly simple split between equity funders and banks. That has changed and the range and variety of lending levels becomes ever more complex, not only with mezzanine funding, but including high-yield funding, private placements, bonds, subordinated and senior bank lending. As companies grow ever more global, they become subject to increasing numbers and varieties of laws in the various jurisdictions in which they operate – the recent European Union insolvency directive is illustrative of how complex these matters can become. Whilst the Insol Global Principles endeavour to bridge the problems of distrust between international funders, protectionism is still an issue and what is acceptable practice in some countries is culturally quite unacceptable in others.

VII. Credit Default Instruments

Even more problematic for the future is the increasing use of derivatives. A particular problem within this is credit default derivatives, or credit insurance. As international lenders seek to diversify their portfolios, known as portfolio management, so the risks are spread wider and involve more people. Put simply, if bank A has a risk of £50 million to a company, it may well take out a credit default contract, for a premium, which effectively swaps away all or part of that risk in a default situation. When the particular company concerned then moves into a problem situation, if the lenders are called together to find a solution, this creates a number of issues for bank A. If it now wishes to exit this situation, then contrary to helping find a working solution, it may suit bank A for a formal default to be declared, so that it may claim on its insurance contract and be repaid.

The insurance contract itself may be “silent”, in other words, it may not be publicly-declared. If so, the behaviour of bank A, which will be driven by the terms of its contract, (unknown to the rest of the lender group that may be endeavouring to achieve a turnaround), may seem quite illogical to the other players. This can create some very interesting and difficult behavioural dynamics. If a requirement of the rescue plan is that lenders put forward further cash to help the business, bank A may not be minded to do this, bearing in mind that it is currently not on risk – why should it take on further risk? Furthermore, in supporting a rescue plan, it may be in breach of its contract, and therefore jeopardize its cover. Pity the poor negotiator or bank endeavouring to achieve a consensus within this group, when any number of the players may be in a similar situation. This is just one example of the complexities facing lender groups.

Conversely, at a time when out of court restructuring is achieving a higher profile internationally than ever before, and when there is increasingly broader acceptance of the values of this practice, so the problems in achieving such resolutions are themselves becoming more complex, and indeed, in the larger cases, less easy to achieve. Perhaps it echoes the old adage that advancement does not necessarily equate to progress.

VIII. The Future

There are, however, good reasons to be optimistic as well as pessimistic. More and more countries are interested in fostering out of court restructuring. The increasing size of major corporations, and the money involved, means that failure can have dramatic effects on a country’s economy. The ramifications can be massive and widespread. Once a company moves into formal insolvency proceedings, its chances of recovery reduce, and actual “business value” diminishes. There is an increasing acceptance that value is best preserved through a consensual process where everyone is working together to achieve a turnaround. The number of invitations to Insol from countries to discuss the Global Principles evidences the growing interest in this process.

What is certain is that out of court restructuring has a major future in many countries and economies where it is not current practice. Balanced against that, especially in the very large cases, must be the fact that the hurdles to a successful achievement will increase.

It is up to each country to examine the case for out of court restructuring, to consider whether it will be beneficial to the overall economy to preserve potentially viable businesses, production and employment, and then to adopt processes that will enable this to work. If they do this successfully, then it will be possible to save a good many troubled businesses, combat the problems that are bound to arise and thus enable a much greater preservation of economic value than is currently the case.

LESSONS FROM OUT OF COURT DEBT RESTRUCTURINGS IN POST-CRISIS ASIA?

by

*Timothy B. DeSieno*¹²⁰

Since the onset of the Asian currency crisis in 1997, many Asian countries have focused political and commercial energy on the development and/or improvement of their corporate debt restructuring systems. These efforts have included a wide variety of steps, ranging from revised insolvency laws to new courts and judicial training to governmental asset management companies (AMCs) to enhanced systems for out of court restructurings. In this work, countries in the region have built on their own history and culture, and each has accordingly mixed the various elements in a unique way. On the other hand, many of the issues faced in all countries undergoing a currency, or other financial crisis are similar, and it may therefore be useful to compare experiences.

This paper was designed as an introduction to a panel discussion at the OECD's Second Forum for Asian Insolvency Reform (FAIR) which took place in Bangkok 16-17 December 2002. The panel discussion is to review and evaluate the successes and failures of the implementation of out of court restructuring systems in post-crisis Asia. Below is a list of questions that the author believed to be the most critical to the evaluation of any out of court system in transition.

First, however, the goals of an out of court system must be determined. Fundamentally, any system should be judged by how well it serves the goals of its creators and beneficiaries. The most apparent goal of an out of court debt restructuring system would be to promote more cost-effective debt restructurings than could be accomplished in the context of court-supervised proceedings. That goal is in turn a subset of a larger goal to resolve the troubles of companies that are over-indebted by deleveraging them and encouraging improved business planning. That goal is, again in turn, a subset of a still larger goal of returning an economy to financial health and productivity.

Many market participants are concerned, however, that these goals may not in fact be the primary motivators in some countries' recent decisions to establish or strengthen corporate debt restructuring systems. Some investors posit that many revisions may have been imposed through official sector funding sources (e.g. other countries or multilateral organisations) to the countries in question, or otherwise, and the countries in question would not necessarily have made the changes otherwise. This sort of possibility could be particularly strong in countries where companies have a high proportion of offshore creditors, and where it is politically difficult to be seen as transferring stakes in companies to those creditors at discounted prices.

¹²⁰. Mr. DeSieno is a Singapore-based partner in the financial restructuring group of Bingham McCutchen LLP. Bingham McCutchen is a United States law firm. The comments and questions expressed herein are those of Mr. DeSieno and not necessarily Bingham McCutchen or any client of the firm.

If these were the facts in any given country, then the goal of the new or newly strengthened system might not necessarily be to delever companies as part of a plan to return an economy to financial health. Instead, the goal could well be to create sufficient apparent deleveraging effort so that the official sector funding sources are satisfied. To the extent that those funding sources do not cease providing funds to the country in question, then the revised system would have served a useful, if short-term purpose. There may of course be other internal or external reasons, unrelated to corporate deleveraging itself, that make effort toward enhanced insolvency/restructuring systems a useful idea.

Many market participants believe that this sort of possibility is sufficiently real that emerging markets and their investors (whether they are official or private sector investors) ought to examine each of the following questions very carefully. The answers to the questions below will help indicate which goals a given country may have for its out of court system and the likelihood of success in achieving those goals.

1. Is there a political will that is truly supportive of resolving a corporate debt overhang?

If the goal of an emerging market's out of court system is to resolve a private debt overhang, then the system's success will be dependent on the prevailing political will to ensure that it succeeds. If there is no political will, or inadequate political power to achieve success, experience shows that it will not happen. In gauging such political will, there is no substitute for results. That is, if the necessary political will is present, investors will know it because debtors and creditors will agree and implement commercial restructurings. Aside from results, and particularly important early on during a transition, there are at least two factors that help predict whether a system will become effective.

- ***Is the country reliant on private capital inflows in the short- and medium-term future?*** If the country in question is significantly dependent on private capital inflows (funding from private offshore sources provided to private local companies, as opposed to funding from the official sector provided to the local government), the country will be much more inclined to encourage its out of court system to de-lever companies in a manner that is consistent with international, market-driven restructuring standards – standards that have proven effective around the world. This result is because private offshore funding sources will be less inclined to invest in a country where the debt restructuring system is thought to be inconsistent with such standards. On the other hand, if the country in question receives adequate funding for its economy from the official sector (or from internal sources), then the country will be much less motivated to ensure that its out of court system will work consistently with proven international standards.
- ***Is there a credible social safety net in place to protect against social dislocation caused by large-scale debt restructurings?*** Another important factor in predicting how well the out of court system will work is the strength of the social safety net. If the government does not provide adequate protection for dislocated employees of failed businesses, investors tend to believe that the debt restructuring system in place will be less likely to function well. In many instances, debt restructuring exercises lead to increased unemployment, and without an adequate unemployment protection, the short-term dislocation of a large scale restructuring effort may pose a cost to the country that appears too expensive. Concern about that expense may tend to prevent successful restructurings, in- or out of court. On the other hand, a strong social safety net tends to indicate that the restructuring system is more likely to succeed.

2. Is there a clear and enforceable legal alternative to the out of court restructuring system? Unless creditors have access to a professional, speedy, and predictable legal system in which to enforce their claims, shareholders of financially troubled companies are unlikely to engage in serious out of court debt restructuring efforts. Shareholders are naturally reluctant to part with their ownership, and unless creditors have a realistic ability to threaten that ownership or otherwise exert leverage against the shareholders, the shareholders may have little incentive to negotiate sensible restructuring terms. Especially once shareholders begin to enjoy the cash flow benefit of ceasing interest payments to their creditors, their reluctance to negotiate restructurings is enhanced.

For the legal system to be effective it is most important that the judges be experienced in commercial matters and that their decisions be predictable and transparent. So long as the rules are known and consistently applied, almost regardless of what the rules actually are, creditors will be able to evaluate what kinds of restructurings to expect in court, and therefore, what is sensible to agree to out of court.

The author suggests that, in this regard, many countries have focused too little attention on liquidation procedures, preferring instead to focus on restructuring/rehabilitation procedures. At bottom, the success of an out of court restructuring system is dependent on the predictability and effectiveness of the in-court restructuring system. The success of any in-court restructuring system, however, is critically dependent on the predictability and effectiveness of the liquidation system. As such, liquidation procedures are the core of creditors' rights on default. Due to the rather shareholder-unfriendly result of a transparent liquidation system, however, it is often not politically helpful to focus on its improvement particularly intently. It appears to the author that weak and non-transparent liquidation procedures, have been among the most fundamental problems preventing more wide-scale success in recent out of court restructurings in Asia.

3. Does the out of court restructuring system adequately include governmental creditors? As part of the debt resolution system, many countries have established governmental assets management companies (AMCs). AMCs are designed to acquire non-performing assets from local financial institutions, and often then to co-ordinate the related restructuring efforts. In most places, AMCs have been both helpful and harmful to the out of court restructuring effort.

- ***Do those governmental creditors have extraordinary powers that are useful?*** Ordinarily, when establishing an AMC, a country will grant it extraordinary powers in order to accelerate restructurings. These powers can include the ability to obtain guarantees from the shareholders of troubled companies, the ability to take control of the debtor's assets without resorting to the judicial system, and other powers and regulatory abilities. In countries where the AMC has a clear and politically-supported mandate, these powers tend to enhance the willingness of reluctant shareholders to come to the out of court negotiating table more rapidly and more commercially than they otherwise might. These powers can therefore be helpful in getting restructuring negotiations underway.
- ***Are those powers adequately constrained, or do they create an inherent conflict of interest?*** On the other hand, if the AMC's powers are too great, especially if the judicial system is relatively weak, a strong conflict of interest arises. An AMC is usually tasked with maximising value for itself, as any rational creditor would be. And, the extraordinary powers of the AMC are ordinarily more valuable to the AMC's own recoveries if they are exercised for the exclusive benefit of the AMC, rather than for the collective benefit of the creditor body. If these powers and incentives are counter-balanced by an effective judicial process for the creditors' collective benefit, then creditors have meaningful recourse if the AMC is seen to be prejudicing the other creditors. If the remaining creditor body has no

meaningful recourse to a capable and powerful collective process, however, then the AMC's processes effectively supplant a judicial system – the AMC's processes may well be the only rules to which the debtor will adhere. This dynamic puts the AMC in the role of creditor as well as insolvency judge. Experience has demonstrated that this conflict is not easily resolvable in a manner that instills confidence in the international investor community. All countries are accordingly well-served to find a credible balance among the competing interests.

4. Are there meaningful incentives for debtors to participate in the out of court restructuring process? In addition to the incentives caused by effective insolvency laws and court systems, experience has shown that out of court restructurings proceed most effectively in countries where there are positive incentives as well. The most customary example is the provision of tax incentives to companies who restructure. Other possibilities include specialised listing or accounting provisions that provide helpful relief for defined periods.

5. Are there meaningful incentives for local financial institutions to participate? Regulations that govern local financial institutions have been another critical stumbling block in achieving commercial restructurings. Often, regulations have permitted local financial institutions to value non-performing assets on their books at (what the market would likely consider to be) artificially high levels. Then, once that institution makes the concessions necessary to achieve a commercial restructuring, some regulations require the institution to reduce the value of the asset on its books, often quite markedly. When aggregated, these “write-downs” can threaten the capital adequacy of a financial institution. In order to avoid this threat, local institutions are often reluctant to participate in restructurings at all. In order to reduce this effect, some countries have considered adjusting the regulatory requirements, either by phasing in a general requirement that overvalued, non-performing assets be written down or by reducing or deferring the effect of the write-downs associated with restructuring deals.

6. Is there well-trained financial restructuring professional talent in the country? International experience indicates that debt restructuring is a highly-specialised skill, and restructuring work proceeds most efficiently when it is led by trained experts. These experts are not only trained in designing complex financial solutions, but also in helping to manage the cultural and interpersonal tensions that often accompany restructuring efforts. In most countries, there is a body of experienced restructuring professionals who can serve as advisors to creditors and debtors. International experience indicates that the out of court restructuring system will be most successful in those countries where there is a culture of engaging such professionals to help drive the effort.

7. Is there a strong secondary market in distressed debt instruments? In addition to negotiated restructurings, a strong secondary market in distressed debt securities presents another option for creditors (offshore and local) to remove non-performing assets from their books. In addition, purchasers of distressed debt ordinarily bring with them significant experience in international and complex debt restructuring. As a result, these purchasers can play a helpful role in accelerating commercial restructuring deals. For each of these reasons, a country will be well-served if its laws and regulations encourage, and do not inordinately constrain, trade in distressed debt instruments.

8. Does the system effectively require that debtors disclose detailed financial information on a regular basis? All successful restructuring efforts are heavily dependent on creditors obtaining detailed and accurate information about their debtor. The gathering of such information has been among the most troublesome and time-consuming aspects in recent Asian debt restructurings. If the legal and regulatory environment in a given country requires companies to prepare and provide

regular, detailed, and accurate financial reports, then a necessary information base, and the company resources to provide additional detail in the restructuring context, will be present. Given the fundamental importance of financial information sharing in restructuring, these items will vastly accelerate commercial restructuring deals and make them more viable.

Hong Kong China

CROSS-BORDER INSOLVENCY ISSUES IN HONG KONG

by

*Alan Tang*¹²¹

I. Introduction

The focus of this paper is on international workouts in Hong Kong as well as the role and treatment of foreign creditors in such situations. We shall discuss both formal and informal workouts, with minor references to formal insolvency proceedings.

For the purpose of this discussion, and pursuant to the “One Country Two Systems” regime, the Peoples’ Republic of China (“PRC”) is treated as a foreign jurisdiction in relation to Hong Kong.

Prior to the Asian Financial Crisis in 1997/98, workouts in Hong Kong were relatively few and far between. With the economy in a boom since at least the early 1980s, financial lenders were generally in positions of relative advantage when dealing with delinquent debts. They sold off the security, appointed receivers or liquidators who were able to realise businesses or assets at fairly good prices. Since 1997/98, market sentiments have been at an historic low, and there have been two occasions over the last five years when Hong Kong actually experienced negative GDP growth rates (at current prices). This had not happened in the last twenty years or so, not even when Hong Kong went through the banking sector turmoil in the early 1980s. From 1997/98, workouts have become a practical and more commonly used alternative to formal insolvency proceedings to financial lenders and debtors alike.

II. Workouts, Restructurings and Turnarounds

Formal workouts in the Hong Kong context are often called restructurings or turnarounds, which are unfortunately and invariably linked to “haircuts” for financial lenders. These are also closely related to the disposal of “listed shells” of companies (see below). However, formal workouts in the Hong Kong context do not necessarily (and in fact rarely) save the original business (or even a part thereof) of the debtor.

It should be noted that, in the Hong Kong context, the vast majority of businesses (including many large listed “public” companies) are owner-run or family-controlled. There are distinct major shareholder groups for most listed companies. This being so, the affairs and financial position of these companies are inextricably and directly linked to those of their majority owners. When faced with financial difficulties, management of these companies often place the interest of their majority owners in priority to those of the company, the “minority” shareholders and somewhat naturally the creditors. These are, of course, issues concerning proper corporate governance in general.

¹²¹ Alan Tang, is a Partner at Grant Thornton based in Hong Kong, China.

Due to over trading, mismanagement, outright fraud or a combination of these and other factors, it is not uncommon for businesses of companies in workouts to have been stripped to their bare bone by the time the workout process starts. Companies undergoing workouts in terms of billions of dollars of debt are known to have no operating office, retaining a few unqualified staff and maintaining little, if any, by way of available books and records. Faced with these, options available to financial lenders are very limited.

More than 80% of formal workouts are estimated to involve principally debt rescheduling work as opposed to genuine business reorganisation and restructuring. In the vast majority of these cases, the standard analysis by independent financial accountants for financial lenders will include a comparison of the return to creditors from a debt rescheduling to that from liquidation. “Haircuts” of 50% of the debt have become the starting point of negotiation of the debtors. In a case involving debts of close to HK\$4 billion, if not for the objection of one bank (for reasons other than pure financial), the bank group comprising over 20 bankers and financial institutions would have accepted a haircut of 97% of the debt!

One peculiar feature of most Hong Kong restructurings is the absence of any core assets or business physically in Hong Kong. Practitioners have only seen too many cases of listed companies having only rented offices in Hong Kong, but with all their assets and investments in China and held through layers of intermediary holding companies. To complicate matters, these intermediary companies are often incorporated in various tax haven countries, the most common of which are Bermuda, the British Virgin Islands and the Cayman Islands. Financial lenders realise, often too *late* that their lending was made to, for example the ultimate listed holding company of a group, but the assets and businesses are actually held by or through off shore companies which have no direct exposure to any financial institutions. The assets are divorced from the liabilities and corporate guarantees are not worth the paper on which they were written.

The publicity and negative impact of most formal restructurings make many of these difficult to complete. Also, financial lenders often do not get a good return. On the other hand, most informal restructurings tend to be low profile, relatively easier to complete and lenders tend to get a quicker and often better return. In either of these cases, the effective sale of a listing shell is often involved. There are pros and cons to all of these.

III. The Legal and Regulatory Framework

Under the “One Country Two Systems” regime, Hong Kong still applies and practises the British based legal system. Still imaged on the UK 1948 Companies Act, there is no separate legislation on corporate insolvency and restructuring (there is, however, separate legislation on personal bankruptcy and debt restructuring). Legislation on corporate insolvency and restructuring is enshrined as parts in the Companies Ordinance and its related subsidiary legislation (e.g. the Companies (Winding up) Rules).

Provisions on “Schemes of Arrangements” form the backbone of most formal restructurings, although contractual arrangements are also commonly used. These terms carry their usual meaning and interpretation under most common law jurisdictions and we do not propose to explain them in detail here.

Listed companies are regulated and governed by, *inter alia*, the relevant Board Rules of the Stock Exchange of Hong Kong, as well as terms of the Listing Agreement.

As many companies listed in Hong Kong are incorporated in various tax haven jurisdictions, the laws of the relevant countries will also apply in any restructuring. It is, therefore, very common for approvals to any formal schemes of arrangement to be sought from both the Hong Kong Court as well as from a court in the place of incorporation of the companies concerned.

The rest of this paper will discuss formal and informal restructuring, involving a listed company in Hong Kong.

IV. Sale of a Listed Shell

When a listed company goes into liquidation, the listing status may be cancelled by the Stock Exchange. Prior to cancellation, or before the company goes into liquidation, such listing status, either on its own, or together with whatever assets, liabilities and operations, may be sold or “transferred”. Since the Asian Financial Crisis in 1997/98, there have been over 20 such sales either by the major shareholders, provisional liquidators or liquidators. The prices of these listed shells ranged from HK\$10 million to well over HK\$100 million. Faced with the alternative of a total write-off of the value of the listing status, any salvageable value is significant and relevant to both creditors and shareholders of these companies.

Commonly there are two ways of disposing of the listing status of a listed company in financial difficulties (LCFD). One is by the major shareholder who also invariably controls the Board of Directors. The other is by the provisional liquidator or liquidator once formal liquidation procedures have commenced. It is worth noting that, under current listing rules, the liquidation of a listed company does not automatically and immediately terminate the listing status. There is a “breathing space” of up to at least 18 months for the listing status to be salvaged or transferred. It is this window of opportunity that insolvency practitioners value as, in a lot of the recent cases involving LCFDs, this is the only avenue of realising any value at all to meet the fees of the insolvency practitioner and other professional advisors of the company, and to bring about return of some sort to its creditors and shareholders.

First, let us look at the mechanisms of the two types of sale of the listing status. For simplicity, we call a shareholder-driven process the “Shareholder Sale” and an insolvency- practitioner-driven process an “IP Sale”. Notably in most cases in recent years, the financial positions of the LCFDs are so bad such that there are no substantial assets or even operations remaining at all. The “attraction” to the investor or white knight is invariably, if not exclusively, the listing status, with the “purchase” effectively resulting in the investor achieving a “back-door” listing on the Hong Kong Stock Exchange.

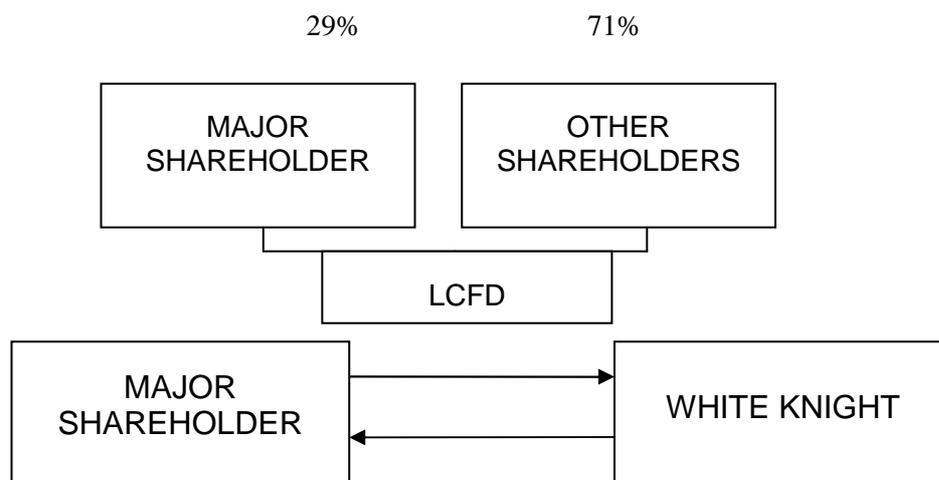
V. Sale by Shareholders

This is how a typical Shareholder Sale works. Most are informal workouts without the need to involve the court. The major shareholder and CEO of a LCFD will try to hold the banks and creditors at bay by suggesting, via press releases or otherwise, that the LCFD is in discussions with a number of potential investors or white knights. Banks and creditors should therefore be patient and should even seriously consider providing bridging finance for working capital. The shareholder and CEO will then try to persuade the banks and creditors individually to accept certain debt restructuring proposals by the prospective white knights. The shareholders and CEO will avoid insofar as possible a meeting of all banks or creditors, let alone the formation of any formal or even informal “Creditors Steering Committees”. It is because the banks and creditors may then be asked by the major shareholder and CEO to accept different restructuring terms without knowledge of what others may be offered or getting. When there appears to be a chance of most of these banks and creditors accepting various

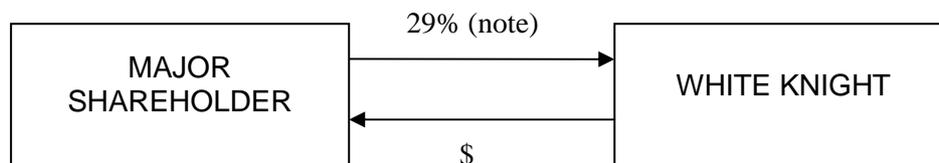
restructuring terms, the major shareholder and CEO will arrange to dispose of his direct and/or indirect shareholding in the LCFD to the new investor, or its representatives. Often, these new investors or white knights are friends or associates of the CEO themselves, or are introduced to them through mutual contacts. In recent years, most investors or white knights are of or claim to have PRC background and connections, and their true identity is often a mystery. Completion is usually conditional, amongst other factors, upon the banks and creditors eventually agreeing to some form of restructuring.

Diagrammatically, this process may be illustrated as follows:

Before

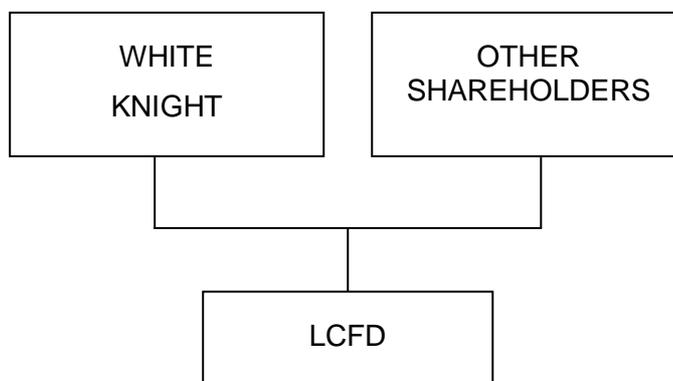


Sale



Note : sale of a block of shareholding exceeding 30% may trigger a general offer to buy all shares

After



The white knights or their representatives by this time would have often already been introduced to the banks and creditors. The white knights, would, therefore be in a position to assess the practical likelihood of these creditors accepting any restructuring (or more commonly a “debt rescheduling”) proposal. Before the major shareholder and CEO execute any formal papers with the white knight to transfer formally any shareholding, the issue of whether a general offer to the public will also be considered, as required under the Listing Rules.

The directors on the Board are then changed. The white knight will ensure that he has overall control of the Board (“the New Board”). The New Board will follow up on the debt rescheduling negotiations with banks and creditors. With injection of cash or other assets into the LCFD, banks and creditors may agree (on an individual contractual basis) to a rescheduling of their respective debts. The debt rescheduling may also be done through a formal scheme of arrangement under the provisions of the Companies Ordinance. But this is relatively rare in a Shareholder Sale.

VI. Sale by Creditors

Another way of disposing of the listing status is by an IP Sale. Since recently, provisional liquidators have been given express powers by the court to assist with the restructuring of a company. As a matter of fact, over the years, the court has approved numerous restructuring or debt-rescheduling proposals put forward by insolvency practitioners. Nearly in all cases, formal insolvency procedures (usually liquidation) have already commenced (albeit some only up to the stage of filing a winding up petition but before the making of any winding up order). After appointment of insolvency practitioners as either provisional liquidators or liquidators, the powers of directors cease. Hence, the directors can no longer act for the company. This is also true for cases where receivers and managers have been appointed under the terms of a debenture, usually given in favour of a bank.

Upon the appointment of (provisional) liquidators, trading of shares in a LCFD will be suspended immediately. It is, however, very likely that trading of the relevant shares has already been suspended, as a result of the filing of the liquidation petition or similar proceedings, or for other reasons as set out in the Listing Rules.

In an IP Sale, there is normally a lot more transparency for all concerned. For professional reasons, the insolvency practitioner would tend to be more prone to using a court supervised Scheme of Arrangement (“Scheme”) procedure to effect any sale of the listing status. This sale is also often linked to a related restructuring or debt-rescheduling proposal put by the white knight to the banks and creditors, who will by now have formed informal, if not formal, Creditors Steering Committees to negotiate with the insolvency practitioner and the white knights collectively.

Once commercial terms of the restructuring or debt rescheduling have been reached, these terms are voted on and confirmed by shareholders and creditors through the process of a formal Scheme, as provided for in the Companies Ordinance. Essentially, this involves the putting forward initially to the court a proposal setting out not just these commercial terms, but also plans and timetables for meetings of creditors and shareholders to vote on these terms. In most cases, professional opinion and valuation reports are also available for the creditors and shareholders to consider the proposal. Once the court endorses this initial proposal, the relevant meetings will be convened and held for creditors and shareholders to consider and vote on the terms of the restructuring or debt rescheduling. The proposal must be supported by a majority in number representing 75% in value of the creditors and shareholders. Approval needs to be obtained from both meetings of shareholders and of creditors. The Court will then formally sanction the Scheme, which will then be binding on all creditors and members.

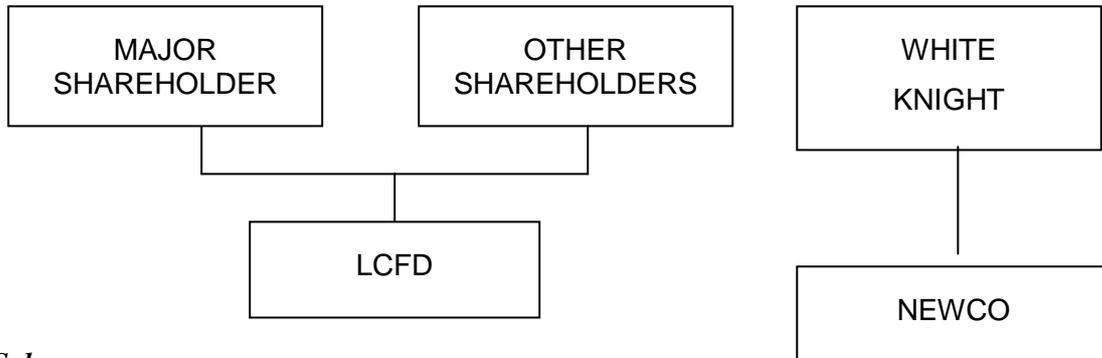
It has been suggested that, in an insolvent liquidation, shareholders have no interest in the outcome or proceedings. However, in a number of cases recently, the court has confirmed that approval from shareholders must be given for sale of the listing status, because after all, it is the very shares registered in the names of individual shareholders that are to be physically sold and transferred to the white knight. Yet, the court has also suggested that the consideration to be given to the shareholders should be only nominal (say 5% of the total consideration) when compared to creditors.

So, what actually is involved in an IP Sale? A company controlled by the white knight, Newco, will make an offer to buy all shares of the LCFD. Consideration to be given to the shareholders of the LCFD will be in the form of shares in Newco. Banks and creditors of the LCFD will be asked to agree to the Scheme in consideration for cash, shares, convertible notes or other financial papers in Newco, or any combination of the above (to be payable under the terms of the proposed Scheme). The listing status of the LCFD is effectively “transferred” to Newco by way of “introduction” whereby Newco is to take up a new listing status upon the surrender of LCFD’s existing listing status. Hence, virtually all such “sales” of listing are conditional upon agreement of the Hong Kong Stock Exchange and the successful listing of Newco.

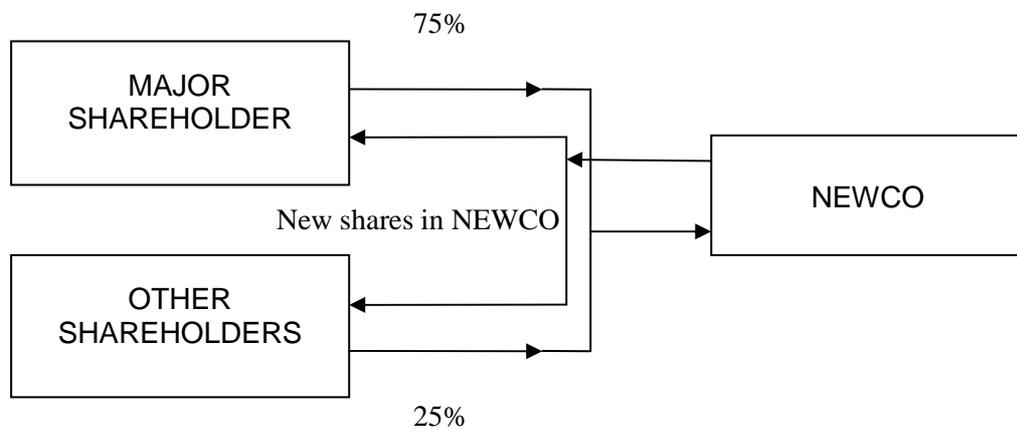
Newco then severs its link with LCFD (which by now has become its wholly-owned subsidiary) by disposing of all shares therein to the insolvency practitioner for a nominal consideration. The insolvency practitioner will hold such shares on trust for creditors of LCFD. If already in liquidation, the liquidation of the shell of LCFD will continue through its course to completion. The insolvency practitioner will invariably take up the role as the Scheme Administrator in the distribution of cash and/or other proceeds to the shareholders and creditors whose claims have been adjudicated and confirmed. Completion of the liquidation will usually follow shortly after completion of the administration of the Scheme.

Diagrammatically, this process can be illustrated as follows:

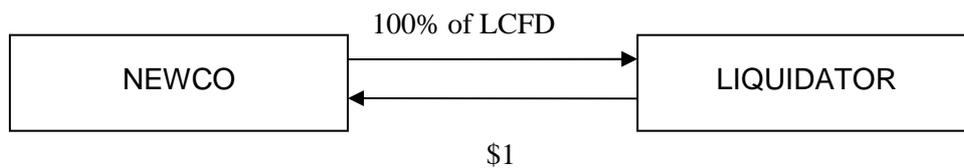
Before



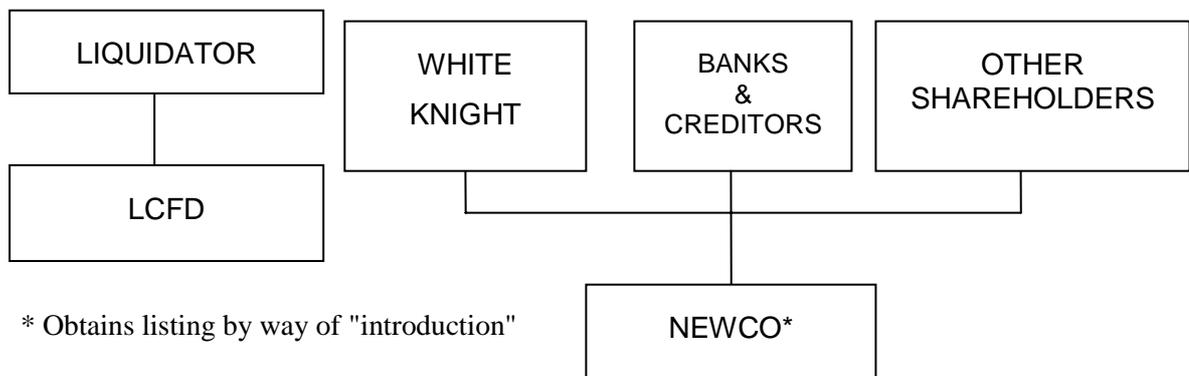
Sale



Transfer



After



VII. Other Issues and Considerations

The above are just but two common (and simplified) ways of disposing of the listing status of LCFDs. There are numerous others as each case may require a tailor-made arrangement to deal with particular features of the shareholding, debt profile and the requirements of the white knight. When the restructuring scheme of a LCFD is duly approved, and if the LCFD has not yet been formally put into liquidation (despite the fact that provisional liquidators may have been appointed by the court), any petition for the liquidation of the LCFD may be withdrawn and the appointment of the provisional liquidators terminated.

Under the current Listing Rules, and commencing from the suspension of trading in shares of LCFD, there is a three-stage delisting process, with each stage covering six months. There have been many situations when the third and final stage has been extended pending the finalisation of complex restructuring or debt-rescheduling negotiations, or pending proposals or arrangements to be approved by the court. Currently, however, plans are afoot to amend the Listing Rules. Amongst the various proposed changes, it is expected that the proposal to cancel immediately the listing of companies in liquidation as the “going concern” status no longer applies will be met with strong opposition from practitioners.

VIII. Role and Treatment of Foreign Creditors

Laws in Hong Kong are not territorial. They apply to all and sundry. They do not give preference to local creditors. Hence, there is no practical difference between local and foreign creditors in insolvency and restructuring proceedings in Hong Kong, be they formal or informal.

However, it should be noted that, for companies which are incorporated in jurisdictions other than Hong Kong, the laws of the relevant countries will apply to assets and proceedings outside of Hong Kong. Also, when assets and proceedings are in China, the local PRC laws apply. There is no mutual recognition or enforcement of court proceedings or orders between Hong Kong and China.

Indonesia

INFORMAL WORKOUTS IN INDONESIA: JITF INCENTIVE AND SANCTION SYSTEM

by

*Bacelius Ruru*¹²²

I. Background

Regardless of how far or how fast an emerging economy has grown, it remains vulnerable to systemic economic collapse. Such collapse is almost always marked by over-leveraging within the corporate sector that can, in the worst cases, overwhelm the capacity of corporations to restructure. Without corporate sector debt restructuring, the real sector is cut off from necessary capital, and employment and tax revenue are sacrificed. In order to cope with such corporate sector paralysis in the face of systemic economic collapse, the public sector frequently steps in and involves itself in the corporate debt restructuring process.

Public sector debt restructuring programmes are created as government initiatives to accelerate the speed of corporate debt restructuring. At their simplest, these programmes may simply serve to educate parties regarding restructuring “best practices”. Alternatively, they may involve some form of mediation with respect to debt disputes. Other programmes may put in place a relatively formal set of procedural guidelines designed to add structure to the debt restructuring process. Still other programmes may involve the government directly in substantive restructuring negotiations in the role of decision-maker.

This paper discusses the practical choices made by the government of Indonesia (the “GOI”) in designing and implementing its public sector programmes for dealing with corporate sector debt restructuring.¹²³ The first section deals with some of the factors impacting debt restructuring in Indonesia, the second section outlines the GOI’s programme, focusing on the incentive and sanction system currently in place under the Jakarta Initiative Task Force (“JITF”), and the final section includes a brief discussion of the effectiveness of the GOI’s programme, as well as suggestions for future reform.

II. Factors Impacting Public Sector Response to Corporate Debt Crises

In fully-developed economic systems, the informal workout process familiar to most restructuring professionals provides a workable alternative to litigation. In emerging markets, however, a combination of factors can cause the informal workout process to break down. Each of these factors is relevant, not only because they explain why emerging market corporate debt restructuring is troublesome, but also because they serve as guidelines for the design and implementation of public sector programmes. Each is discussed separately below.

¹²² Mr. Bacelius Ruru is Chief Executive Officer of The Jakarta Initiative Task Force, Indonesia.

¹²³ General issues regarding informal workout techniques in Indonesia and their relationship with the Indonesian courts’ interpretation of the Indonesian bankruptcy laws is discussed in the paper submitted by Samuel Tobing, Chief Operating Officer of the Jakarta Initiative Task Force.

A. *Lack of Substantive Restructuring Experience*

The success of informal workout negotiations depends heavily on the talent and knowledge of those in charge of the discussions. In particular, a thorough understanding of restructuring "best practices" is invaluable in settling disputes and shaping deal structures. Well into an economic crisis, it is likely that experience with restructuring will be developed and, to the extent it is not, outside professionals will make themselves available. However, at the onset of a crisis, particularly in a country that has been experiencing substantial economic growth, it will be unlikely that appreciable market knowledge will be in place to deal with the crisis efficiently. In the absence of such experience and market knowledge, the pace of informal workout discussions will suffer as the parties struggle to "reinvent the wheel".

B. *Weak Framework for Enforcing Creditors' Rights*

As mentioned at length in the paper submitted by Mr. Tobing, the effectiveness of out of court workout negotiations is heavily dependent on the strength and predictability of in-court insolvency procedures. In countries where the legal rights of the parties are unclear in the event of debt default, or where one party or the other possesses insufficient legal remedies, the parties will be left with inadequate rules upon which to base their debt restructuring decisions. In the absence of such guidance, the parties will have no way to adequately assess their respective negotiating leverage, and stalemate will frequently result.

C. *Need to Co-ordinate with Financial Sector Restructuring Programme*

Because economic crises in emerging economies are often systemic in nature, the need frequently arises to restructure both the corporate sector and the domestic financial sector, which can itself be brought to the edge of collapse through its exposure to distressed corporate loans. This, of course, can provide policymakers with an opportunity or a threat, depending on how co-ordination is handled. By utilizing government involvement through nationalised banks, corporate restructuring can be accelerated. On the other hand, poor co-ordination can result in government financial sector actors behaving at odds with espoused corporate sector policy goals. Either way, the systemic nature of emerging market debt crises presents unique challenges for policymakers seeking to co-ordinate government activity.

D. *Cultural Differences*

In fully-developed economies, those engaged in informal workout discussions frequently come from a common business culture. However, the cross-border nature of much emerging market financing virtually ensures that cross-cultural issues will arise. The adversarial nature of debt restructuring negotiations can be counted on to exacerbate these differences, resulting in unnecessary friction if the discussions are not handled diplomatically. Similarly, in addition to basic issues of business culture, different attitudes toward "rescue culture" may be evidenced, with varying views being expressed toward, for instance, the primacy of creditors' rights versus corporate rehabilitation. Although it is likely that these differences will become less important as time passes and the various parties increase their exposure to one another, at the initial stages of an economic crisis, cultural differences should not be underestimated as a source of friction and delay in informal workout negotiations.

III. GOI Programmeme for Corporate Sector Debt Restructuring

The primary programme adopted by the GOI for dealing with corporate-sector debt default was the Jakarta Initiative Task Force (“JITF”), which was created in 1998 as a voluntary mediation programme to foster speedy resolution of corporate-restructuring negotiations. At inception, the JITF was formulated primarily to address points A and D, above, namely, the lack of restructuring expertise present in Indonesia at the time of the crisis as well as conflicts in business and restructuring culture that were expected to surface once restructuring negotiations were underway.

Over time, however, it became clear that the JITF was needed to address a different set of needs. It was, in fact, the case that, at the onset of the crisis, little experience existed with debt restructuring in Indonesia and, additionally, radically different views of rescue culture were evidenced by debtors and creditors. The JITF has always played a constructive role in this regard; however, over time, these issues have largely resolved themselves, as local restructuring expertise has been developed and all parties have gained a greater understanding of each other. On the other hand, points B and C, above, namely a lack of creditors’ rights and need for co-ordination with financial sector restructuring programmes, have turned out to be the key tasks facing the JITF.

As discussed separately by Mr. Tobing, the revised Indonesian bankruptcy law has never been implemented in a way that creditors view as transparent. This has, in turn, resulted in an unwillingness of creditors to use the Commercial Courts as a forum to settle debt disputes and has increased calls for the JITF to serve as an alternative forum, one possessing more structure than a strictly voluntary mediation body. Similarly, given the sheer size of the distressed loan portfolio administered by the Indonesian Bank Restructuring Agency (“IBRA”), that body has emerged as the preeminent force in Indonesian debt restructuring, and a greater need has arisen for the JITF to co-ordinate out of court debt restructuring discussions with the activities of IBRA.

With these needs in mind, the format of the GOI’s corporate restructuring strategy was amended in early 2000 in a number of important aspects. First, the Indonesian Financial Sector Policy Committee (“FSPC”) was created as a ministerial level committee to oversee both IBRA and the JITF and to make specific decisions on behalf of the GOI with respect to corporate debt restructuring. Since creation, the FSPC has met regularly to discharge this duty. Second, the form of the JITF was revised to include so-called “structured mediation” provisions, essentially creating a time bound mediation process which, once initiated, ceases to be completely voluntary.

Under the revised JITF mediation procedures, unco-operative parties are defined as those which fail to adhere to the mediation schedule put in place by the JITF, or fail to attend meetings with sufficient negotiating authority. In the event that the debtor company participates in the JITF programme in good faith, it and its creditors are provided with a number of specific incentives, including the following:

- Targeted tax relief, including a 30% discount on tax payable as a result of debt forgiveness, the conversion of withholding tax payments to a cash basis, and the ability to shield gain realised as a result of a debt-for-equity swap from taxation.
- Protection from delisting from the Jakarta Stock Exchange, so long as the company is classified as restructuring in good faith.

- With respect to financial institutions, limited waivers of legal lending limit (“LLL”) regulations of Bank Indonesia.¹²⁴

In the event a company is classified as unco-operative by the JITF, then limited sanctions are applied. All of the foregoing incentives are denied the company and, in addition, the JITF is instructed to prepare a report outlining the company’s misconduct. This dismissal report is filed with the FSPC which, in theory, is empowered to refer the matter to the Indonesian Office of the Attorney General for the institution of bankruptcy proceedings.

IV. Effectiveness of GOI Corporate Restructuring Programme and Suggestions For Future Reform

The creation of the Indonesian FSPC to co-ordinate government decision-making in connection with corporate debt restructuring issues has been extremely successful. On numerous occasions, thorny issues which had prevented informal workout deals from being completed were resolved through FSPC edict for the benefit of all parties, and co-ordination between the JITF and IBRA has been improved dramatically as a result.

The JITF structured mediation programme has resulted in a marked increase in the number of cases for which memoranda of understanding were achieved. As of the date of this paper, over US\$18 billion in debt had reached at least the MOU stage under JITF mediation. In particular, the JITF has received favorable comments regarding its ability to provide a forum, as an alternative to the Commercial Courts, within which orderly restructuring negotiations can take place.

As to the incentive and sanction system under the JITF, the results have been mixed. An appreciable number of companies have sought out the JITF tax incentives, and the existence of such incentives have, in a number of cases, provided leverage necessary to modulate debtor behavior and to force the completion of restructuring deals. Though less sought after, the other JITF incentives have played a constructive role in motivating companies to negotiate their obligations in good faith.

On the other hand, the JITF sanctions, exercised through a referral of matters to the FSPC, have had limited impact. For certain companies, there does exist a marked reluctance to see the JITF dismiss a matter and file a critical report with the FSPC. However, because of doubts regarding the effectiveness of the Commercial Courts, the threat of subsequent action by the Office of the Attorney General has not been taken seriously by most debtors. As a result, the JITF has been left with only limited sanction power against unco-operative parties.

As mentioned elsewhere, use of the secondary market for the repurchase of debt by original equity holders has served to inject liquidity into a number of distressed corporations and to thereby permit restructurings to proceed. Against this backdrop, the existence of the Indonesian FSPC and the JITF have provided a useful forum to contain negotiations so that progress can be made. In this limited sense, the JITF has served as an alternative to the Commercial Courts, but it is there that the similarity ends. Still missing from the system is a concrete sanction which can be brought to bear against unco-operative debtors and in the absence of such sanction, the GOI’s corporate sector restructuring efforts have served as a helpful, but limited playing field upon which the various actors can contest their views regarding debt valuation.

¹²⁴ It must be noted that these incentives are set to expire at year-end, 2002, and it is presently unclear which, if any, will be extended. The JITF has experienced an upsurge of cases in recent months as debtors attempt to finalise restructurings prior to the expiration of the JITF incentives.

In the future, it is suggested that any public sector restructuring programme be designed with specific reference to the operation (effective or not) of existing judicial mechanisms. Absent a functioning system for the enforcement of creditors' rights, expectations must be moderated regarding the ability of any public sector effort to force accelerated restructuring.

INFORMAL WORKOUTS IN INDONESIA

by

*Samuel Tobing*¹²⁵

I. Background

Among the countries affected by the Asian financial crisis, Indonesia arguably suffers from one of the weakest legal systems, particularly when it comes to the enforcement of creditors' rights. Cases such as PT Asuransi Jiwa Manulife Indonesia have cast doubt over the operation of the Indonesian legal system as a whole, and cases such as PT Panca Overseas Finance¹²⁶ have served to underscore the lack of faith which creditors have when negotiating debt restructuring transactions with Indonesian borrowers.

At first blush, one would be forgiven for assuming that the lack of a credible legal remedy against defaulting debtors would lead to a greater volume of informal out of court restructuring transactions in Indonesia. After all, out of court restructurings are the primary, if not the only, alternative to court-administered reorganisation. However, the reverse has proven to be true. Absent legally enforceable rights in Indonesia, creditors have been forced to face borrowers from a position of extreme weakness. As a result, many borrowers have found themselves under no real pressure either to pay their debt or to restructure. Moreover, such non-payment and associated inaction have, within many industries, become strategic in nature. Since any given company's competitors frequently avoid payment, by servicing debt that company would place itself at a competitive disadvantage.

¹²⁵ Samuel Tobing is Chief Operating Officer at The Jakarta Initiative Task Force (JITF), Indonesia.

¹²⁶ In the PT Manulife case, the lower court ruled that the Indonesian subsidiary of the Canadian insurer could be bankrupted over a failure to pay a dividend to an ousted former partner. The case was later reversed on appeal. In Panca, the debtor was able to obtain confirmation of a composition plan based upon the affirmative votes of a large number of newly-created creditors, despite objections by the IFC that such claims had been fraudulently created.

During the course of the crisis, the argument has been raised on numerous occasions that future funding pressures should, and will, ultimately force borrowers to restructure their debt in good faith. After all, the argument goes, borrowers which restructure early and constructively will be favoured when it comes to obtaining future financing, and will grow their businesses at the expense of their recalcitrant brethren. This, however, has not been the case in practice. Though there have been many complaints regarding a lack of working capital, most companies have been able to continue operating during the crisis by diverting internal cash flow (which would otherwise have been used to service debt) to working capital purposes. It is also the case in Indonesia that many corporate owners have diverted large amounts of cash offshore, and these funds can be called upon to keep corporate operations afloat. Finally, it has been observed that, even for those companies who restructure their obligations, new financing has been extremely difficult to obtain in Indonesia, such that co-operation with creditors poses little, if any, short-term benefit for many Indonesian corporates.

As a result, without the “stick” of credible enforcement of creditors’ rights, and the absent “carrot” of future financing to motivate companies, informal workouts in Indonesia are predisposed to proceed at an extremely slow pace. Frustration with this slow pace has been high. However, as set forth below, mechanisms to solve this impasse have been developed and most parties remain engaged within existing restructuring mechanisms, since there are few alternatives available.

II. Informal Workout Mechanisms

It was recognised early on that Indonesia would need a mechanism to facilitate corporate restructuring and, as early as 1998, several steps were taken to ensure that corporate restructuring proceeded. First, while not directly related to informal workouts, substantial revisions to the Indonesian Bankruptcy Law were put in place with the knowledge that a smoothly-functioning formal insolvency mechanism would provide the necessary certainty to make informal workouts possible. In addition to the revisions to the bankruptcy law, the Jakarta Initiative Task Force (“JITF”) was created to provide a forum for the mediation of debt restructuring negotiations based upon the “London Approach” to corporate debt restructuring.¹²⁷ Finally, the Indonesian Bank Restructuring Agency (“IBRA”) was created to, among other things, administer the distressed-debt portfolios of nationalised Indonesian banks. Taken together, it was thought that these institutions, along with the structural changes to the bankruptcy law, would provide the necessary framework within which informal restructurings could take place.

However, the Indonesian bankruptcy law revisions were never implemented effectively by the Commercial Courts. As a result, effective pressure has never been brought to bear against defaulting Indonesian corporates. Despite the massive-scale of the Indonesian corporate debt crisis, it is telling to note that only a handful of distressed companies have ever undergone involuntary bankruptcy in the Commercial Courts. The resulting lack of creditor leverage has had follow-on effects for both the JITF and IBRA in that the former was originally designed as a strictly voluntary body while the latter has been, in actual operation, highly dependent on the Indonesian Courts for the enforcement of its rights.

¹²⁷ The “London Approach” is a set of informal workout “best-practices” articulated by and informally enforced by the Bank of England.

When this state of affairs became apparent steps were taken by the government of Indonesia to, as much as possible, correct the situation. IBRA has increased its engagement in the informal workout process as time has gone by, and the JITF programme was amended in early-2000 to comprise a structured, time bound process with implicit incentives and sanctions to motivate borrowers to cooperate.¹²⁸ These revisions have had a positive effect on the performance of the JITF, and as of the date of this paper, memoranda of understanding had been obtained with respect to over US\$ 18 billion in debt under the JITF programme. However, it bears mention that the fundamental inoperability of the Indonesian bankruptcy system, coupled with the relatively modest extent of proffered JITF incentives, has limited the extent to which the JITF has been able to operate as a catalyst for informal workouts. A significant number of cases have remained impossible to solve, and frustration remains at the slow pace of corporate restructuring.

III. Informal Workout Techniques

The fundamental problem facing most Indonesian corporates is the mismatch between ongoing debt and cash flow. Of course, this mismatch is, in many cases, a product of inefficient operations or faulty business models, but from the perspective of the owners of the corporation, it is the cash/debt mismatch that is of primary concern.

Typically, this mismatch is rectified through a debt-for-equity conversion, with the result that existing ownership is diluted and the company emerges from the restructuring exercise with a rationalised balance sheet. However, for many Indonesian companies, the scale of the overleveraging is so great that any market-based debt-to-equity conversion would result in forfeiture of control over corporate operations, a result that has not been palatable to most equity owners in Indonesia. As there is no credible mechanism to force equity owners to surrender control, stalemate has resulted — creditors have refused to write-off debt while owners have refused to surrender control in the absence of a mechanism to force them to do so.

Against this backdrop, two mechanisms have successfully been employed in Indonesia to permit restructurings to take place without the necessity of directly addressing the thorny control issue. Each is discussed separately below.

A. *Secondary Market Debt Repurchases*

The secondary debt market has, of course, been around for some time. However, within the past two years, it has emerged as the primary restructuring catalyst in Indonesia, permitting deals to be completed which, in earlier years, were thought to be impossible. Some four years into the crisis, creditor fatigue has set in, and given the current lack of a meaningful enforcement mechanism, secondary debt prices for many Indonesian corporates are extremely low. At the same time, the equity owners of these same corporations possess, in many cases, significant offshore resources (allegedly pilfered from the corporation in some cases) which can be used to repurchase outstanding debt at a discount. This has proven to be a key technique by which informal workouts are completed in Indonesia.

¹²⁸ These incentives and sanctions will be addressed separately in the remarks of Bacelius Ruru, Chairman of the Jakarta Initiative Task Force.

There are undoubtedly advantages to this approach. By repurchasing loans at a discount, unsustainable debt is reduced and, from the perspective of the equity holder, the situation is improved, since less of a debt-to-equity dilution will be required upon restructuring. From the perspective of creditors, this situation is an improvement so long as outside funds are used to effectuate the purchase. If corporate funds are employed, then the benefit of such purchase will, of course, depend on the discounts obtained. In any event, following a period of suspicion evidenced by creditors against the practice, there now seems to be widespread acquiescence among most creditors to related-party debt repurchases (at proper discounts), since creditors are permitted the opportunity to exit without “surrendering” the control debate while those who stay are, in most cases, enabled to achieve a higher rate of recovery.¹²⁹

B. Share Lock-Up Mechanisms

Aside from secondary-market debt repurchases, certain restructurings have been completed through the use of so-called share “lockup” mechanisms. Under such arrangements, a controlling interest in the debtor corporation is placed in escrow, or under similar control, and its subsequent disposition is then made dependent on the borrower’s performance under the restructuring agreement. Under such arrangements, compliance with the restructuring terms will result in the existing owners retaining control over the corporation while default will result in a surrender of control to creditors.

The advantage of such share incentive plans is that they provide existing equity holders with the hope that control can be regained while, at the same time, providing creditors with some assurance that the company will perform under the terms of its restructuring documentation. Given the fact that most companies are over-indebted to the extent that equity is of dubious value at the time of restructuring, agreement to such lock-up mechanisms may be less of a concession by creditors than it first appears, since it gives a new assurance that the contractual terms between the parties will be honoured.

IV. Benefits and Dangers of Informal Workouts

To date, the primary benefit of informal workouts in Indonesia has been the deleveraging¹³⁰ that has occurred. At the onset of the crisis, it was clear that Indonesian companies were carrying far too much debt, and if anything approaching economic recovery were to be achieved substantial deleveraging would need to take place. As a result of the large amount of secondary-market debt that has been repurchased, as well as the direct restructuring efforts of private actors, IBRA and the JITF, many Indonesian debtors have significantly lessened their debt burdens and are in a position to share in any economic recovery.

¹²⁹ Unlike commercial creditors, however, IBRA has stated a policy of refusing to sell loan positions back to original equity owners. However, it is suspected by many that creative equity holders are finding routes around this restriction.

¹³⁰ Deleveraging means the reduction of a debtor’s debt as a result of debt restructuring negotiation, particularly debt buy back which provides implied discount to the debtor.

However, this emphasis on deleveraging has not been without its costs. To begin, deleveraging has, in most cases, come at the expense of credible operational restructuring, and the same individuals and practices responsible for past failures have, in many cases, been left in place. This, of course, creates significant moral hazard, and has denied Indonesia the usual rejuvenating effects of economic crisis, namely, the injection of new management and entrepreneurial talent to maximise efficiency and economic output. Additionally, the deleveraging that has occurred has been accomplished with no small amount of bitterness among those in the business of providing cross-border capital (and, indeed, it is precisely such bitterness that has driven debt prices down to levels sufficient to have permitted these restructurings to take place). Although it is too early to tell for certain, it is likely that this experience will result in at least a short-term reluctance of outsiders to commit further funding to Indonesia, at a time when the country needs such investment to lift itself out of economic crisis.

V. Conclusion

As indicated above, the Indonesian debt restructuring experience has very much been a product of the failure of the country's legal system to deal adequately with issues of default and creditors' rights. In light of the complete absence of pressure available to force companies to deal with their debt obligations, it is perhaps surprising that progress has been made at all, and the restructurings that have occurred are testament to the ingenuity and dedication of those involved. That being said, the past and ongoing challenges should serve as a cautionary tale to those contemplating informal workout systems in countries with weak legal systems. The experience in Indonesia has made it amply clear that the success of informal workout efforts will be directly dependent on the speed, predictability and efficiency of existing in-court insolvency procedures, and absent credible creditors' rights, the restructuring techniques ultimately employed in such jurisdictions will be targeted toward deleveraging at the expense of longer-term operational restructuring.

Chinese Taipei

**CROSS-BORDER INSOLVENCY AND INFORMAL WORKOUTS: A VIEW FROM
CHINESE TAIPEI**

by

Prof. Lawrence S. Liu¹³¹

I. Introduction

For good reasons, Chinese Taipei has an archaic insolvency regime, which is now being revamped. A short explanation for this phenomenon is that an insolvency system was not necessary during the period of high economic growth when government policy encouraged export by small- and medium-sized enterprises. But Chinese Taipei has to globalise, so it has opened up and diversified the domestic market, as both industrial upgrading and financial reform policies demand more national investment in insolvency reform.

Antiquity and Rigidity

The antiquity and rigidity of the insolvency regime in Chinese Taipei comes in several forms. Firstly, insolvency matters are treated as “non-litigious matters”, that is, matters that do not involve lawsuits and disputes. This cannot be farther from truth and reality: all practitioners and economists understand the high stakes involved in insolvency proceedings, and the human instinct to dodge and play mischief. But this is not how Chinese Taipei received its insolvency law as part of the Civil Law transplant that began at the turn of the last century in China.

¹³¹ Prof. Lawrence S. Liu is an Attorney at Law with Lee and Li, in Chinese Taipei

Secondly, the system has suffered from “code fragmentation”. There has not been a unified code of insolvency laws. For example, the Company Law enforced and maintained by the Ministry of Economic Affairs contains a chapter on corporate reorganisations. But only public reporting companies (including listed companies) are entitled and subject to its application. Not even their subsidiaries can be included (although in informal workouts, practitioners can deal with this constraint through private negotiations).

The Bankruptcy Code, on the other hand, is a separate code in Chinese Taipei, and is maintained by the Judicial Yuan, its judiciary. In other words, liquidation and composition proceedings are governed by a statute separate from the corporate reorganisation proceedings.

Thirdly, the government heavily controlled the banking sector until the early 1990s. Conservatism had led to asset-based lending without much emphasis on understanding the firm value and risks (including insolvency risks and costs).

Fourthly, there is no special bankruptcy court. Judges are not well-trained. Nor were they expected, under the “non-litigious matter” mode, to be fully educated in matters involving industry and finance so as to intelligently rule on important bankruptcy cases. In addition, courts in Chinese Taipei are usually very congested. Therefore, the proceedings in major corporate reorganisation cases and outright bankruptcy (that is, liquidation) cases are often long drawn out. Judges also move on to their next rotational assignment without closing the pending insolvency docket.

Fifthly, like many other Asian or emerging markets, Chinese Taipei has not developed the necessary institutional arrangements for a credit industry. Fraudulent conveyances are always a concern in all foreclosure-type proceedings and workout situations. Collection, retrieval and processing of credit information is underdeveloped and fragmented, in part because article 48 of the Banking Law prohibits banks from sharing information with non-bank institutions.

Pressure for Reform and Progress

This archaic insolvency system has persisted, frankly speaking, because until recent years, the high-growth economy has not felt the need for massive national investment to improve it. Other than business cycles and global oil crises, Chinese Taipei has not experienced major bankruptcies.

Of course, this all changed by the late 1990s. Industries began to experience the pains of global economic downturn. Banks started to accumulate non-performing loans. The government had to rush through receivership and debt resolution legislation (like the 2000 Banking Law amendment and 2001 Financial Restructuring Fund Law) and take over community financial institutions (like credit departments of fishery associations and farmers associations).

Despite some earlier, ill-conceived efforts to apply administrative guidance on banks to grant moratoriums to big borrowers, since 2001 the government has demanded a cleanup under a “2-5-8” plan. Financial institutions on the whole are to reduce their NPL levels to below 5% and increase their capital adequacy levels to the BIS-mandated 8%. These results are to occur within two years after passage of a pending amendment to the FRF fund law that would authorise more than NT\$1 trillion of tax dollars for debt resolution.

In addition, the 2000 Financial Institutions Merger Act authorises the formation of asset management companies to buy NPLs from banks. The Securitisation Law enacted in mid-2002 permits and encourages banks to securitise performing loans. In November 2001, the Company Law underwent a major amendment including the improvement of the corporate reorganisation provisions. Since 2000, the Judicial Yuan of Chinese Taipei has embarked on an overhaul of the Bankruptcy Law, and currently there is already a discussion draft.

Unfortunately, the draft amendment to the Bankruptcy Law still follows the mode of separate codes. In its effort to reform the bank sector, the FIMA law sponsored by the Ministry of Finance allows AMC's to enjoy foreclosure powers that are at odds with general bankruptcy law principles.

Warts and all, Chinese Taipei has begun to reform its outdated insolvency system. It is still too early to see the directions and impact of this reform effort. However, this effort will definitely affect cross-border insolvency proceedings and informal workouts in Chinese Taipei.

II. Cross-Border Insolvency Rules

Proper Context for Analysis

In discussing cross-border insolvency rules in Chinese Taipei, it is important to note that there are very few cases, formal or informal. In addition, most foreign investors in Chinese Taipei and most Chinese Taipei investors investing abroad set up local subsidiaries, which are separate legal entities.

Where a Chinese Taipei company (albeit a wholly-foreign owned subsidiary) is involved, one can say that technically there is no "cross-border" insolvency, because no foreign companies are involved. Similarly, when a foreign subsidiary of a Chinese Taipei company files for insolvency proceedings abroad, there are technically no "cross-border" insolvency concerns.

The exceptions are trading companies, banks, insurance companies, securities firms, air lines, shipping companies and other businesses which, for business or regulatory reasons (like landing rights), have to use the "branch" model for their investment in Chinese Taipei.

What this means is that, technically speaking, cross-border insolvency matters in Chinese Taipei can only involve Taiwan branches of foreign companies. This is a very limited scenario, but there is still a likelihood of its occurrence. For example, if United Air Lines were to seek Chapter XI protection in the U.S., its Taiwan branch would need to deal with cross-border insolvency issues arising from Chinese Taipei's bankruptcy laws.

Bankruptcy Law and Related Rules Currently in Force

Under the Bankruptcy Law, the concept of bankruptcy means liquidation and dissolution of the bankrupt firm. In addition, Article 4 of Chinese Taipei's Bankruptcy Law does not accord any binding effect on the bankrupts' assets in Taiwan. As a result, for example, a stay order arising from Chapter XI of the U.S. Bankruptcy Code will not be applicable with respect to assets of a Chinese Taipei branch of the American company seeking protection under Chapter XI. No courts in Chinese Taipei have opinions on the issue of whether such a Chapter XI proceeding would constitute a bankruptcy within the meaning of Article 4 of Chinese Taipei's Bankruptcy Law. In light of the vintage of this legislation and the pattern of narrow interpretations, the courts most likely would not draw such a conclusion.

In addition, a stay arising from a foreign insolvency proceeding is not a foreign judgment within the meaning of article 402 of Chinese Taipei's Code of Civil Procedure. Under this rule, Chinese Taipei courts would not review a judgment *de novo* if:

1. the foreign court has competent jurisdiction (as viewed under Chinese Taipei laws);
2. in proceedings leading to the foreign judgment against a defendant in Chinese Taipei, it has been properly served (personally or through Chinese Taipei's "letter rogatory" judicial assistance procedures);
3. the foreign judgment does not contravene Chinese Taipei's public order or good morals; and
4. the foreign court accords reciprocity over judgments made by Chinese Taipei courts.

Most importantly, such a judgment has to be final and non-appealable. By contrast, a stay order is only interim in nature and is not a final judgment. In other words, under Chinese Taipei laws, creditors of a foreign company may still seek relief over assets of the foreign company located in Chinese Taipei.

The foreign company then would have to consider petitioning, through its Chinese Taipei branch, for protection under Chinese Taipei's insolvency laws. There are several problems. Firstly, a branch is not a full legal entity. Secondly, the Company Law's corporate reorganisation rules only apply to public reporting companies. As such, they cannot be invoked. Thirdly, the Bankruptcy Law of Chinese Taipei only contemplates outright liquidation and dissolution. This could create a problem when the proceedings in the home state are, instead, reorganisation in nature.

In addition, a Chinese Taipei or foreign creditor may seek enforcement against the local assets of that foreign company. Such enforcement actions include attachment from final judgment, pre-trial provisional attachment (requiring a bond of usually one-third of the claim and a lodging a definitive complaint within seven days of such levy).

In summary, the current state of cross-border insolvency law is a case of straightforward irrelevance. The current insolvency laws in Chinese Taipei do not contemplate cross-border insolvency situations at all. They do not reach over assets located outside Taiwan. For assets of a foreign company that are located in Taiwan, Chinese Taipei's insolvency laws would give effect to only local legal proceedings.

III. New Proposal under the Preliminary Bankruptcy Law Amendment Bill

Chinese Taipei's Judicial Yuan has published for discussions and comments a preliminary Bankruptcy Law amendment bill in 2002. This draft contains rules which are a significant departure from both the current law and the 1999-2000 draft, in which cross-border rules were short and ill-conceived. Indeed, I had occasion to comment on the 1999-2000 version and suggested that the Judicial Yuan look into the work of the UNCITRAL, that is, the Model Law on Cross-Border Insolvency.

Allowing Recognition of Foreign Proceedings

The 2002 preliminary bill allows a procedure to recognise a foreign court order permitting composition or declaring bankruptcy through an application filed by the representative of the composition or bankruptcy proceedings. (Art. 208) Once recognised, the law of the foreign

proceedings will determine the procedure and effect of the disposition of assets of the foreign debtor that are located in Chinese Taipei. (Art. 213) The recognition will be binding upon the debtor, bankrupt and affiliates with respect to their assets in Chinese Taipei. As a result of the recognition order, the representative of the foreign composition or liquidation proceedings will have power over the assets of the foreign debtor located in Chinese Taipei in accordance with Chinese Taipei's Bankruptcy Law. (Art. 214)

Parallel Proceedings

Cryptically, the 2002 preliminary bill contains extensive provisions dealing with parallel proceedings. They cover foreign proceedings that are the subject of a recognition order, and proceedings in Chinese Taipei that arise under the Bankruptcy Law. This can be very confusing.

For example, the 2002 preliminary bill contains a rule that, despite a recognition order by a Chinese Taipei court, the same composition, liquidation or bankruptcy proceedings in Chinese Taipei would not be affected. Representatives of the foreign proceedings covered by the recognition order, however, would be entitled to participate in the parallel Bankruptcy Law proceedings in Chinese Taipei. (Art. 217) If the text means what it says, a recognition order does not mean much.

Where a Chinese Taipei court has pending before it an application for permitting composition or declaring bankruptcy in the parallel Bankruptcy Law proceeding in Chinese Taipei, the 2002 preliminary bill requires it to stop and think. In other words, before it makes a non-appealable decision in the parallel proceeding under the Bankruptcy Law, it shall discontinue the review of the application for the recognition order, except when recognition would be more advantageous to creditors in Chinese Taipei. (Art. 218) Again, this rule could create problems in actual cases.

Because the 2002 preliminary bill essentially allows parallel proceedings to co-exist, it also contains rules governing the distribution of the estate where a creditor has been paid or will be paid out of the foreign proceeding. In such a situation, that creditor will not be entitled to participate in distributions under the Chinese Taipei parallel proceedings unless other creditors enjoying the same seniority have been paid proportionately. (Art. 219, 220).

The 2002 preliminary bill further provides that local representatives in the parallel Chinese Taipei proceedings may participate in the foreign proceedings. In addition, they may provide assistance and information to the foreign representatives and demand the same from foreign representatives. (Art. 221, 222).

In summary, the parallel proceedings rule of the 2002 preliminary bill gives some, but not priority or exclusive effect to foreign proceedings. It then essentially weakens the recognition mechanism.

Foreign Reorganisation Proceedings not Covered

One of the major problems with this recognition procedure is that it does not apply to recognition of foreign orders in a reorganisation proceeding. This seems to be a ill-conceived corollary of the premise that the Bankruptcy Law can only deal with liquidation proceedings. Therefore, it would not be appropriate to include foreign reorganisation proceedings when the Bankruptcy Law does not contemplate (local) reorganisation proceedings.

Time Gap

In addition, there always will be a time gap between (at least) the foreign court permitting composition or declaring bankruptcy and the Chinese Taipei court's recognition order. The 2002 preliminary bill allows "good faith" (meaning unknowing) counter parties dealing with the debtor and providing consideration for transactions with the debtor involving assets located in Chinese Taipei to assert the validity of the transaction against the estate. Where the counter party knowingly engages in such a transaction, it may still assert the validity of such transaction to the extent the estate has benefited from it. (art. 215) This rule could create problems in actual cases.

Requirements for Recognition Order

The 2002 preliminary bill also requires certain documents for such a recognition procedure. (Art. 209). The more important documents are:

1. translations and originals or authenticated photocopies of the foreign court orders permitting composition or declaring bankruptcy;
2. credentials of the representative in the composition or bankruptcy proceedings and translation thereof;
3. a full description of the financial status of the foreign debtor, including its assets, creditors and debtors, and translation thereof; and
4. the original full statutory text of the foreign insolvency law on whose basis the foreign court order was rendered, or a translation of the relevant statutory text.

While this rule is clear, it seems slightly more demanding than the requirement of the Model Law. (Art. 15-18) Once recognised, the foreign court order and the recognition order as well as relevant documents shall be published. (Art. 211)

Decision With Respect To Application for Recognition

The 2002 preliminary bill contains an important provision on the criteria to determine whether to recognise a foreign court order permitting composition or declaring bankruptcy. The Chinese Taipei court shall deny recognition if:

1. under Chinese Taipei laws, the foreign court does not have jurisdiction;
2. recognition would unjustifiably harm the interest of creditors in Chinese Taipei; or
3. the foreign order contravenes Chinese Taipei's public order or good morals.

In addition, where the foreign court does not grant reciprocity to comparable orders of Chinese Taipei courts, the Chinese Taipei court may refuse recognition.

This rule follows Article 402 of the Code of Civil Procedure governing the recognition of foreign judgments in general. A slight improvement is relaxing the reciprocity requirement (which has been the rule under Chinese Taipei's Arbitration Law for recognising foreign arbitration awards). However, the test of "unjustifiably harm the interest of creditors in Chinese Taipei" is potentially a Pandora's Box well liked by creative practitioners to forestall recognition attempts.

Provisional Relief

Before a Chinese Taipei court renders a recognition order and an application is already pending, the court may in its own discretion or upon the application of the representative of the foreign composition or bankruptcy proceeding grant the following provisional relief:

1. prohibit or discontinue foreclosure proceedings against the debtor;
2. prohibit any transfer, mortgage or other dispositions of assets by the debtor; and
3. other necessary provisional relief.

Unless otherwise stated in the definitive recognition order, such provisional reliefs will not be effective on rendering such an order. (Art. 212)

Rescission of Recognition Order

Where justified, a Chinese Taipei court may rescind a previously rendered recognition order. Such justifications are:

1. where conditions under Article 210 for denying recognition existed;
2. where the foreign proceeding has been terminated or rescinded;
3. where the representative provided false documents or representations; or
4. where the representative has materially breached its duty under the Bankruptcy Law. (Art. 216)

IV. Informal Workout: The Wang Laboratory Case

As mentioned above, there have been only a few cross-border insolvency cases of note in Chinese Taipei. The context of such cases is also instructive: Chinese Taipei branches of foreign companies do not play any central role in such debt resolution.

However, an interesting cross-border insolvency case in the late 1980s is noteworthy. This matter involves Wang Laboratory Taiwan (WLT), a subsidiary of Wang Laboratory, Inc. (WLI) founded by Chinese American Dr. An Wang. WLI had owed significant amounts of trade payables to WLT, which had been its dominant oversea manufacturing plant. In an attempt to restructure and strengthen the business, WLI then invited President Enterprise Company (PEC), a leading food processing company from Chinese Taipei, to be a minority shareholder in WLT. But WLI soon experienced significant losses resulting from competition from personal computers and sought Chapter XI protection in America. How to deal with WLT and PEC in the WLI reorganisation proceeding thus became an issue.

Company Law of Chinese Taipei at that time prohibited share buyback[s], with one major exception. A company incorporated in Chinese Taipei may buy back its shares from a shareholder who is bankrupt, if that shareholder owes debt to the company. This is a very unique rule that allows debt-equity cancellation. Whilst this provision of Company Law may not be consistent with insolvency law principles, it was invoked in the WLT case.

In this case, WLT applied with the MOEA for a ruling and was assured that it could repurchase shares held by WLI so as to cancel the debt owed by WLI to it. As a result of this buyback, WLT would be essentially taken over by PEC. The Bank of Boston acted as financial adviser in this informal workout, which proceeded smoothly. Importantly, even though the relevant Company Law rule (Art. 167) only mentions bankruptcies (which usually mean liquidations) as the triggering condition, the MOEA had no problem including reorganisation (and indeed a foreign reorganisation) proceedings in the ambit of this unique rule.

Technically, this is not a cross-border insolvency case because WLT is a Chinese Taipei company, and WLI itself has no other assets in Chinese Taipei. However, the importance of this case is that WLT had been run as if it were a branch. Also, although one can quibble about the policy of having a debt-equity cancellation rule like Article 167, the fact of the matter is that the parties were able to efficiently and speedily resolve their financial claims and consummated a workout/buyout to everyone's satisfaction.

The 2002 preliminary bill of the Bankruptcy Law, however, does not show this much flexibility. Therein lies the opportunities to further improve the bill.

V. Conclusion

Chinese Taipei will continue its insolvency reform in earnest. The reason is obvious: the administration realises that it has to engage in financial reform for Chinese Taipei to stay competitive globally. Increasingly, the insolvency system is viewed as part and parcel of the financial system. Therefore, insolvency reform has to be a part of the financial reform.

The key to this reform is judges in the Judicial Yuan. They have the responsibility in Chinese Taipei for both administering bankruptcy and reorganisation cases and updating the Bankruptcy Law by sponsoring amendments. In this regard, problems in the cross-border insolvency chapter of the 2002 preliminary bill mentioned above need to be addressed in line with the Model Law on Cross-Border Insolvency as soon as possible. Indeed, there should be a more ambitious attempt to explore, for example, the work emerging from the UNCITRAL process on the draft Legislative Guide for Insolvency Law.

The executive branch in Chinese Taipei also has a large role to play. It needs to somehow design a model for a unitary insolvency legislation that includes all kinds of insolvency proceedings. This is important because the MOEA is charged with updating the corporate reorganisation rules of Company Law. But this fragmentation approach is not desirable. Again, the executive branch could monitor and explore the current work of the UNCITRAL on a unitary, modern insolvency regime. It also needs to be patient with insolvency reform initiatives of the judiciary, and meanwhile not seek "quick fixes." One such quick fix is to write hastily crafted special insolvency rules into banking legislation like FIMA so as to favour banks or privately held AMCs in ordinary corporate insolvency cases.

The private bar and the financial service community in Chinese Taipei have demonstrated much maturity in recent years where local reorganisation cases are concerned. Since they operate in the private sector and have to react to market forces, they have been very responsive and adaptive to foreign practices and new concepts. For this reason, it would come as no surprise if the private sector comes to lead the effort in meaningful insolvency reform in Chinese Taipei.

Thailand

INFORMAL WORKOUTS FOR CORPORATE DEBT RESTRUCTURING IN THAILAND MECHANISMS, TECHNIQUES & CHALLENGES OF FINANCIAL CRISIS MANAGEMENT

by

*Tumnong Dasri*¹³²

The economic crisis that erupted in 1997 resulted in numerous corporate failures and a record number of non-performing loans (NPLs) in the financial system. The highest level reached 47% of total credits in the system in 1999. Unfortunately, the resolution of these NPLs has become very difficult and time-consuming due to various factors including deficiencies in internal infrastructures that were not designed to cope with such problems.

To address the NPL problems, informal workout processes have been developed and the formal court process has been amended.

Informal Workout Mechanisms

A number of institutions have been established to tackle the distressed asset problem after the severe economic crisis in 1997. These include the Central Bankruptcy Court, Financial Sector Restructuring Authority (FRA), Asset Management Corporations (AMC), state-owned Asset Management Companies, Privately-owned Asset Management Companies, Thailand Asset Management Corporation (TAMC), Corporate Debt Restructuring Advisory Committee (CDRAC), Provincial Sub-committee for Debt Restructuring, Court Mediation Centre and SMEs & P Financial Advisory Centre (SFAC).

The tools used for expediting the informal workouts include the Bank of Thailand's Notification on Debt Restructuring (or BOT's Guidelines), the Framework for Corporate Debt Restructuring in Thailand (Bangkok Framework), Inter-Creditor Agreement on Restructuring Plan Votes and Executive Decision Panel (ICA), Debtor-Creditor Agreement on Debt Restructuring Process (DCA) and the Simplified Debtor-Creditor Agreement (Simplified Agreement or SA).

Techniques Used in Informal Workout to Facilitate Debt Restructuring

1. BOT's Guidelines for Debt Restructuring

To facilitate informal workouts, on 2 June 1998 the Bank of Thailand (BOT) issued a notification to serve as a general guideline for financial institutions in order to assist in the restructuring of the large number of distressed assets in the financial system. The guidelines were later amended on 1 June 1999 to reflect practical issues. If the debt restructuring of any cases follow these guidelines, the cases will qualify for the pre-arranged tax benefits and duty-stamp exemptions and reduction of land transfer fees to 0.01%. The key elements of the guidelines are as follows:

1. Debt restructuring should be carried out to maximise the creditor's chances of obtaining repayment subject to the debtor's ability to repay its loans, or in some other way improve on

¹³² Tumnong Dasri is the Director of the Corporate Debt Restructuring Group, Bank of Thailand. He is also a Member and Secretary of the Corporate Debt Restructuring Advisory Committee (CDRAC).

the conditions set out in the original contract to both parties. In particular, debt restructuring should be carried out to help debtors who have difficulties in loan repayment due to the effects of the economic crisis but are expected to recover in future. Financial institutions should ensure that restructuring is not carried out with the objective of postponing or avoiding debt classification or provisioning requirements, or the avoidance of stopping interest accruals.

2. Financial institutions must establish a formal strategy for debt restructuring whereby the highest level of management should participate directly in formulating this strategy. The strategy must form part of the institution's written business policy. In addition, the strategy should cover every stage of the restructuring process from start to finish including clear time bound objectives, the approach and methodology for evaluating and granting loans, measures for monitoring and reporting on performance against those objectives to ensure that the restructuring has been carried out correctly in terms of its objectives and its accounting principles.
3. From the onset, financial institutions must clearly set out written procedures regarding the role and responsibility of officials in restructuring approval, reporting, and monitoring of the restructuring case, including the formation of an action plan for every stage of the restructuring process.
4. In cases where the financial institution is affiliated with or has interests in the debtor due to its involvement in assisting the debtor to solve its troubled debt difficulties, institutions are not required to use another financial institution or third party to evaluate the debtor's financial status, the debtor's repayment capacity, or his cash flows.
5. Financial institutions must draw up action plans and prepare the relevant documents in each stage of the debt restructuring.
6. Financial institutions must have follow-up procedures to monitor restructured loans which are in accordance with the regulations set out. This is to ascertain whether debtors are able to repay their debts as agreed in their revised contracts.

As these BOT guidelines are only general approaches for regulatory purposes, each individual financial institution must develop its own specific procedures of operation that is not only in line with the BOT guidelines, but also most compatible with its institutional structure. Each financial institution must seek approval from the Bank of Thailand of its specific procedures.

2. *Bangkok Framework*

In order to generate a more co-ordinated informal workout approach, the Board of Trade of Thailand, the Federation of Thai Industries, the Thai Bankers' Association, the Association of Finance Companies and the Foreign Banks' Association jointly prepared a Framework for Corporate Debt Restructuring in Thailand in early 1998. The framework is non-binding and non-statutory but is a statement of the approach that is expected to be adopted in corporate workouts involving multiple creditors. The framework exists based on general market acceptance and its practices may be altered or amended to serve the needs of the business and financial communities.

The basic premise is to ensure that a business can survive if there is a reasonable possibility that it is viable. The framework is designed to promote a spirit of timely co-operation amongst concerned

stakeholders for their mutual benefit. There was no intention that this approach force any creditor to forgo any of its rights.

The objective was the successful implementation of an informal framework outside court proceedings for the efficient restructuring of the corporate debt of viable entities to benefit creditors, debtors, employees, shareholders and the Thai economy. This would be done by minimising losses to all parties through co-ordinated workouts and also prevent companies from being placed unnecessarily into liquidation, thereby preserving jobs and productive capacity wherever feasible. There are 19 Principles included in the Framework that are complimentary to the Bank of Thailand Guidelines. Some key Principles of the approach are as follows:

1. Any corporate debt restructuring should achieve a business, rather than just a financial restructuring to further the long-term viability of the debtor.
2. Priority must be given to rehabilitate assets to performing status in full compliance with Bank of Thailand regulations. For example, financial restructuring must not be implemented in a manner to merely avoid debt classification or the maintenance of reserves or to evade income recognition rules.
3. Each stage of the corporate debt restructuring process must occur in a timely manner.
4. Both creditors and debtors must recognise the absolute necessity of active senior management involvement throughout the duration of the debt restructuring process.
5. New credit extended during the debt restructuring process above existing exposures as of the standstill date on reasonable terms in order that the debtor may continue operations must receive priority status based on security, inter-creditor agreements or indemnities.

3. *CDRAC's Debt Restructuring Process*

A Joint Public-Private Consultative Committee (JPPCC) Resolution dated 22 June 1998 established the Corporate Debt Restructuring Advisory Committee (CDRAC) to encourage and accelerate informal workouts. CDRAC's key role is to act as a facilitator or an independent intermediary in the restructuring process in order to facilitate and expedite the negotiation among all parties concerned. The Governor of the Bank of Thailand is the Chairman of CDRAC, while its members are represented by the chairpersons from both the creditor and debtor associations, namely the Thai Bankers' Association (TBA), the Foreign Banks' Association (FBA), the Association of Finance Companies (AFC), the Federation of Thai Industries and the Board of Trade of Thailand. The Bank of Thailand provides a Corporate Debt Restructuring Group (CDG), formerly known as the Office of the Corporate Debt Restructuring Advisory Committee, as the secretariat to co-ordinate and facilitate the debt restructuring between parties concerned and operate in accordance with the resolutions of CDRAC. The Director of CDG is also a CDRAC member and secretariat.

CDRAC's restructuring process is based on the Inter-Creditor Agreement on Restructure Plan Votes and Executive Decision Panel Procedures (ICA), the Debtor-Creditor Agreement on Debt Restructuring Process (DCA) that is used for large and multi-creditor debtors and the Simplified Agreement (SA) that is used for small- and medium-sized debtors. These Agreements were modified from the Bangkok Framework, approved by CDRAC and signed by financial institutions in Thailand in March 1999 as part of the operation of the structured informal workout process through the CDRAC.¹³³

The ICA provides the basic conditions under which the creditor parties to a workout will conduct themselves in endeavoring to reach consensus on proposed plans for corporate restructuring. It deals with such things as voting on plans, time limits for decisions, mediation of inter-creditor disputes, and the appointment of an 'executive decision panel' to review and approve or reject a proposed plan. The decision of the executive panel is final and binding on the creditors who have executed the inter-creditor agreement.

The DCA is required to be signed by a debtor corporation that seeks to invoke the CDRAC informal workout process. The debtor must be first approved as a target debtor by the CDRAC. In essence, this Agreement is made with the banks and other financial institutions that have agreed to the Inter-Creditor Agreement. The DCA binds the parties to the Inter-Creditor Agreement. The DCA provides for such things as convening of meetings, lead creditor, steering committee, provision of information, promises by the debtor while the negotiation process is under way, mediation of disputes, debt trading, voting and approval of plan, implementation of plan. The agreement contains detailed schedules for the commencement and advancement of the workout process and of information that the debtor is required to provide.

¹³³ Initially, these agreements were signed by commercial banks, finance companies, EXIM Bank, and the Industrial Finance Corporation of Thailand. In 2001 and 2002, asset management companies also signed into these agreements. Only those who have signed into the Agreement, either financial or other editors, are bound by the CDRAC debt restructuring process."

The negotiation of debt restructuring is processed under a tight schedule set out in the process schedule of the DCA. If the negotiation is carried out according to the schedule and can be settled by the First Vote, it would take only between four and five months. The conditions for a Sufficient Plan Approval is that not less than 50% of the creditors *and* not less than 75% of the credits outstanding of voting creditors vote in favor of the plan. If the plan is not approved in the First Vote, the debtor has the opportunity to amend the plan in accordance with the comments of the disapproving creditors and re-submit it for a second vote.

If, in the second vote of the creditors under step 11 of the Process Schedule, a Proposed Plan is approved by creditors holding not less than 50% of the total Credits owed to voting creditors or not less than 50% of the number of voting creditors, but does not receive Sufficient Plan Approval, the Steering Committee, Lead Institution or any Creditor shall submit the Proposed Plan to CDRAC within ten Business Days from the date of such second vote with a request for CDRAC to appoint an Executive Decision Panel.

In the event of the submission of a Proposed Plan to CDRAC, the ICA will continue to be binding on all Creditors, provided however, that any Creditor may elect in writing not to continue to be bound for its particular credit (regardless of amount) to a Debtor that has credits outstanding totaling in aggregate more than Baht 1,000,000,000 (one thousand million Baht) in principal obligations. To be an effective election, such Creditor must provide notice of such election to CDRAC and the Lead Institution or Steering Committee within ten Business Days of service of the Statement of Issues under Section 6(b) of the ICA¹³⁴. Such notice must state specific reasons for the election and the minimal amendments to the Proposed Plan necessary to cause the Creditor under this Agreement to be bound hereunder as regards the Proposed Plan. CDRAC shall provide any such notices to all Creditors within three Business Days of receipt thereof.

If, after completion of the second vote of the Process Schedule, the Proposed Plan is not approved by creditors holding at least 50% of the total Credits of all voting creditors or being at least 50% of the number of voting creditors, the Creditors under this Agreement shall immediately file a joint petition with a court having jurisdiction for collection of all their Credits and/or the reorganisation under new management or the liquidation of the Debtor.

Enforcement Mechanisms

All stakeholders commit to a definitive timetable for restructuring, forcing decisions to be made and actions to be taken. The process includes guidelines for all parties to follow, making the restructuring clear and concise. The structured informal process has been significantly assisted by the ICA and DCA through the enhancement of efficiency and the avoidance of unnecessary delays in the process. These Agreements provide for mechanisms to deal with any breaches of the agreements.

The occurrence of any of the following events shall constitute a breach of this Agreement:

1. The Debtor for any reason fails to perform or observe any of its obligations under the DCA and, if such failure is capable of remedy, the Debtor does not effect a full remedy within five Business Days;

¹³⁴ 6(b) When a Statement of Issues is filed with CDRAC, within three business days CDRAC shall deliver to all Creditors under this Agreement with the Statement of Issues at their respective domiciles or places of business by telefax, return post or by any other means as it deems appropriate.

2. Any representation or warranty given, made or deemed made by the Debtor is or becomes or proves to have been untrue, incorrect or misleading in any material respect and, if capable of remedy, the Debtor does not effect a full remedy within five business days;
3. The DCA or any part hereof shall at any time for any reason cease to be in full force and effect or shall be declared to be void or shall be repudiated or frustrated or the validity or enforceability hereof shall at any time be contested by the Debtor or any person, or the Debtor shall deny that it has any or further liability or obligations hereunder;
4. Any action or proceeding of or before any court or authority shall be commenced to enjoin or restrain the performance of and compliance with the obligations expressed to be assumed by the Debtor hereunder, or in any manner to question the legality, validity, binding effect or enforceability of the DCA;
5. Any governmental authority or any person acting or purporting to act under governmental authority shall have taken any action to condemn, seize or appropriate, or to assume custody or control of, all or any substantial part of the property of the Debtor or shall have taken any action to displace the management of the Debtor to curtail its authority in the conduct of the business of the Debtor; or
6. The Kingdom of Thailand or any legislative, executive or judicial body thereof (whether by a general suspension of payments or a moratorium on the payment of indebtedness or otherwise), or any treaty, law, regulation, communiqué, decree, ordinance or policy of Kingdom of Thailand shall purport to render any provision of the DCA invalid or unenforceable or shall purport to prevent or materially delay the performance or observance by the Debtor of its obligations hereunder.

Debtor Default

At any time after the occurrence of a breach and upon the receipt by the debtor of written notice from the required creditors, the agreement shall terminate immediately as to the debtor without the requirement of any further notice or action. After three unremedied breaches by the debtor, the creditors agree to seek collection of their credits under judicial process and/or immediate liquidation or reorganisation of the debtor under new management pursuant to the Bankruptcy Act.

Creditor Default

With regards to the DCA, if any Creditor (a “Non-Complying Creditor”) fails to comply with Section 9 hereof (Voting on Proposed Plan; Implementation of Approved Restructuring Plan) any other Creditor under this Agreement may report the non-compliance to CDRAC.

Subject to the laws and regulations applicable to financial institutions in Thailand, by virtue of the provisions of this Agreement BOT may take any or all of the following measures with respect to any Non-Complying Creditor

1. Give a warning letter to the Non-Complying Creditor;
2. Impose a fine on the Non-Complying Creditor as a result of non-compliance. Such fine shall be payable to CDRAC against the operating expenses of CDRAC and its members and shall not exceed 10% of the Non-Complying Creditor’s claims against the Debtor but in no event be less than Baht 500,000.

In the event of any material breach other than Section 9 by a Creditor, any other Creditor may report such breach to CDRAC and CDRAC may issue a warning letter to the breaching Creditor.

As for the enforcement mechanisms under Section 7 of the ICA regarding the Executive Decision Panel, if any Creditor (a “Non-Complying Creditor”) fails to comply with the decisions of the Executive Decision Panel or any other material term or condition herein in relation to a Credit while it is the holder of such Credit, any other Creditor may report the non-compliance to CDRAC and BOT.

Subject to the laws and regulations applicable to financial institutions in Thailand, BOT by virtue of the provisions of this Agreement may take any or all of the following measures with respect to any Non-Complying Creditor.

1. Give a warning letter to the Non-Complying Creditor;
2. Impose a fine on the Non-Complying Creditor as a result of non-compliance. Such fine shall be payable to CDRAC against the operating expenses of CDRAC and its members and shall not exceed 50% of the Non-Complying Creditor’s claims against the Debtor but in no event be less than Baht 1,000,000.

Progress of Corporate Debt Restructuring of CDRAC Target Debtors

From mid-1998 to 31 September 2002, CDRAC approved 15,321 cases with credits outstanding of 2,836,816 million baht as 1998-2001 Target Debtors and 2002 Target Debtors. Details of the restructuring up until the end of September 2002 are as follows:

1. As of September 2002, a total of 10,260 debtors with credits outstanding of 1,363,252 million baht have been successfully restructured. The majority of restructured debtors are represented by the wholesale and retail trade sector with 2,608 cases, followed by the personal consumption sector with 2,438 cases and the industrial sector with 1,606 cases. Details are as follows:

	Total as at 30 Sept. 2002	
	Cases	Mil. Baht
1. 1998 – 2001 Target Debtors	10,126	1,303,233
2. 2002 Debtors	134	60,019
Total	10,260	1,363,252

2. Debtors that have been unable to successfully restructure their debts under the CDRAC process, combined with a total of 3,110 debtors with credits outstanding of 774,176 million baht that did not enter into the CDRAC process in the first place, totaling 4,773 target debtors with credits outstanding of 1,189,307 million baht that have been filed in court.

3. The remaining 202 debtors with credits outstanding of 101,610 million baht remained in the restructuring process as at the end of September 2002. All of these cases are 2002 target cases.
4. Furthermore, an additional 26 debtors with credits outstanding of 22,985 million baht have been transferred to the TAMC and 60 cases with credits outstanding of 159,662 million baht are performing.

Alternative Restructuring Methods

The cases under the management of CDRAC process have been successfully restructured by various methodologies. While most restructured cases used a combination of more than one method in their debt restructuring plans, some methods are more prevalent throughout the spectrum of restructured cases. As at the end of July 2002, it is observed that most of the cases restructured under the CDRAC process was restructured by means of extension of the loan period (27.3%) followed by 21.7% of debt forgiveness and 17.8% of conversion of debt into equity or other assets by creditors. The following table lists the various debt restructuring methods and the percentage of restructured debt:

	Debt Restructuring Method	Proportion of restructured debt (%)	
		2000	2002 *
1	Upfront payment	13.07	17.29
2	Extension of Loan Period	39.68	27.26
	2.1 With Grace Period for principal or interest	25.40	15.90
	2.2 Without Grace Period for principal or interest	14.28	11.36
3	Conversion of Debt to Convertible Debenture /Convertible Loan/Debenture/Zero coupon Bond	4.51	-
4	Conversion of Debt to Equity or other Assets **	12.50	17.76
5	Debt forgiveness	15.05	21.69
6	Continuation of original Working Capital	8.99	15.88
7	Other credit lines (ie. continuation of credit guarantee)	5.83	0.11
8	Transfer of total debt burden to affiliated company	0.36	-
	Total	100.00	100.00

* Preliminary

** Other assets include: real-estate, houses, office buildings, golf courses, machinery, investment capital, claims on debtors

Necessary Dynamics and Environment

Even though the procedures and timeframes are strictly specified in the Agreements, sincere commitment of both the creditors and debtor to work together towards a productive outcome in negotiations is an indispensable factor. All stakeholders commit to a definitive timetable for restructuring, forcing decisions to be made and actions to be taken and the process includes guidelines for all parties to follow, making the restructuring clear and concise. The structured informal process has been significantly assisted by the ICA and DCA through the efficiency enhancement of and the avoidance of unnecessary delays in the process. Never before did Thailand have a speedy and simple restructuring process under definitive guidelines and timeframe. The appointment of an Independent Accountant and Financial Advisor ensures all stakeholders of fair treatment and equal information in support of debt restructuring. The agreements were also innovative in that they allowed for the appointment of an approved mediator in case negotiations reach a deadlock. Companies are able to retain control of their business operations.

Some agreements reached through the CDRAC process must be ratified by the court, in order to bring the dissenting creditors into line. Even though CDRAC is a quasi-policy body and not a judicial one, its process is voluntary and more flexible than that of the Bankruptcy Court. CDRAC has become the preferred venue for debt negotiations and has, to date, restructured a significant amount of loans.

In addition to the authorities and CDRAC, many other parties are also involved in the voluntary debt restructuring process such as Thai commercial banks, foreign banks, finance companies, finance & securities companies, the Export-Import Bank of Thailand, the Industrial Finance Corporation of Thailand as well as the Financial Sector Restructuring Authority, the Asset Management Corporation, asset management companies, trade creditors and CDRAC's target debtors. Furthermore, the independent advisors and specialists such as financial advisors, independent accountants, engineers and independent valuers are also involved in developing the debt restructuring plan and providing expert advice. The commitment of all these parties to restructuring is a factor in successful cases.

Incentives and Triggers in Facilitating Informal Workouts

As the economic crisis severely affected the financial system, commercial banks – both government and private-owned – were encouraged to set up AMCs in order to separate the bad assets from the books of the banks. In this way, commercial banks' balance sheets were cleaned up, while private AMCs concentrated their operations on debt restructuring and loan recovery.

Incentive structures were designed to support and attract the resolution of private indebtedness through negotiations in good faith. These included tax exemptions and reductions for the transfer of properties (to encourage debtors to transfer collateral in payment for the debt), and regulatory changes for NPLs under the new definition of three-months past due (from 12 and 6 months past due) to be allowed for up to five accounting periods from end 1998 to 2000. The state's role was concentrated on mediation, through the establishment of CDRAC.

CDRAC is responsible for mapping out debt restructuring measures in support of efficient negotiations between the debtor and financial creditors or other creditors who signed into the process. CDRAC's debt restructuring process allows for both the debtors and creditors to voluntarily negotiate the debt restructuring under a market-oriented approach. To attract creditors and debtors to come together to resolve their debts voluntarily, the BOT has co-ordinated with the Revenue Department, the Land Department and other relevant agencies in issuing measures to provide tax exemptions and reduce land-transfer fees for creditors and debtors who successfully restructured their debts in a way that complies with the BOT guidelines.

The Bank of Thailand provides a Corporate Debt Restructuring Group (CDG) as the secretariat to co-ordinate and facilitate the debt restructuring between parties concerned and operate in accordance with the resolutions of CDRAC. As part of the Bank of Thailand, the CDG is well respected by all financial institutions and other parties concerned. This has significantly aided the restructuring process in bringing all the creditors together to the negotiation table. Without the CDG, some creditors may not co-operate with other creditors. The CDRAC process entails a prior agreement among lending institutions (its members) to abide by certain rules in their negotiations with debtors, for example not to seek recourse to the courts until the avenue of negotiations within CDRAC with its strict time frame is closed.

In 2001, however, there was a shift in strategy towards a more pro-active and centralised resolution of the NPL problem. The Thai Asset Management Corporation – more commonly known as the TAMC — was established on 9 June 2001. It took over a part of NPLs from both private and state banks and now manages about 700 billion baht of non-performing loans, or about less than half of the NPLs in the system. Since then, NPLs in the banking system have declined steadily, while banks have gradually turned in profits, specifically pre-provisioning profits. Credit growth has picked up, especially in the consumer loans, housing, infrastructure and utilities sector. Loan repayment continues, reflecting the ongoing deleveraging in the corporate sector. The capital market, both equity and debt, quickly made headway as the new source of funding. Against this backdrop, bank credit growth has not expanded much, although overall economic activities both in the banking and non-banking sector have improved markedly.

The question is what happens to the NPL remaining in the system and whether these NPLs still pose a risk to the macroeconomic and financial system. In considering this, it may be useful to examine the various parts of the financial system where NPLs are parked. There are NPLs which still remain in the books of commercial banks and finance companies, NPLs that have been transferred to the TAMC, NPLs that are being managed by the AMCs of state banks, and NPLs of private banks. Among these, the remaining NPLs at commercial banks and finance companies pose a threat to the financial institutions' stability while the rest has been well taken care of by the authorities concerned. This is discussed below.

As at the end of June 2002, NPLs that remain at commercial banks and finance companies stand at 843 billion baht, down from 2,729 billion baht at the same period in 1999. The current level of distressed assets represents 17% of the total value of credits outstanding in the financial system of 4,757 billion baht. Of the 843 billion baht in distressed assets with commercial banks and finance companies, the entire value has been fully provisioned by the financial institutions. Furthermore, 157 million baht of distressed assets have recently been restructured and are awaiting removal from NPL status after three months of debt service according to their restructuring plan.

Of the 716.8 billion baht worth of NPLs transferred to the TAMC, 118.4 billion baht has been restructured by June 2002. This leaves 598.5 billion baht worth of debt, 82 billion baht of which is under legal execution, and 516 billion baht under negotiation. The TAMC purchased these debts at 33% of face value – or at a value equivalent to the underlying collateral value. As the recovery rate is typically higher than net collateral value, no further loss to the taxpayer is expected from these debts. As such, these NPLs are not likely to pose a further risk factor to the economy.

NPLs held by the AMCs of state banks stands at about 400 billion baht. These assets were transferred to the AMCs at a relatively high price – somewhat higher than the collateral value. The potential losses from these assets have been accounted for in the estimation of the fiscalisation of the losses from financial sector restructuring, and therefore should not pose a risk to the economy.

NPLs held by private AMCs remain at about 140 billion baht, which are in the process of restructuring. Potential losses from these NPLs should remain relatively low as past record of the recovery rate has been high.

NPLs of commercial banks have been provisioned beyond minimum requirements, while the recovery rate from NPLs in the TAMC should exceed their collateral value. Further losses from NPLs in state-owned AMCs have already been factored in the fiscalisation estimates. In short, the chances that further losses from the resolution of NPLs will pose systemic risk and stall the recovery process are very small.

Challenges of Informal Workouts

The economic crisis was more severe than expected and all parties involved in debt restructuring had limited experience and practical knowledge in dealing with such high levels of NPLs in the financial system. Furthermore, so there are practical challenges to constructive debt restructuring negotiations when debtors or creditors interpret the ICA/DCA to their advantage and at the cost to other creditors. Like bankruptcy proceedings everywhere, the CDRAC process faces the problem that creditors' incentives differ greatly among themselves as well as with those of the debtor. In addition to the conflict between secured and unsecured creditors, the financial institutions' incentives to write off debts also differ greatly. This combined with unconstructive attitudes towards the negotiations led to the slow progress in debt restructuring at the initial stage of CDRAC's operations.

Some debtors have misguided attitudes in debt restructuring in that they only want to see the creditors forgive as much of their debts as possible. Loans of other debtors are considered to be 'strategic NPLs' in that the debtor has the ability to make repayments but chooses not to do so. At the same time, creditors aim to limit their losses or suffer no losses at all, fearing the burden of having to make the reserves for loan losses or having to increase their capital. Such attitudes are not congruent with CDRAC's restructuring process, which aims for debtors to be able to continue their business operations in order to make fair repayments to their creditors who should receive more in return than they would from liquidation in the court proceeding. The process of writing down the assets and liabilities of the debtor company should be as speedy as possible, so that it can get on with its business without the disruption caused by a credit constraint. For the macro economy, if too many companies remain insolvent for too long a period, the recovery from the crisis may be significantly delayed.

Some aspects of Thai business practices and the nature of the crisis combine to slow down this process considerably. The first problem is with the shareholders of the debtor firms. When a reduction in the values of assets and liabilities become necessary, it should be the shareholders' interest that takes the first loss. Where the shareholders' equity is reduced to zero, this means their ejection from the company. However, in Thailand, most companies, especially the small- and medium-sized businesses, are family-owned and managed. To eject the owners would raise many problems for the creditors, as they would lose the management as well, thereby losing part of the value of the company. This is therefore one of the major bottlenecks in restructuring efforts.

Benefits from Informal Workouts

Before CDRAC Thailand did not have a speedy and simple restructuring process under definitive guidelines and timeframe. Under CDRAC the red-tape and the time-consuming legal technicalities can be avoided through the informal process and participants are able to benefit from a well-structured process and standards that ensure fairness to all parties.

The appointment of an Independent Accountant and Financial Advisor ensures all stakeholders of fair treatment and equal information in support of debt restructuring. In many cases, the accounts of a debtor need to be verified by an accepted third-party auditor. The Financial Advisor's expertise benefits the financial institutions in alleviating the heavy burden of developing customised and in-depth workout plans for all non-performing creditors. The Legal Advisor ensures that the workout plans comply with laws and are legally enforceable.

The informal workout as prescribed by the ICA and DCA were also innovative in that it allowed for the appointment of an approved mediator in case negotiations reach a deadlock. Instead of heading to the court process right away, the parties involved will have the opportunity to resolve their dispute with the help of a mediator. The Executive Decision panel becomes effective when creditors are unable to reach sufficient plan approval level and is another way of avoiding entry into the court process.

Ultimately, the objective of the informal process is for viable companies to retain control of their business operations and generate income for the repayment of their debts. The potential returns from the informal process more often than not bring about a greater level of returns than the court process that may result in liquidation of the company. In this regard, both the creditors and debtor will benefit from the informal process.

Conclusion

Authorities and the private sector will continue to work closely to resolve the remaining NPLs in the financial sector. The Bank of Thailand is working on the Financial Sector Master Plan to create a blueprint for a competitive financial system. Corporates are regaining health through firm and steady reforms. Meanwhile, sound monetary and fiscal policies are providing the support for continued corporate and financial sector reforms.

CDRAC has been downsized significantly and that CDRAC is effectively almost closed. However the ICA/DCA will continue to be binding to all Creditors unless the Creditor applies in writing to be unbound.

TECHNIQUES USED IN INFORMAL WORKOUTS IN THAILAND

by

*Peter Warbanoff*¹³⁵

I. Introduction

The objective of this paper is to review informal workout procedures in Thailand, identify environment and incentives which promote successful workouts and assess the current situation in Thailand as well as areas for improvement.

II. Techniques Used in Informal Workouts to Facilitate Financial and Operational Restructuring and the Practices that have Developed

In Thailand, the informal workout process established in the late 1990s was titled CDRAC — Corporate Debt Restructuring Advisory Committee, which put in place a “formal approach” to informal workouts outside of the court system. CDRAC was established in June 1998 as an unincorporated body consisting of the Board of Trade, the Thai Federation of Industries and the Bank of Thailand (“BoT”).

CDRAC commenced with 351 cases and established a framework for the efficient restructuring of corporate debts of viable entities, to benefit creditors, debtors, employees, shareholders and the Thai economy. The rules governing CDRAC replicated some of the practices which had been established in informal workouts in the West.

Creditors who agreed to be part of the CDRAC process agreed to be bound by the processes and schedule of corporate debt restructuring with individual debtors, who must have executed a Debtor Accession in accordance with CDRAC requirements, thereby binding all parties to the CDRAC process.

At the time of implementing the CDRAC process, the Thai government indicated that it wanted a process which would enable creditors to reach consensus, as efficiently as possible, on the approval or disapproval of proposed plans for the restructuring of outstanding debt, and to prevent any deterioration of the debtor’s assets.

Two major agreements form the backbone of CDRAC as follows:

- (i) The Inter-Creditor Agreement (“ICA”), effective March 1999; and
- (ii) The Debtor-Creditor Agreement (“DCA”).

The ICA is signed only by financial institutions, whilst the DCA is entered into between a debtor and its financial creditors wishing to take part in the CDRAC process.

The ICA and DCA set out certain procedural guidelines for debt restructuring which were similar to those in the rehabilitation process under the Bankruptcy Act, with respect to approval of debt restructuring plans.

¹³⁵. Peter Warbanoff is Senior Vice President — Special Assets Management with Standard Chartered Nakornthorn Bank Public Co. Ltd., Bangkok, Thailand.

Corporate debtors were eligible to be restructured under CDRAC if the debtor was listed on the BoT's "watch list". After signing the Debtor Accession to the DCA, creditors were bound to commence restructuring procedures pursuant to the DCA with the debtor.

The execution of the Accession marks the commencement of the suspension of payments of default interest during the period taken for the proposed plan to be approved by the creditors. If the proposed plan is not approved, only then will the suspended default interest become due and payable.

The process under CDRAC can be commenced by a creditor, CDRAC or the debtor itself. The process under the initiation of a creditor or CDRAC is the same, in that these parties give written notice to the debtor for the first meeting of creditors. The debtor then has 5 business days to provide a list of creditors together with outstanding debts and a copy of the Debtor Accession. Within 15 business days, the first meeting of creditors is held. From this point onwards, the process is the same, whether it was commenced by CDRAC, the creditor or the debtor.

If the debtor initiates the process, it does so by executing the Debtor Accession and notifying each creditor of the time and place of the first meeting of creditors. At least 10 business days' notice must be given but the first meeting must be within 15 days of the execution of the Debtor Accession.

The first meeting of creditors has two purposes as follows:

- (i) The election of the Lead Institute and the Steering Committee; and
- (ii) To set out the schedule for the workout-action plan and timeframe.

Lead Institution

All creditors attending the first meeting must vote to elect the Lead Institution. As a prerequisite, the Lead Institution must have restructuring experience, a significant exposure to the debtor, and a professional working relationship with the Senior Management of the debtor.

It is the responsibility of the Lead Institution to establish goals and schedules for the workout plan, facilitate inter-creditor discussions, liaise with financial and legal advisors and resolve disputes between parties. As the title implies, it is the Lead Institution's responsibility to lead negotiations with the debtor and to ensure all relevant information is cascaded to all creditors. Also, the Lead Institution must calculate the creditors' voting rights based on the outstanding debt.

The costs associated with undertaking the Lead Institution role are borne by the debtor and taken into account in any approved restructuring plan. The Lead Institution must distribute, within 10 business days **from the date of the first meeting of creditors**, details of action plans and the timeframe for the restructuring plan submission.

Steering Committee

Membership of the Steering Committee must comprise at least three creditors, including the Lead Institution, which will chair the Committee. The role of the Steering Committee is one of co-ordinator, and not agent of the debtor. The Steering Committee has the power to retain professional advisors, if necessary, at the expense of the debtor.

Provision of Information

At the conclusion of the first meeting of creditors, a time clock is commenced for the submission of relevant information and the appointment of professional advisors. This is designed to ensure transparency between parties and such relevant information is to be shared amongst creditors, the debtor and other concerned parties.

The critical pieces of information and actions to be provided or undertaken are as follows:

- The Lead Institution or debtor must notify creditors, debtor or CDRAC of its appointment within five business days of first meeting.
- The Debtor must submit preliminary information within seven business days of first meeting. Appendix V of DCA details what preliminary information is to be made available.
- Appointment of independent accountant/expert within seven business days of first meeting. This appointment is made at the request of the Lead Institute, as nominated by creditors. The debtor is required to fully co-operate with the independent expert by promptly providing all information requested.
- Creditors must submit claims in writing, to the Steering Committee within 15 business days of first meeting. The debt must be denominated in Thai Baht.

Until the submission of a plan creditors are free to sell their debt to a third party including an affiliate of the debtor. However, the third party must have executed an Accession to be bound by the terms of the DCA.

The debtor has two months within which to submit a proposed plan and other information requested. This period may be extended by CDRAC for a period of up to one month.

During this period covenants are in place that prohibit the debtor, without the consent of all creditors, from undertaking the following key actions:

1. Creating or assuming additional debt;
2. Incurring expenses outside the ordinary course of business;
3. Disposing of assets outside the ordinary course of business;
4. Entering into any transaction with a related party other than in the ordinary course of business;
5. Creating any additional security interests on the debtor's assets; and
6. Making preferential payments i.e. repaying debt.

The above covenants help to achieve a standstill arrangement between the financial creditors. This allows the company to only undertake business-as-usual decisions, ensuring that on going operations are continued.

During this period creditors are also suspended from charging default interest as discussed earlier.

While the first draft of the plan has to be circulated within three months, the plan does not have to be ready for voting for five months after the first meeting. This is because a two-month extension may be granted with CDRAC approval.

If the debtor fails to submit the proposed plan within the stipulated timeframe CDRAC will appoint a qualified financial advisor to submit a plan within 30 calendar days, at the debtor's expense.

The plan must meet the following criteria:

1. The restructuring value (not defined in either ICA or DCA) must exceed the liquidation value of the debtor;
2. All creditors must be treated reasonably and fairly taking into consideration the ranking of creditors under the Bankruptcy Act; and
3. The plan must substantially be in compliance with the set of guidelines issued by the BOT in respect of the provision of information, fair treatment of creditors, etc. in restructurings.

Creditors have 10 business days to propose amendments to the plan. Such amendments must be in writing. The Lead Institution, together with CDRAC, must then convene a meeting to vote on the proposed plan within 15 days after receiving all proposed amendments.

Voting on the Proposed Plan

The decision on the eligibility of a party to vote on a proposed plan is generally resolved between the Steering Committee and CDRAC on a case-by-case basis. In certain cases, only those financial institutions that are parties to both the ICA and DCA have been permitted to vote. In other situations, financial institutions who are not party to the ICA but accede to the DCA, with respect to a particular debtor, have been allowed to vote on the proposed plan. Also other cases have arisen where all financial institution creditors of the debtor have been permitted to vote.

In order for the proposed plan to be passed and thereby adopted, a Special Resolution by the majority of the voting creditors must be attained. A Special Resolution is defined as at least 75% of the total value of the debts of the voting creditors.

This only applies to the first vote on the plan. If the plan is not approved on the first vote, creditors who vote against the plan may propose amendments as they see fit. The creditors must then reconvene to vote on the amended plan or reconsider the original plan if no amendments were proposed, within 10 business days after the date on which the proposed plan was first considered.

However, a significant difference at the second meeting is that if the plan receives either of the following number of votes then the plan can be referred to the Executive Decision Panel ("EDP"):

1. Not less than 50% of the total amount owing to voting creditors; or
2. Not less than 50% of the number of voting creditors by number.

That is to say the decision to approve the plan, despite not obtaining a Special Resolution but only an ordinary majority, be it either by value or number, is vested with the EDP.

In the event the plan does not achieve simple majority, by either number or value of debt, the creditors shall immediately file a joint petition with the court for the reorganisation or liquidation of the debtor.

Executive Decision Panel

The EDP comprises of three members appointed from three separate lists of executives proposed by the Thai Banker's Association, Foreign Banker's Association and Association of Finance Companies. The decision to be binding must be unanimous and the EDP has the power to appoint any financial, legal or other advisor or expert as it sees fit, at the debtor's expense.

The EDP's decision is only on an "as is" basis, in other words, it has no power to amend either a modified or proposed plan. Section 6 of the DCA covers in depth the procedures governing the EDP including issues such as independence, appointment and resignation. Critically, the EDP has 33 business days after receipt of all documentation, which includes any submission by creditors to CDRAC of their position on disputed issues, to hand down a decision on the plan. This timeframe can be extended by the EDP and CDRAC.

The decision of the EDP is final and binding. However, where the plan has been rejected by the EDP, creditors holding more than 26% of the debt may submit an alternate plan to all creditors. Similarly, the debtor can also submit an alternate plan. This alternate plan will be adopted if a Special Resolution is passed. If the plan does not obtain a Special Resolution it can be referred back to the EDP.

Once the process is completed and an approved restructuring plan is in place no further amendments can be made. All creditors party to the DCA are compelled to vote in favour of the plan at any subsequent creditors' meeting or court proceedings, if rehabilitation is entered into.

The above is a very convoluted process which at best can be achieved within five months but closer to nine months if the EDP is involved.

The other technique for informal workouts is to apply London Rules, which in effect is to enter into a standstill agreement between the financial creditors and the debtor. Such a standstill relies on trust and experience, and adopts similar principles detailed in CDRAC, but avoids some of the bureaucracy associated with CDRAC, and also avoids the potential for minor creditors to be at the sufferance of the major creditors.

The principles underlying the standstill agreement that achieve the optimal results are similar to the covenants placed on the debtor and creditors under CDRAC, and are founded on the willingness of both parties to achieve a win/win result. The strength of this mechanism in the West is predicated on a strong legal system which is efficient and effective in its dealings and judgments. Unfortunately, these are attributes which are not considered as strong in Thailand.

This paper does not consider in depth the informal negotiations process which takes effect in Thailand outside of CDRAC.

III. Environment Needed to Make Workouts Successful

Strong and Balanced Legal System

A critical feature of a successful environment for workouts is a strong legal system, which is efficient, effective and transparent.

The legal system provides the backbone to the insolvency environment, as it is critical for parties (creditors and debtors) to know and fully understand the “last resort” in workout situations. A strong legal system in which parties are confident, will enable parties to pursue open and forceful but fair discussions. The legal system should be sufficiently fair to protect both creditors and debtors and as a result, provide a “carrot and stick” to the parties involved in informal workouts to motivate them to achieve satisfactory settlement or resolution. At the same time, the legal system cannot be seen as a deterrent to making the difficult decision of not achieving resolution in an informal workout.

Implicit in any strong legal system, is clear and user-friendly insolvency legislation, which contains formal processes for debt recovery and restructuring.

In Thailand, the lack of insolvency experience and skills in the market at the start of the 1997 crisis, plus the lack of clear insolvency legislation, resulted in CDRAC being developed to enable parties to adopt a standardised approach to workouts. This at least allowed for a consistent approach across the country and endeavoured to eliminate any perception of favouritism towards larger or more “influential” debtors. Notwithstanding the flaws in the CDRAC process, it at least set out a process which could be followed by debtors and creditors, the majority of which had not had any extensive experience in dealing with insolvent companies.

A strong legal system must be all encompassing, in that at every step of the process legislation allows for the efficient and effective management of insolvent companies. It is not enough to simply have an effective rehabilitation law which allows for the resuscitation of companies. The system must also have laws which appropriately deal with the liquidation of security expeditiously and cost effectively.

If the legal system does not adequately protect the creditor in respect of dealing with its security, the entire system is compromised. Informal workouts will favour debtors, as creditors will be reluctant to rely on a legal system which does not suitably reward good commercial business practice. The legal process in dealing with security is a major dynamic in the workout process because as indicated earlier this in the eyes of the creditor is generally the last resort, and setting aside vindictive motives, creditors are loathe to take such steps as enforcing security through court action when such action may take a number of years to achieve a result. The “carrot and stick” therefore are not sufficiently balanced, as the prospect of enforcing security or taking legal action is a means to an end, which is often a veiled and ineffective threat that debtors are confident creditors will not act on due to weaknesses in the legal system.

Flexibility

Each workout is unique. The facts and situation in any two cases are never the same. Therefore, some workouts are relatively straight forward, whereas others are not. Flexibility in the process and the minds of the debtors and creditors is essential to achieving success.

Having a regimented process which is dictated by guidelines is not always optimal and this can be a significant hindrance, particularly for large companies. The deadlines can be a hindrance but

similarly, may equally be a stimulus to achieving a result. However, the deadline and more importantly, the consequences of missing imposed deadlines can at times compromise the quality of the workout because it is based on flawed information.

Overall, it is hard to be in favour of defined timeframes. However, in many cases this structured approach has enforced discipline that was otherwise missing — so this is a benefit.

Requirements of the Individual Parties

Dealing now with the individual groups — debtors and creditors — the discussion below highlights a number of critical issues these respective parties look for in a workout environment:

Debtors

- Knowledgeable and experienced creditors who have realistic targets and expectations.
- Transparency in dealings – it is critical that creditors remain faithful to decisions made, unless circumstances or situations precipitate a necessary deviation.
- A fair trial – after the initial reaction to hearing of the financial problems facing the debtor, the emotional aspect must be taken out of the equation. To achieve this it is critical that creditors focus on the future and not the past.
- Reputable independent accounting and legal advisors who can maintain an appropriate level of impartiality when dealing with the relevant stakeholders. This is critical in the initial workout period as trust is being built and developed between the parties. Keeping promises at the early stages is essential to building up credibility in the eyes of all parties concerned.
- Strong Lead Institution, which understands the problems and can clearly communicate to the creditors. A good open relationship with the Lead Institution can pave the way for a successful workout.

Creditors

- A committed debtor, who is prepared to give a little to get a little. In all workout negotiations “quid pro quo” is a necessary part for the simple reason that creditors need to be seen as achieving some wins along the marathon of a workout, which inevitably will entail some pain at some stage. Hence, the sentiment of the guarantor releasing additional unencumbered property for the creditors or, injection of funds, sends a strong message that the debtor is committed to resolving the situation to everyone’s acceptable level of satisfaction.
- A viable underlying business with strong management. Without this there is no point of having an informal workout. Liquidation is the appropriate action when the business is clearly non-viable and, based on detailed analytical reviews and valuations, liquidation is shown to provide a higher return to creditors.
- Following on from the point above and from the debtor requirements, reputable independent accountants and legal advisors.

- A co-operative debtor and creditor group. The co-operation of the debtor is obviously essential but it is equally important that as a group the creditors remain co-operative with each other and share the same goal of minimising the downside of the negotiations. This will be enhanced by having experienced creditors on the Steering Committee (if one is formed) or in the group generally, who can focus on the relevant issues and avoid being derailed by irrelevant issues which add no value to the workout process.
- Reliable information from the debtor; this relates to the point about independent accountants. Reliable information, which can be independently verified is a critical element in building a conducive workout environment.

IV. Incentives which Assist in Facilitating Informal Workouts

If the legal system is efficient and allows for the wresting of control from the incumbent debtor's owners into the hands of its creditors with relative ease, then the debtor will be motivated to workout its financial problems on an informal basis. Thailand has a system which does not allow this to readily happen and therefore it can be difficult for the creditor to enforce a workout either formally or informally.

Ultimately, the key incentive which drives the debtor to the workout table is the need for cash which, not surprisingly, creditors are not willing to continue providing unless certain terms and conditions are imposed. It is the need for cash and the desire to retain control of its own destiny that pushes the debtor to the negotiation table. Clearly it is protection of its capital that motivates a creditor to achieve a resolution to the financial difficulty the debtor is facing.

Having a formalised approach to workouts as set down by CDRAC can have a converse effect on the workout process. The timeframe establishes deadlines to which parties must work towards and this in itself will facilitate the process towards achieving a result of some kind. Conversely, however, the timeframes can be tight in larger cases, as previously mentioned, thereby inhibiting the workout process or, at the very least, compromising the quality of the workout.

Respective parties can abuse the deadlines to push decisions through and thus there is a solid argument for not having a timeframe in place. Overall, however, in countries where there is a lack of discipline in complying with regulations and financial prudence, together with a lack of general insolvency experience, the adoption of a CDRAC-type structure makes commercial sense.

Dealing with the two respective groups, major incentives or triggers in facilitating informal workouts are as follows:

Debtors

- Ability to retain control of the company which, after making the difficult decisions usually associated in a workout, is generally in much better shape.
- The opportunity to reduce debt through interest waivers or debt forgiveness is generally the major incentive to the debtor. Usually the debtor will reach the point where it cannot continue operating as it is insolvent. Trading-while-insolvent rules and preferential payment rules evident in Australia and the UK are non-existent or are not practically enforced in Thailand. Such legislation acts to incentivise the meeting of the debtor with its creditors. However, often the workout process in Thailand commences very late in the loan lifecycle, so that a default has already occurred (usually a missed interest payment). This default,

together with the realisation that the cash has dried up forces the parties to meet and is generally addressed by financial restructuring (or in many cases rescheduling), and not by operational restructuring addressing the fundamental underlying problems.

- The transparency of the workout process is also a critical factor for the debtor. The behaviour and the willingness to compromise by the creditors sends a strong message to the debtor and it is one of the better requirements in CDRAC, that creditors must indicate why they oppose the proposed plan and/or submit amendments. Such action at least facilitates open communication and clearly establishes the parameters of what is considered negotiable or not negotiable.

Creditors

- Transparency as indicated above, together with a genuine willingness to resolve the financial restructuring on an equitable basis are powerful incentives to a creditor. If creditors do not perceive that the debtor is making a genuine attempt to restructure the debt but instead is “loading the votes” to bulldoze a debtor-favoured plan, then not only do creditors become disincentivised, but the whole process is compromised and the quality of the restructuring becomes questionable.
- Equality of classes of creditors. Creditors seek fair and reasonable treatment between the different classes of creditors. This principle is essential to any workout and any inequality between creditors is a major deterrent. Similarly, related-party transactions and how they are dealt with are often a major bone of contention with creditors. The forgiveness of inter-company loans and/or shareholder loans are seen as significant gestures by the debtor evidencing a genuine willingness to achieve the best result for creditors. The stacking of votes in the CDRAC process with related-party debtors is a bane on the process.
- During the workout process, creditors naturally maintain a healthy degree of scepticism concerning the debtor’s incumbent management’s capabilities and its honesty. This is natural given it is the same management that has led the debtor to the financial difficulties it is in. A key incentive for the creditor group is to ensure that there is no further dissipation of cash or assets out of the company, while the debtor and creditors work through a solution. The ability to control this by freezing its facilities can be achieved readily enough, but it does not necessarily mean that the debtor will not seek or obtain additional debt from a third party. Similarly, the payment of some creditors in preference to others also puts at risk the possibility of a satisfactory resolution. These issues are addressed in CDRAC, with the covenants stipulated in the DCA. However, often the monitoring of these covenants is difficult unless there is an independent third party, such as an accounting firm, appointed to take control. A strong incentive to creditors in a workout is the ability to take greater control of the debtor’s purse strings, and place it in the hands of a reputable, independent professional.

V. Benefits Informal Workouts Have Produced

The primary benefit of informal workouts is that they allow the debtor to survive and, in many cases, prosper by giving the debtor the necessary breathing room it needs to get its house in order. If the process is commenced early enough the options available to the debtor and its creditors are significantly varied and the debtor’s chances of surviving the financial strain are significantly increased.

The informal workout also ensures that the standstill, which is the cornerstone of the true informal workouts in the West, is effectively in place through the DCA covenants. This essentially enables the company to operate on a business-as-usual basis, but protects creditors from the fear of assets being dissipated, or preferential payments taking effect.

The informal workout process also ensures that all debtors are ostensibly treated equally under the CDRAC process, in that even if the creditor was unaware of the debtor facing financial difficulty, it would be protected if it was a party to the CDRAC process. This process can therefore reward creditors with weak monitoring controls in place, while equally penalising those creditors who are ahead of the pack.

The CDRAC process, being as detailed as it was, institutionalised the practices for debtors and creditors to follow and, given the lack of insolvency experience in the country at the time of the crisis, has been a major benefit at least in the initial stages. Such a regimented process does have drawbacks, but at the time a regimented process was required to provide direction and discipline to the parties.

The CDRAC process has also allowed the country to work through non-performing loans without having to clog up the court system. This allows for a quicker process than formal channels, which invariably take longer and require court approval. The cost differential is questionable.

The Dangers of Informal Workouts — Have They Been Abused?

Debtor integrity is a major concern in this region, and the informal workout process is only as strong as the integrity of the debtor involved in the process. The major danger is obviously abuse of the system by debtors which pass through plans that do not address the fundamental underlying problem, which caused the debtor to face the financial problems it is experiencing. This situation can be exacerbated in the scenario where no independent advisor has been appointed to review the financial and business operations of the debtor and the creditors are stacked with related parties thereby pushing through a debtor proposed scheme which is not favourable to creditors.

Has This Happened? Yes. Will It Continue to Happen? Yes. How Can It Be Resolved?

If there is one major weakness it is that the CDRAC process still leaves a significant level of control in the hands of the debtor, thereby allowing manipulation through the appointment of biased advisors or avoiding the appointment of an independent party.

In Australia, the voluntary administrative process can be abused in a similar way. However, creditors can vote out an administrator. One major amendment would be to allow only creditors to elect the independent advisor, an appointment which must be compulsory from the time the CDRAC process is commenced. This independent party would have full control of the finances of the debtor.

In informal workouts outside of the CDRAC process, control of the company generally remains with the company. However, the appointment of an independent advisor is generally a pre-requisite to continuing negotiations and this appointment is usually at the behest of the financial creditors. It is “their” appointment.

Stronger insolvency laws concerning trading whilst insolvent which provide for significant penalties would act as a deterrent to continued operation of an insolvent company. The lack of such legislation means it is difficult to apply pressure on the company to give control to creditors.

The structured-time- frame approach of CDRAC has ingrained disciplines which were necessary, as mentioned. However, as also discussed, the timeframe can be counterproductive and can compromise the workout process and the ultimate solution.

Many workouts have been nothing more than rescheduling of debts, not ground-breaking restructures which take into account the underlying business operations of the debtor. Cashflow analysis and asset valuations have often been accepted without sufficient critical analysis, as banks seek to maximise recoveries, without any heed to business reality. It is not unusual to see proposed plans with full recovery of principal and interest based on a proposition of a three-year principal grace period with reduced interest rate, followed by three years or more of minimal principal repayments at commercial rates with a balloon repayment in year ten. Such restructurings are a blight to the process and a significant cost to the economy. Banks, however, readily accept such proposals as their balance sheets will reflect that the debtor is a performing loan and the matter, for all intents and purposes, is swept under the rug for ten years when default is likely.

These “restructurings” are based on the perception that the crisis was an aberration, normal GDP annual growth of 8-10% will return, and things in general will return to normal in a few years time. Accepting the paradigm shift has been difficult and is still difficult to accept for some in the business world. This is not to say that the CDRAC process is solely to blame for such abuse, but clearly it does facilitate the acceptance of such practices given its pro-debtor slant on passing plans. The fact that the debtor has so many opportunities to have a plan approved means that inefficient insolvent companies continue to survive, draining bank resources and capital on assets which are returning below market expectations. This is an area which needs significant review and cannot be simply addressed without undertaking substantial financial and legal reform.

United States of America

A U.S. PERSPECTIVE ON CROSS-BORDER "INFORMAL" WORKOUTS

by

George M. Kelakos¹³⁶

I. Preliminary Observations

Most of the larger and more complex business reorganisations and debt restructurings in the U.S. are conducted through a formal bankruptcy court process under the U.S. Bankruptcy Code (11 U.S.C. Section 101 *et. seq.*) (hereinafter, "Bankruptcy Code"). While the parties may develop the "exit strategy" outside of a court-supervised process, negotiations often culminate with the submission of a "pre-packaged" or "prenegotiated" plan that is "washed through" the bankruptcy process to bind dissenters to the plan.

As financial transactions become increasingly multi-tiered and complex, it is virtually impossible to achieve a 100% "buy in" from all necessary constituents for a workout-absent the threat of a credible formal bankruptcy alternative. Since a small group of dissenters may thwart attempts to achieve an out of court compromise or debt restructuring, the U.S. bankruptcy process, with its pervasive "automatic stay" and ability to cram down dissenters, can be a credible and useful business tool to effectuate a sound restructuring/reorganisation plan.

Even in liquidating cases, powers afforded by the Bankruptcy Code (such as the ability to sell assets free and clear of liens, the power to avoid preferential and fraudulent conveyances and the ability to assume and assign or reject unexpired leases and certain types of contracts where obligations remain unperformed by both parties to the contract) provide additional vehicles for realising value for creditors of an insolvent debtor.

From a debtor's perspective, the Chapter 11 bankruptcy process allows a debtor to remain in control of a workout; if creditors push too hard, the Debtor may seek to retain control by filing a voluntary petition under Chapter 11 of the Bankruptcy Code.

Under U.S. Federal law, bankruptcy courts have pervasive *in rem* jurisdiction over property of the estate wherever located and *in personam* jurisdiction over any person within the territorial boundaries of the U.S. These broad jurisdictional powers of the bankruptcy courts coupled with the "automatic stay" induce recalcitrant creditors (even foreign creditors) to the bargaining table. Thus, parties in "workouts" conducted outside of the bankruptcy process in the U.S. (or with a U.S. "nexus") always negotiate against the backdrop of the rights and remedies afforded by the Bankruptcy Code.

II. "Non-Bankruptcy" Alternatives

Many of the mid-tier and smaller business reorganisations/debt restructurings and liquidations in the U.S. are conducted outside of the bankruptcy process. While the alternatives range from contractual arrangements (forbearance agreements, creditor compositions, Assignments for the Benefit of Creditors, trust mortgages) to proceedings conducted under State or Federal court supervision (such as State and Federal court receiverships), in all of these alternatives, there is always the possibility that dissenting creditors (or a debtor) may seek to invoke the rights and remedies afforded by the

¹³⁶ Co-Chair, International Committee of the American Bankruptcy Institute.

Bankruptcy Code by filing an involuntary (or voluntary, in the case of a debtor) petition under Chapter 7 (liquidation) or Chapter 11 (reorganisation) of the Bankruptcy Code. The following is a summary of the most common "non-bankruptcy" alternatives currently in use in the U.S.:

- **Assignment for Benefit of Creditors ("ABC").** A creature of state law, a typical ABC involves the transfer of all assets of a debtor's estate to a fiduciary (the "Assignee") who is charged with converting all the debtor's assets to cash and distributing the proceeds *pro rata* to like creditors similarly situated — usually in accordance with the priority scheme set forth in the U.S. Bankruptcy Code. Notice of the assignment is given to creditors and all parties-in-interest and parties may assert claims for payment against the estate. In order to participate in the assignment estate, creditors have to timely file claims by a bar date set by the Assignee and must signify their assent to the ABC by executing an assent form (essentially, the ABC becomes a binding contract between the assenting creditors and the Assignee). The Assignee is also charged with pursuing claims or causes of action belonging to the estate for the benefit of the estate and its creditors. While an ABC may be a useful tool-particularly in a liquidating case, creditors might file an involuntary petition in bankruptcy in order to have the liquidation conducted under the auspices of a bankruptcy proceeding where, for instance, they believe that there may be a greater return to creditors through recoveries under the avoidance powers and other causes of action afforded by the Bankruptcy Code.
- **State or Federal Court Receivership.** State and federal court receiverships can serve as a less-costly and burdensome alternative to the bankruptcy process. In some situations, where the "stigma" of a Chapter 11 filing might have a deleterious effect on a business, a debtor and its lenders might consensually agree to the appointment of a receiver in state or federal Court. In these situations, the receiver might be charged with preserving the business and preparing the enterprise for sale as a going concern.. In sum, a receiver (a private party who is often chosen for his particular knowledge of the debtor's business) may operate the business to preserve its going concern value (pending a sale, for instance) and conduct private or public auctions of the debtor's assets and pursue litigation on behalf of the estate. Here again, dissenting creditors might seek to file an involuntary bankruptcy petition (or, in the case of non-consensual receivership, the debtor might try to regain control over the estate through a voluntary Chapter 11 filing). However, in such an event, the bankruptcy court might very well choose to dismiss the filing if the court were to find that such dismissal were in the best interest of creditors.
- **"Trust Mortgage" or "Secured Escrow".** In some out of court workouts, negotiations with creditors (particularly, with representatives of unsecured trade creditors) might result in the granting of security to creditors — usually in the form of a junior lien on the debtor's assets — to secure the payment stream under the proposed workout plan to that class of creditors. In these situations, the debtor might execute a "Trust Mortgage" or "Secured Escrow" naming a "Trust Indenture Trustee" or "Escrow Agent" (usually the attorney for the creditor group) who would serve as a fiduciary for that class of creditors and would be charged with the task of monitoring the workout plan, collecting payments made by the debtor to the class and distributing the payments to the allowed claims of assenting creditors of that class *pro rata*.
- **Secured Party Sale.** A common remedy for secured creditors in the U.S. is the disposition of collateral (including sales of all or substantially all of the assets of a business where the creditor has an all-asset lien) by way of a foreclosure/public trustee foreclosure (real estate) or a secured party sale (personal property and general intangibles, for instance) conducted

under Article 9 of the Uniform Commercial Code (adopted by all the states in the U.S.). While the threat of a foreclosure or a secured party sale may force a debtor into seeking relief through a voluntary Chapter 11 filing, in some instances secured party sales are undertaken with the debtor's consent, particularly where the purchase price exceeds the secured party's debt thereby possibly providing a small return to unsecured creditors.

- **Creditor Composition.** A "creditor composition" can be a versatile and useful reorganisation or debt restructuring tool, particularly where a debtor has an open line of communication with its key creditors and is able to achieve near 100% "buy in" from its secured and unsecured creditors. Some of the factors that lead to a successful composition include clear and open communication with the debtor's creditors, a well-developed and "transparent" plan or "exit strategy" and a bleak "liquidation alternative" to the composition. While creditor compositions are particularly useful in smaller cases where a debtor may not have a complicated debt structure, many compositions can evolve into "pre-packaged" or "prenegotiated" plans of reorganisation/liquidation where resort to the bankruptcy process may be necessary to "cram down" the plan on dissenting parties.
- **Forbearance Agreement.** A forbearance agreement is the most common non-bankruptcy workout tool in use in U.S. workouts involving secured lenders. From a lender's perspective, a well-drafted forbearance agreement will extract additional concessions from the debtor (such as liens on previously free assets and guarantees) and will usually require that the debtor conduct its operations during the forbearance period in accordance with a tight budget and under careful monitoring by the lenders and their professionals. During the forbearance period, the parties engage in negotiations resulting (in successful cases) in a debt restructuring, a refinancing (usually by an outside lender) or, in many cases, in the development of an "exit strategy" which may involve "washing" the plan through the bankruptcy process.

III. Foreign and Domestic Creditors' Rights/Remedies in and outside of the Bankruptcy Process

U.S. courts are open to domestic and foreign litigants alike. However, foreign litigants must take heed that the initiation of a lawsuit in a U.S. court is a "two-edged sword", as the foreign litigant may be subjecting itself to the jurisdiction of the U.S. court (and to suit by other parties in the U.S.). Foreign creditors may also avail themselves of the rights and remedies afforded by the Bankruptcy Code (such as participating as a petitioning creditor in an involuntary bankruptcy petition) and participate in distributions from U.S. bankruptcy estates

Under the Bankruptcy Code, "Foreign Representatives" (e.g. receivers or trustees in foreign insolvency proceedings) may also avail themselves of the provisions of the Bankruptcy Code by (i) participating as a petitioning creditor in an involuntary proceeding under Section 303 of the Bankruptcy Code (ii) requesting that the bankruptcy court abstain from proceeding with a domestic plenary case to allow matters to be resolved in the foreign proceeding under Section 305 of the Bankruptcy Code and/or (iii) filing a petition commencing an "ancillary" U.S. bankruptcy proceeding under Section 304 of the Bankruptcy code as an aid to the orderly administration of the foreign proceedings. Section 306 of the Bankruptcy Code provides that the foreign representative may take the steps outlined in (i)-(iii) above without fear of being subjected to the jurisdiction of any court in the U.S. "for any other purpose". Finally, foreign parties may also file plenary bankruptcy proceedings in the U.S., provided that the jurisdictional requirements of Section 109 of the Bankruptcy Code are satisfied. Although Section 109(a) of the Bankruptcy Code requires that a person "must reside or have a domicile, place of business or property in the United States", these jurisdictional

provisions have been liberally construed by the U.S. courts (even the existence of a bank account in the U.S. may be sufficient).

The process for asserting claims in bankruptcy cases and the Bankruptcy Code sections relating to involuntary bankruptcy cases, abstention motions and ancillary cases are outlined below:

- **Involuntary Bankruptcy Cases (Section 303 of the Bankruptcy Code).** Where there are fewer than 12 creditors, a single creditor with claims of at least \$11,625 may file an involuntary petition seeking relief under Chapter 7 or 11 of the Bankruptcy Code. Where there are more than 12 creditors, there must be at least three creditors with claims in the aggregate of at least \$11,625. Petitioning creditors' claims must not be "contingent as to liability or the subject of a bona fide dispute". Moreover, unlike other regimes where the "bar" to the entry of an order for relief is a "balance sheet" test of insolvency, under the U.S. system, the petitioners must only establish that the debtor is "generally not paying such debts as such debts become due". A "foreign representative" may also file an involuntary petition. In sum, if a debtor is generally not paying its debts as they become due, it is fairly easy for creditors to obtain an order for relief under Chapter 7 or 11 of the Bankruptcy Code. In practice (especially in cases involving operating businesses) when threatened by an involuntary filing, debtors will often file a voluntary petition under Chapter 11 (or convert the involuntary case to a voluntary Chapter 11 reorganisation case), thereby regaining control over the process.
- **Abstention (Section 305 of the Bankruptcy Code).** On motion to the bankruptcy court, a creditor may seek the dismissal of or suspension of all proceedings in a bankruptcy case if the court determines that "the interests of creditors and the debtor would be better served by such dismissal or suspension" or, in the event there is a pending foreign proceeding, a "foreign representative" may seek such dismissal or suspension if the court finds that certain factors are present (see discussion below on Section 304 of the Bankruptcy Code). In sum, under certain circumstances, foreign creditors (and foreign representatives) may move for and obtain dismissal of a bankruptcy case or suspension of all proceedings in that case.
- **Cases Ancillary to Foreign Proceedings (Section 304 of the Bankruptcy Code).** A "foreign representative"(defined in the Section 101 (24) Bankruptcy Code as a "duly selected trustee, administrator, or other representative of an estate in a foreign proceeding") may, under this section, commence a case in a U.S. bankruptcy court ancillary to that foreign proceeding to obtain relief (such as an order enjoining domestic creditors from pursuing domestic litigation) in furtherance of the goals of that foreign proceeding (such as requiring that all claims be asserted and determined in that foreign proceeding). In recent years, there has been an explosion of ancillary filings in the U.S., as foreign representatives in foreign insolvency proceedings have taken advantage of this section of the Bankruptcy Code to assist them in their administration of their debtors' estates. In determining whether to grant the petition, this section of the Bankruptcy Code also provides that the court should be guided by factors that would "best assure an economical and expeditious administration" of the estate including: (i) the just treatment of claims and interest holders in the estate (ii) protection of U.S. claimholders against "prejudice and inconvenience" in the processing of claims in the foreign proceeding (iii) the prevention of preferential or fraudulent dispositions of property of the estate (iv) an orderly distribution of estate proceeds substantially in the order prescribed by the Bankruptcy Code (v) comity and (vi), "if appropriate", the opportunity for a fresh start for the individual debtor that is the subject of the foreign proceeding. In recent years, courts have liberally construed these standards to give great deference to foreign insolvency proceedings and laws.

- **Claims Process.** The assertion of claims in a formal bankruptcy proceeding in the U.S. is fairly straightforward and there is no discrimination against foreign creditors. In a Chapter 11 case, where a creditor's claim is scheduled (on the debtor's schedules of liabilities) as being non-contingent, liquidated and undisputed, the creditor need not take any further steps to assert its claim, as long as the creditor is in agreement with the amount as scheduled and the classification of the claim by the debtor (e.g. secured, unsecured or priority). However, in the event a creditor's claim is disputed by the debtor (or in the event the creditor's records reflect a higher claim than as scheduled by the debtor on its schedules), the creditor must file its written "proof of claim" (essentially, a form setting forth the name and address of the creditor, the basis of the claim, the amount and any claimed priority with attached supporting documentation) by the "bar date" set by the court and such claim is deemed to be *prima facie* valid unless properly objected to. In a Chapter 7 liquidation case, a creditor must file its proof of claim by the bar date (which is usually 90 days after the first meeting of creditors—approximately 120 days after the entry of an order for relief). In a Chapter 11 case, the timing of the bar date will be driven by the pace of the reorganisation case. Thus, in a "pre-packaged" or "pre-negotiated" plan scenario, the bar date will be set earlier on. On the other hand, if a debtor is embroiled at the outset of the case in skirmishes with its lenders or with other creditors, the debtor may postpone its request for a bar date until it is ready to proceed with its plan. In the event of a timely objection to a proof of claim, unless resolved by the parties out of court, the objection will be resolved by the court upon notice and opportunity for hearing.

With respect to notice of bar dates, generally, notice in small cases is given by mail and in larger more complex cases, by publication or in some cases, by the posting of the bar date on web pages ("mega" cases like *Enron* and *WorldCom*, for example, maintain web pages where parties may obtain all sorts of relevant information concerning these cases).

IV. Concluding Observations

Foreign creditors in debt restructurings/business reorganisations/liquidations that are conducted either in or outside of the bankruptcy process essentially have the same rights as domestic creditors to participate in the filing of involuntary proceedings, to request that a bankruptcy court dismiss or suspend proceedings and to file suit against U.S. defendants and assert claims against U.S. debtors. Foreign creditors should take heed, however, that the filing of a claim in a bankruptcy proceeding or a lawsuit in U.S. courts may subject the creditors to the jurisdiction of U.S. courts.

Because of the efficacy of the "formal" U.S. bankruptcy process, there is less of an impetus towards the development and utilisation of a harmonised "informal" workout structure in the U.S.

Foreign creditors must be mindful that since all "out of court" workouts in the U.S. are conducted against the backdrop of the rights/remedies afforded to parties under the Bankruptcy Code, in the event negotiations break down, the proponents of the reorganisation/orderly liquidation plan may resort to a bankruptcy filing in the U.S. in order to bind dissenters to the plan.

The relative explosion of ancillary case filings by foreign representatives in the U.S. coupled with the U.S. courts' deference to foreign insolvency proceedings and procedures, along with the increased and creative use by U.S. bankruptcy courts and foreign insolvency courts of "protocols" in cross-border cases (setting forth the "ground rules" for court-to-court communications, disposition of assets, resolution of claims, etc.) have enhanced the ability of parties (and courts) to effectively manage increasingly-complex cross-border cases.

While it is anticipated that the U.S. will shortly adopt the UNCITRAL Model Law on Cross-Border Insolvencies (which, if adopted by the U.S. and a “critical mass” of countries, should be an important step towards the path of increased co-operation between countries in cross-border insolvency situations and hopefully, lead to a global “level playing field” for creditors asserting cross-border claims), much work needs to be done to harmonise the substance of international insolvency law to alleviate the conflicts of cultures and regimes that persist in today's environment.

PART III

NON PERFORMING LOANS AND BULK SALES

Regional Overview

HISTORY OF BULK SALES IN ASIA:

by

*Morgan Kelly*¹³⁷

I. History of Bulk Sales in Asia

Bulk sales of NPL's have been effectively used in a number of jurisdictions throughout Asia, and AMC's have traditionally played key co-ordinating roles, such as:

- Thailand (FRA, TAMC),
- Korea (KAMCO),
- Indonesia (IBRA),
- Vietnam (VAMC)
- Malaysia (Danaharta)
- Taiwan

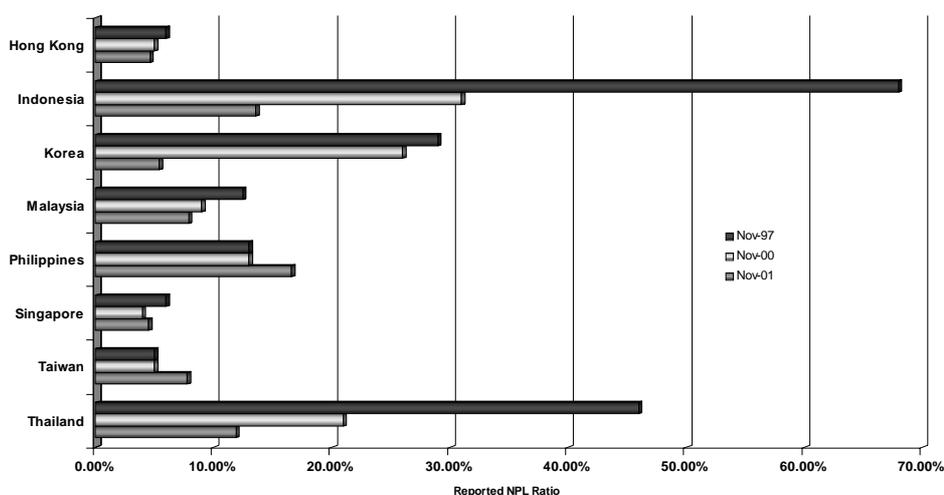
Debt trading has become a thriving business in Asia, and financial institutions seeking to remove NPL's from their books are often able to find investors to purchase these debts by taking advantage of the secondary debt trading market.

The lack of adequate credit analysis and risk management practices in both local and foreign banks served to accentuate the effects of the recent financial crisis in Thailand. Traditionally, most Thai banks had made loan decisions based almost exclusively on two criteria: the borrower's reputation or social stature and the book value of underlying collateral. The borrower's ability to repay the loan, measured through projected cash flow, was typically overlooked. Throughout years of solid growth, in the wake of competitive pressure and a lack of relevant and reliable data, many foreign banks also practiced forms of relationship-based lending.

¹³⁷Morgan Kelly is an Account Director with the Deloitte Corporate Reorganisation Group based in Sydney, Australia. From 1997 to 2002 Morgan was based in Bangkok, Thailand and worked throughout Asia Pacific. Morgan has conducted engagements and projects in Australia, Thailand, Singapore, Malaysia, Taiwan, the Philippines, Korea and Vietnam, utilising the skills of his core specialty, assisting financially distressed organisations in the commercial and government arena.

When, as a result of the crisis, borrowers began to cease repaying their loans on time, banks were slow to react forcefully, not wanting to endanger relationships with key clients. The use of bulk NPL sales is to a degree a reaction to this, as drastic steps need to be taken to address a large and entrenched problem. The NPL situation in Asia is gradually improving, and each country has utilised unique and specific resolution frameworks and mechanisms to deal with NPL problems, with varying degrees of success.

The following chart indicates the NPL ratio trend in a number of countries throughout Asia from 1997, 2000 and 2001.



Although improvements generally are clear, and in some cases dramatic, it is important to note that the NPL ratios are *reported* ratios. They are driven by the classification criteria used in the relevant jurisdiction, and are particularly affected by the criteria used to determine when a loan returns to performing status.

The same NPL's, although the reported ratios are improving, still exist. They are either:

- Being worked out by a new investor
- In a "holding pattern" in an AMC
- Subject to negotiations with creditors and being restructured, or
- Have been restructured and returned to performing status.

More on the difference between debt restructuring and rehabilitation will be discussed in Section 4 below. I will now provide some broad and general comments on specific countries in Asia and their experiences with and responses to the NPL crisis in Asia:

Indonesia:

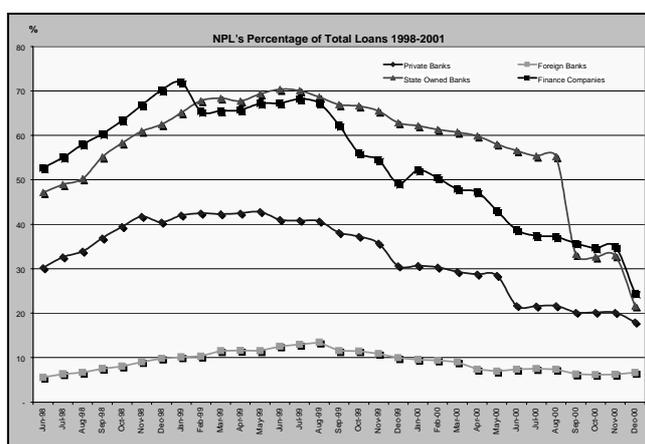
The government formed the Indonesian Bank Reconstruction Agency (IBRA) with over \$US 60 billion in assets in its care. Sales of NPL portfolios have been slow, partially due to an overdeveloped

bureaucracy and a cumbersome internal approval process. Ministry of Finance (MOF) transaction approval is not always forthcoming, which slows the process still further.

There is also a general refusal to discount principle, which reduces the saleability of risky assets. Holding companies have been established to facilitate sales, but these retain incumbent management. Foreign investment restrictions are also limiting sales.

Thailand:

In August 1997 Thailand committed to a \$US 17.2 billion rescue package managed by the IMF, and by the end of 1998 Thailand was in economic recession, worsened by a significant outflow of capital. Bankers and credit officers in Thailand lacked the skills and experience at that time to manage the complexity of many of the issues which arose (many through syndicated lending issues and different approaches, agendas and mandates of different banks) and the sheer volume of NPL's that had to be examined and restructured.



The chart (source: the Bank of Thailand) illustrates the movement in NPL's in Thailand over the period 1998-2001.

Note that the definition of a non-performing loan for the purposes of the Bank of Thailand is any loan which has remained outstanding for greater than three months.

The original AMC in Thailand (1997-1999) was established to act as the bidder of last resort at FRA auctions. Legal and regulatory issues facing credit officers in government banks included potential criminal liability for loss of public funds (which could have included writing off bad debts). This created significant concerns regarding the workability of the original AMC.

The Thai Asset Management Corporation (TAMC) was expected to manage over US \$31 billion in NPLs represented by 6,000-7,000 borrowers. TAMC's establishment was delayed by constitutional issues on superpowers and appeal limitations which led to considerable parliamentary debate. There were also initially some concerns regarding influence and transparency, which were addressed.

The stated main strategy of TAMC to be employed in restructuring is debt-for-equity swaps and “haircuts”, or reductions in accrued interest and loan principle. Both strategies were designed to help targeted borrowers reduce their debt-to-equity ratios and better match up loan payments with cashflow, with the ultimate goal being making companies independent of new long-term borrowing altogether.

Assets transferred must involve debt of over THB 5 million owed by at least two creditors. The TAMC will have a lifespan of approximately 12 years. After two years, the finance minister will establish an assessment committee to oversee the agency’s performance. After seven years, the agency will begin preparations for closure and formal dissolution will occur after 10 years and full payment of accounts after 12 years.

Transfers were made at book value, with 10-year bond finance guaranteed by the Financial Institutions Development Fund (FIDF), and methods for sharing gains and losses were also established. Super powers were granted for reorganisation, and immunity for officers conducting workouts was achieved.

Korea:

The Korean Asset Management Corporation (KAMCO) was restructured and given a new mandate as an AMC in 1997. KAMCO manages US \$76.4 billion of NPLs.

KAMCO structures NPL sales using asset-backed securities (ABS), by transferring assets to special purpose vehicles allowing securitisation. These vehicles (Corporate Restructuring Companies or CRC’s and Special Purpose Vehicles or SPV’s) operate as joint ventures, and permit foreign ownership in reality, as well as skills transfers and cash injection.

KAMCO has also formed a large number of joint ventures with foreign firms, and has signed MOU’s with seven countries to share experiences and know-how. More recently, KAMCO has begun to move its focus from NPL sale to managed workout.

Malaysia:

Malaysia’s Danaharta was established in June 1998, and only managed 2,000-3,000 accounts. A willing buyer / willing seller approach to transfers was used. Super powers were also granted to credit officers. Danaharta assisted restructurings by using special administrators or by acting as lead bank in syndicated credit restructurings. 80% of assets under Danaharta’s care have been sold.

Japan:

NPLs in the Japanese banking sector are more than four times those of the US Savings and Loans crisis. The Resolution and Collection Corp, a debt collection agency funded by Deposit Insurance Corp has taken assets of 90 institutions purchased at considerable discounts from failed institutions only – these NPL’s are not attractive to operational banks and difficult to sell.

There are substantial issues surrounding organised crime links for NPL’s, which also make restructuring and resolution difficult, and adversely impact on the will and impetus to conduct workouts.

Taiwan:

The Taiwan Asset Management Company (TAMC) was established in May 2001. NPL levels in Taiwan remain high, and resolution problems are exacerbated by difficulties with level of confidence in government and regulators and financial reform packages proposed by the government.

Recent efforts by private banks have started the NPL sale process and market. The reported ratio of NPL's to good loans fell to 7.48% in the June quarter from 8.04% in the previous quarter, and the Government Financial Restructuring fund requires another NT \$910 billion to reduce the overall ratio to 5% within two years.

The total NPL market in Taiwan is valued at NT \$1.43 Trillion (US \$42 Billion).II. Why Are Bulk Sales Performed?

A nation's economy is very like a human body. Cash is like blood, and the banking sector like the circulatory system. The banking sector is the system that delivers cash to the places it is required, such as financing of a new business venture, which creates employment and productivity, and ultimately economic growth.

NPL's are places in the system where cash is paralysed. Extending the analogy, NPL's are like blood clots or arterial blockages. NPL's prevent cash from being delivered to where it is required, and also create additional costs for the institutions holding them.

NPL's reduce bank profitability as well as available reserves, and create "funding drag", a combination of opportunity cost and real cost. Elimination or transferral of NPL's from the books removes this funding drag.

Market Lending Rate	=	Σ	(Average Funding Cost) (Risk Margin) (Profit Margin)
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By eliminating, selling or transferring NPL's away from a bank, the NPL's can be converted to cash, removing the blockage.

This also reduces the funding cost, being the cost of raising funds from capital and deposits, which is incurred as NPL's generate little or no revenue, so the financial institution makes ongoing losses funding these assets.

It also reduces the opportunity costs to the bank, because the funds tied up in the NPL cannot be applied to a good, income-generating loan.

The usual vehicle for facilitating a bulk sale is an Asset Management Company (AMC). AMC's are either developed as a separate division of an existing financial institution, a joint venture with some third party, a separate private organisation, or a centralised government authority. Using AMC's improves banks capital structure, and frees up cash for allocation to more profitable areas.

Why do we use the AMC structure? AMC's:

- Protect the franchise and image of the originating bank, prevent adverse publicity and potentially more damage,
- Directly improve the banks profitability and balance sheet,

- Centralise debts under one creditor (particularly in syndicated loans) which vastly simplifies negotiations and recovery,
- Eliminate possible confusion or doubt in the mind of the borrower as to who should be paid, and allows a systematic repayment structure to one creditor to be established,
- With the establishment of special powers, improve chances of recovery,
- Dedicate and centralise resources for workout or sale, and concentration of skills,
- Allow for many NPL's to be combined and dealt with simultaneously (tranche sales), and
- Convert NPL's from blockages to cash.

AMC Mandates and conflicts

The objective of an AMC structure is to ultimately improve the overall quality of certain assets, which are under-performing or distressed through either one or a combination of two alternative approaches.

The improvement in quality of an NPL is measured by reference to the percentage of the NPL's book value which is ultimately recovered in cash. For the purposes of fair comparisons, the calculation is normally performed as net present value (NPV) of the income stream or sale proceeds of the NPL.

AMC's are reporting entities too, and are accountable for achieving results. There are two main ways in which an AMC can manage assets in its care:

- Sale of loans, or outsourcing management, and
- Internal management and internal workout.

Each of these approaches has major ramifications for the management style, approach and techniques that will be employed by the AMC in recovering from these assets, and in managing recovery risk. In many cases a combination of these approaches is used. The primary objectives driving an AMC are speed of recovery and results, and maximising the recovered value. These objectives are sometimes mutually exclusive. In some cases the faster an NPL is resolved, the smaller the recovered value. Where more time is allowed recovered value can increase (although holding costs increase over time).

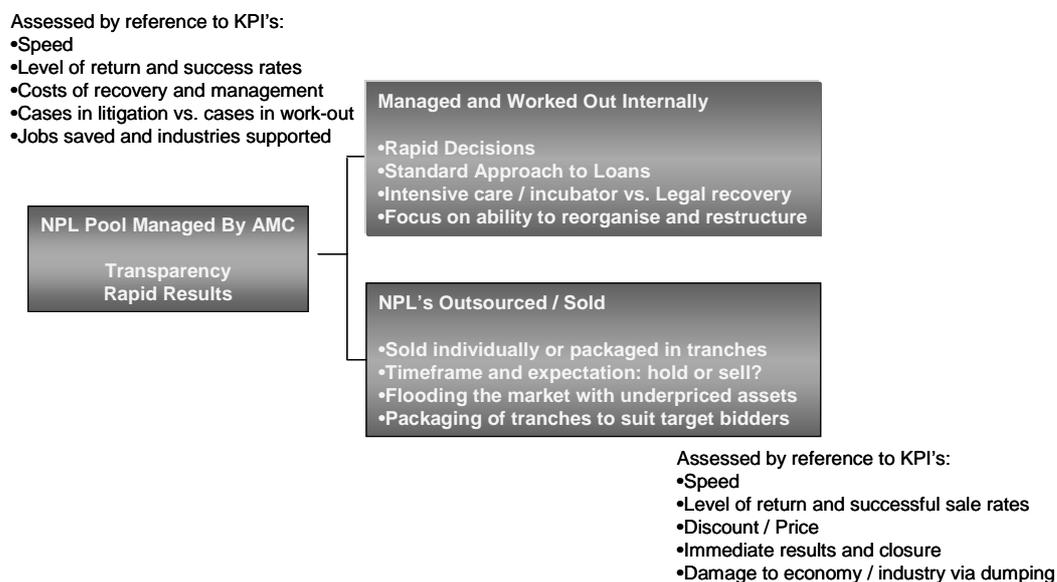
	Sale and outsource approach	Internal management and workout approach
Description of approach	This involves the strategic “quick fix” approach involving the sale and packaging of NPL’s to external parties. Usually this includes packaging loans into tranches grouped with like characteristics to make the tranches more attractive to potential buyers. Value is realised from the receipt of sale proceeds.	This involves working with the borrowers being administered, with particular attention being given to larger loans with better viability restoration prospects. Some loans with greater potential are granted “intensive care” status and all loans are progressively graded in terms of recovery potential. Value is recovered from repayment and progressive recovery, although liquidation is resorted to in some cases.
Skills required	Sale skills, asset due diligence and packaging for targeted bidders is the key skill required. The main constraint or driver of the process is timing: sale of loans usually equates to an expectation of rapid results.	Restructuring, workout and reorganisation skills are required, as well as an in-depth understanding of business and commercial issues and cashflow analysis. This is because decisions need to be made quickly regarding loan classification, and they need to be correct so the right level of attention is focussed in the right areas. All loans are assessed in the same way, but loans with better recovery prospects get more attention.
Performance indicators: how are they assessed?	<ul style="list-style-type: none"> • Speed of recovery and asset turnover, • Quantum of return vs. OPB or acquisition cost, • Holding costs incurred, • Discounts or prices achieved, • Distribution of recoveries (returns to originating banks). 	<ul style="list-style-type: none"> • Speed of recovery and asset turnover, • Levels of returns on an NPV basis vs. acquisition cost, • Opportunity costs or funding drag (over time) and operating costs, • Proportion of negotiated workouts vs. litigated ones.

An AMC can either recover / convert to cash *quickly* – improving returns by maximising cash in hand and therefore NPV, or nurture and incubate the loan through a workout or resolution framework, to improve the quality of the loan and potentially return the loan (or part of the loan) to performing status. Performing status loans perform on normal commercial terms.

Unfortunately, an AMC has conflicting mandates:

- Produce results QUICKLY, and
- MAXIMISE returns from NPL’s.

The two objectives are not compatible. In fact, they are mutually exclusive.



To explain further: under the internal management approach, the AMC puts a top percentile of loans with good recovery prospects under “intensive care”. At the same time, “portfolio fishing” helps identify other good loans to place in intensive care. This means helping the debtor repair or reorganise their business to become profitable.

The ultimate aim is to increase cashflows over the life of the loan.

Where reorganisation and restructuring is managed internally, the credit officer remains mindful of:

- The ratio of new write-offs against reorganised loans,
- Returns achieved from recovered / saved loans,
- The ratio of workout loans to litigation / recovery action loans,
- Movements in asset levels (provisions vs. write backs),
- Operating costs vs. operating income,

Individual credit officer time spent on individual loans (i.e. the ratio of officer time spent to the value of the loan).

In contrast, the outsourcing or sale approach is focused purely on handing the NPL's on to someone else: the AMC is a warehouse for the loans until they are sold to a new owner.

Concerns are mainly:

- Asset reduction against NPL turnover,

- Prices and returns achieved vs. book value,
- Costs incurred relative to portfolio value,
- Timing of sales and number of sales held, and
- Immediate and tangible results, perception of the public, regulators and investors.

Benefits and dangers associated with conducting bulk sales

The benefits of conducting bulk sales of NPL's are many and varied. Some of the key benefits are:

- Protection of individual banks image and franchise, allowing them to continue to operate as viable banks without a marketplace adverse perception,
- Removal of funding drag and opportunity costs from banks balance sheets, allowing them to operate more profitably,
- Allows banks to focus on core business rather than disaster management,
- Economies of scale: concentrating problem loans into one pool and focusing management,
- Uniform approach to restructuring is adopted through AMC policy: all parties know where they stand,
- Multi-creditor restructurings become single creditor restructurings, eliminating conflicting policies, procedures and objectives. Enhancement of bargaining position with debtors, particularly where AMC's have special powers,
- Potential for securitisation of asset pools,
- Centralised ownership of collateral: enhances enforcement, and also disposal of grouped assets,
- Breakage of links with connected debtors, and
- In some cases, where confusion or doubt exists with debtors as to who should be paid, centralised identified collection authority.

There are also dangers associated with using AMC's:

- Expectations of more favourable treatment by debtors,
- Breakage of relationships and information links which can facilitate or accelerate debt restructuring and recovery,
- A lack of "ownership" or responsibility of the AMC and AMC staff for recovering the funds: reduced motivation,
- Where delays occur in communicating with borrowers, payment discipline can collapse,
- Complexity of transfers can create significant lengthy delays,
- AMC's can on occasion be used to "hide" or "warehouse" bad loans and conceal problems,
- Loss of skills in the banks in recovering debts and managing bad loans, and
- Moral hazard: banks do not take responsibility for their mistakes. One of the greatest risks and dangers of an AMC is the unnatural dumping or flooding of a market with assets which can significantly worsen a national economic problem.

For example, depressed real estate or motor vehicle markets can be significantly adversely impacted by flooding the market with underpriced non-performing assets attached to NPL's, and care must be taken when determining a strategy for NPL disposal to address this.

Bank pricing thinking always considers the NPL is worth more, and are usually suspicious of the purchasers pricing model. The real value of an NPL is what a willing buyer and a willing seller can negotiate. The buyer has other investment options, whilst the lender must resolve the NPL and eliminate the funding drag, or potentially face closure.

III. How Is It Done?

Options for AMC structuring

There are a broad range of legal structures that may be used to structure an AMC, and a variety of issues to be considered when determining which is the most appropriate structure. Some alternatives are:

- A separate department within an existing bank.
- A joint venture with an organisation with the right skills sets or funds.
- A separate government agency.
- A separate corporate entity, owned by the owner of the NPLs.
- An independent third party (foreign investor) buying in.
- A consortium of independent third parties.

Considerations when structuring an AMC include:

- Who will manage the portfolio?
- How will the manager be held accountable?
- How will the internal governance framework be established? To whom will the AMC be answerable?
- How will costs of establishment, operations and recovery be shared?
- How will management be remunerated? How will fees be structured?
- How will gains and losses be allocated between the institutions?

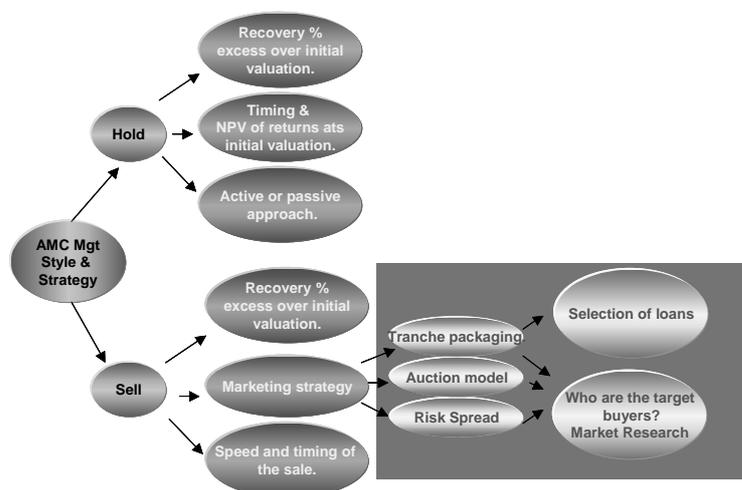
Where the strategic planning and conduct of NPL management or sale will significantly impact on the economy or a business sector, government-level guidance and intervention is often required.

Similarly, where special powers will be required for the AMC, regulatory intervention and assistance is prudent.

There is usually a desire for the original NPL owner to distance themselves from an AMC to avoid adverse publicity and brand damage. Tax considerations are also crucial in determining the structure (particularly JV's).

Tranche packaging and valuation

This flowchart summarises the decision chain discussed earlier. Presuming a bulk sale is to be performed, we will now focus on the highlighted section of the NPL sale process.



Some of the key considerations here are:

- What are the types of loans available for packaging? This will provide guidance on the composition of the tranches, and assist in structuring the sale focus.

- What is the quality (value) of the loans in the portfolio? This will assist in determining the risk spread, also a critical consideration when composing tranches.
- Who are the likely targets / likely purchasers of these loans? Finally, this will determine the sales strategy. Who will the characteristics identified appeal to, and how can they be combined in such a way as to make them more appealing, and maximise price?

Packaging and saleability will obviously be affected by the types of loans included in the tranche:

- Size and term of the debt
- Nature of credit (motor vehicle, credit card, working capital),
- Whether the debt is cashflow or collateral dependent, and
- If the loan is a special purpose project loans.

Property loans require particular attention to market characteristics, e.g.

- Commercial
- Residential
- City
- Provincial
- Development

When pooling loans into tranches, the following considerations should apply:

- Transfer of loans grouped with similar characteristics,
 - Transfer of larger loans first,
 - Identification of immediate disposal opportunities and strategies for loans tagged for immediate recovery action (i.e. loans for which workout is impossible),
 - Terms and method of payment: is there a process for a new purchaser to rely upon or adapt after purchase?
 - Accounting treatment for the original bank debt, loss adjustment or write-off where appropriate, post sale. Broader considerations, which will affect the marketing strategy and the tranche appeal, also need to be considered:
- Quality of the loans being transferred to tranches,
 - Composition of the tranches, mixed or specific, loan dynamics (characteristics and underlying industries),

- Requirements and objectives of the target purchasers, and the tranche composition that will be most attractive to them,
- What trends can be expected for the tranche in the future: how will they perform?

Valuation

Why do we perform a valuation and examine the risk spread of the NPL's we are selling?

- To assist with tranche packaging: we need to know what sort of loans we are offering to a potential buyer. The most important characteristic is risk, and we must understand it to present a more attractive package,
- To set price parameters and criteria for accepting or rejecting bids made,
- To assess bids made for our NPL's from an informed perspective: we need to form our own view of what the NPL's are worth, and ensure we maximise our return for them rather than sell them at undervalue, particularly if there is negotiation involved,
- To assist with the AMC's own budgeting and planning: especially where it is expected a sale programme is going to take a long time.

There are many different approaches to valuing NPL's, each with their own strengths and weaknesses. The "real" value of a portfolio of NPL's is of course whatever someone is willing to pay for them. Astute analysts utilise several techniques or combinations of techniques to calculate a range of values. The following tables provide a summary of some of the more common methods used for valuing NPLs, and their relative strengths and weaknesses:

Approach	Advantages	Disadvantages	Key Requirements
Discounted cash flow	Provides free cash flow to assess capacity to service obligations. Allows quick sensitivity testing. Expresses value in today's currency. Rigorous and widely accepted.	Difficult to quantify cash flows. Difficult to find right discount rate, and difficult to estimate terminal value.	Estimates of the assets terminal value, appropriate discount rate. Identify and value assets not contributing to cash flow.
Asset valuation going concern	Provides a quick assessment of value.	Difficult to obtain reliable asset values. Does not allow for time value of money, nor costs and taxes.	Difference between FMV and BV. Allow for prior charges and undisclosed liabilities, allow for realisation costs and time delay.

Asset valuation-liquidation	Facilitates a quick sale process.	Represents a minimum value only.	Consider appointment of external administrator.
Portfolio valuation	Provides a cost effective method for valuing smaller loans.	Valuation is not as accurate as more detailed techniques for each loan.	Sample test portfolio to set benchmarks (by size, loan type, industry etc)
Comparable values	Provides a general benchmark and a “reality check” against other valuation methods.	Subjective and simplistic. Requires ready access to appropriate comparables.	Identify many comparable cases.

Typically, loans are allocated to one of two categories, high-value loans, a small number of loans representing high-credit concentration, and large-volume, low-value loans. Often the 80/20 rule can be used as a guide for making this classification.

Key loan criteria are identified, stratifying the NPL portfolio characteristics, such as:

- Loan Size,
- Industry Group,
- Nature of collateral security,
- Ageing and arrears, and
- Loan terms

Specific Reference is given to variables based on the RISK impact and their VALUE impact. For example:

<p><i>RISK IMPACT</i></p> <ul style="list-style-type: none"> • <i>Collateral Existence and Value</i> • <i>Location</i> • <i>Industry</i> • <i>Arrears</i> 	<p><i>VALUE IMPACT</i></p> <ul style="list-style-type: none"> • <i>Repayment Frequency</i> • <i>Term to Maturity</i> • <i>Instalment</i> • <i>Interest Rate</i>
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Three main approaches for applying these variables will be discussed:

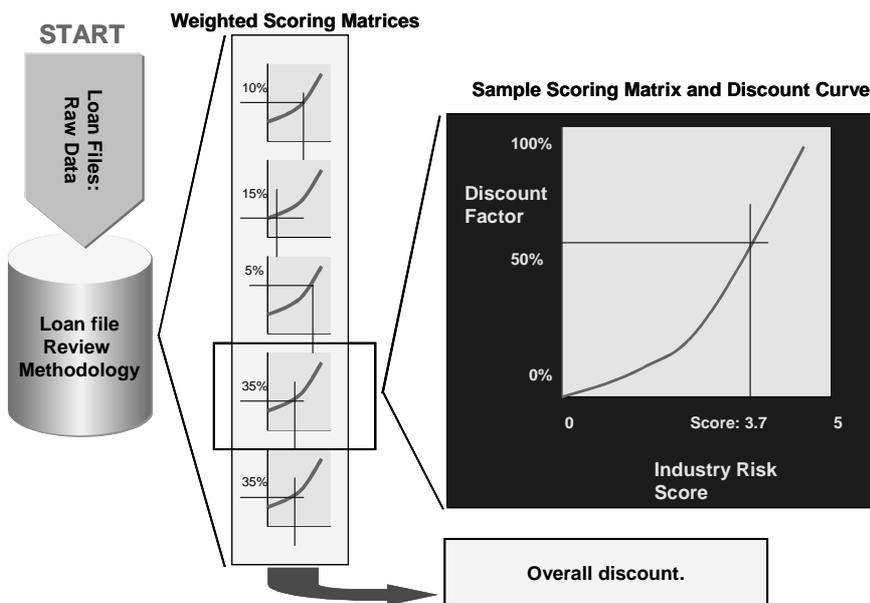
- Sampling / statistical analysis,

- Collateral based / asset-based valuation, and
- Net present value / cash-flow-based valuation.

Statistical sampling method

By analysing the local industry dynamics in conjunction with the loan portfolios historical performance, we are able to allocate to the risk factors a discount percentage. This is the input for our *Loan Portfolio Discount Matrix*. These discounts are weighted to provide an overall discount coefficient for the individual loan. The advantage of using local industry source data for this exercise is its relevance to the marketplace. However, this often requires a significant amount of research to ensure the discount percentages for the risk factors are right once we have the indicative impaired value of the loan, using the value impact variables allows us to determine the net present value of the impaired loan, and determine an overall indicative value of the loan portfolio as a whole for benchmarking purposes.

This is a very subjective approach, and provides a rough indication only. However, it looks at the entire portfolio and provides a broad range of indications. A diagrammatic representation of the process appears below:



The various risk factors and their coefficients are weighted to ensure that all relevant data is captured in the overall discount, yet reflected accurately in terms of importance.

Collateral/asset based approach

Generally, this approach is used where the subject loans are collateral dependent, i.e. completely reliant on the value of underlying assets (cash-flow from the loan only accrues at the end of the life of the loan).

The approach is also useful for special purpose/special project loans (e.g. ships, oil rigs). Often specialised assets, and independent experts are required for the valuation.

This approach is rigorous, but it is difficult to cover the entire portfolio. Generally the analyst will use credit concentration rules for sampling the population.

NPV / Cash-flow approach

Again, a more rigorous approach: credit concentration rules must be applied to select loans for analysis. Involves detailed study of cash-flow dynamics and sensitivity analysis: useful for estimating anticipated time of default. Discounted cash-flows over the life of the loan provide loan valuation (P&I repayments).

This approach usually provides a range of values, however it can be difficult to conduct due to selecting discount rate, and the cost/benefit analysis of spending large amounts of time reviewing data of dubious accuracy.

Tranche valuation and risk spread

Once we have the indicative values of the NPLs and the portfolio it is necessary to allocate to each loan a simple risk grading system to “tag” NPL’s. This assists in allocating those loans to tranches in the desired risk spreads.

As these risk tags are the result of earlier work, they incorporate:

- Industry factors and the debtor’s position within that industry,
- Gearing comparatives (Industry specifics),
- Performance trends v. cashflow assumptions / projections (industry specifics),
- Collateral support v. unsecured,
- The local industry, economy and market dynamics.

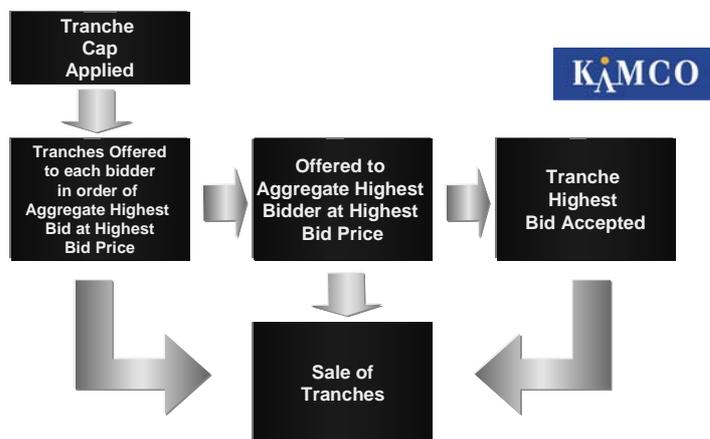
The end result of the risk-spread tagging exercise is a loan grading reflecting comparable numerics across an entire portfolio, allowing us to mix and match riskier assets with less risky assets to alter tranche composition:

- Normal loans graded A to D,
- Watch loans graded E,
- Substandard loans graded F,
- Recovery loans graded G,
- Bad / loss loans graded H.

Loans such as a G or H are higher risk and therefore cheaper, but the potential upside for the buyer is also higher (risk /return).

Tranche packaging and sales strategy

Generally, the due-diligence process conducted by the seller forms the basis of the IM. It is normal to provide a data room, or electronic format portfolio data to qualified bidders for analysis on payment of deposit. More recently, web-based IMs and NPL data have provided easier access for bidders.



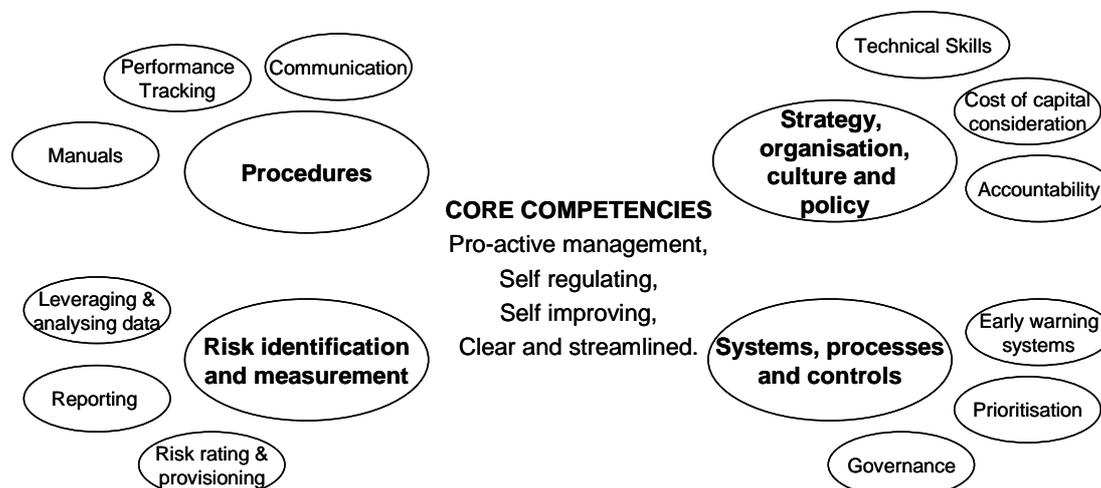
Bids can be open or closed. The nature of the bid varies in jurisdictions and is often driven by the nature and quality of NPLs, and the range of competing bidders. The selection process for successful bidders also varies. Auction models such as direct bid, spectrum auctions and linked bids (successful bids for one tranche commit to purchasing another, lower quality tranche) have also been used effectively.

Example: one of the contemplated KAMCO selection processes for tranche

sale by auction.

What makes a good AMC?

Naturally, AMC competencies interrelate and support each other. Some of these relationships are diagrammatically represented below: Technical Skills



- Training of staff in NPL performance assessment and reappraisal,
- Training of staff in specific financial and workout skills,
- Training staff in identifying recovery risk, and techniques for mitigating recovery risk,

- Providing legal support to staff. Where very specific and technical skills are required must either retain appropriately skilled lawyers as part of its own staff, or outsource these requirements,
- Education of staff in commercial aspects of NPL recovery, with particular emphasis on continual identification of profit making opportunities.
- Accountability
 - Encouragement of staff in continually identifying profit-making opportunities,
 - Linking staff performance bonuses to specific recoveries against set targets or benchmarks.
- Communication
 - Encouragement of skill and knowledge sharing amongst different divisions,
 - Conducting training courses where possible with attendees from different groups,
 - Formalising an intra-departmental communication channel for support and assistance.
- Leveraging and Analysing Data
 - Using existing data and historical recovery records to establish benchmarks,
 - Establishing a progressive system of information refinement as new data is added,
 - Converting recovery data held into industry / loan type specific information for due diligence / acquisition strategy use. Using experience and data gathered to indicate “good buys” will significantly mitigate acquisition risks.
- Reporting
 - Extending reporting to cover efficiencies staff are achieving / failing to achieve against benchmarks,
 - Regular reporting of performance against benchmarks to encourage aggressive and active portfolio management.
- Risk Rating and Provisioning
 - Using benchmarking approaches and data to link specific loan characteristics to risk factors,
 - Using risk factors to rate loans and categorise these appropriately,
 - Automated conduct of risk rating regularly for reassessment purposes (daily, weekly) and to encourage active portfolio management by staff,

- Systems, Processes and controls
 - Development of good early warning systems,
 - Prioritisation of NPLs with better recovery opportunities.
- Internal governance
 - All loans treated in a uniform manner,
 - Procedures for loan files exhaustive,
 - File maintenance disciplined and accurate,
 - Decision-making processes documented,
 - Adequate paper trail created, from OPB to sale / realisation value.
- Communication and Cost-of-Capital Considerations
 - Conducting internal staff seminars/training sessions to educate staff in objectives and techniques,
 - Training of staff in NPL valuation and performance measurement using NPV and funding drag techniques,
 - Educating staff in recovery maximising techniques, procedures and approaches. For example, a market-driven approach to asset realisation, pooling assets where possible, or seeking enhancement opportunities, to increase overall recoveries.
- Performance Tracking
 - Establishing formalised regular performance measurement reports (against benchmarks and targets rather than acquisition cost),
 - Formalising follow up and reassessment procedures for NPL's failing to meet targets,
 - Development of a risk-rating systems,
 - The risk rating system must become a pervasive part of the thinking of all staff in conducting day-to-day work. Encouraging a more aggressive, active and hands-on approach to managing the loan portfolio is critical. **IV. Lessons Learned: Disposals vs.**

Restructuring

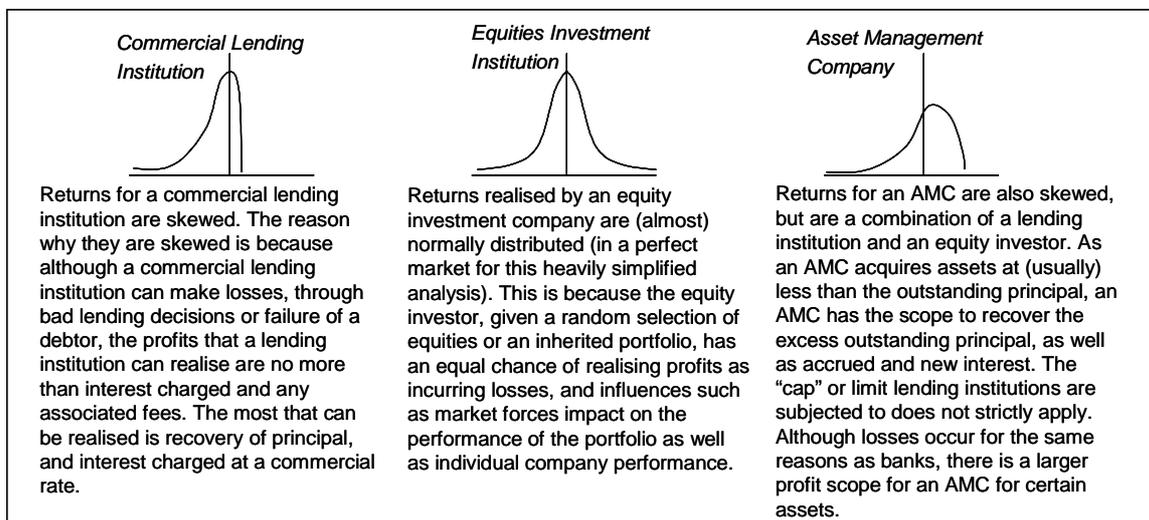
As discussed earlier, there are two main approaches or philosophies to managing an AMC:

1. Sale of NPLs and outsourcing management, and
2. Internal workout

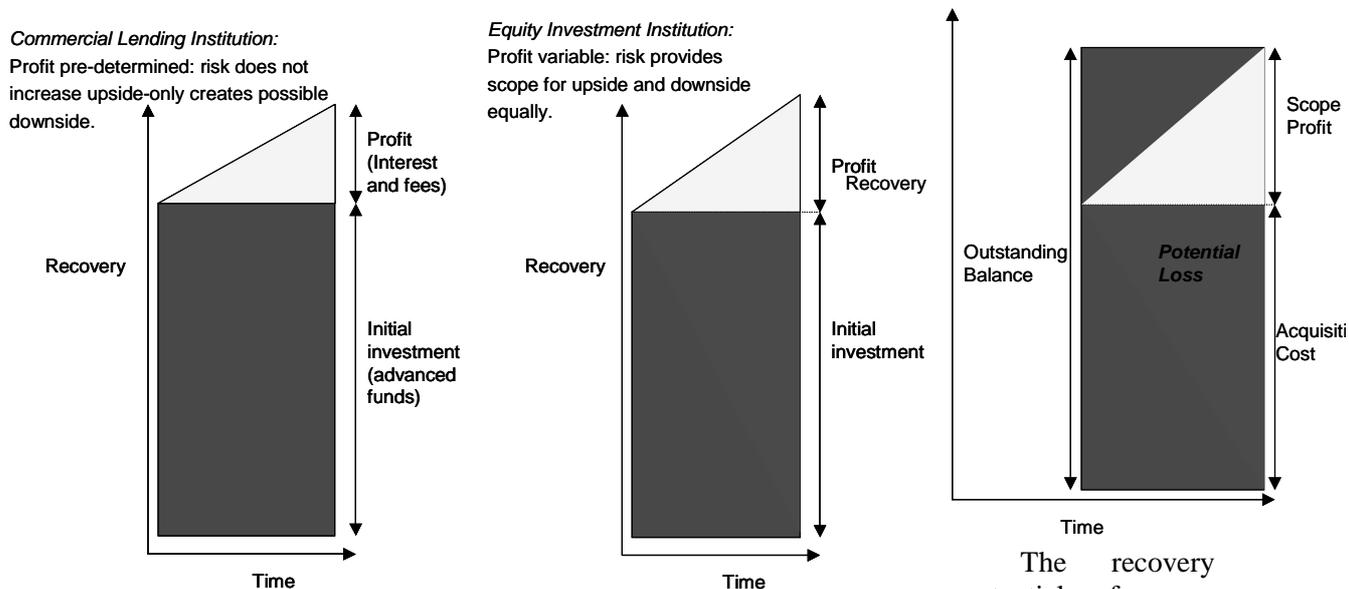
As AMCs are driven largely by rapid results, the first approach is often the most popular. The following table summarises the key differences between the two approaches:

	Sale and outsource approach	Internal management and workout approach
Description of approach:	This involves the strategic “quick fix” approach involving the sale and packaging of NPL’s to external parties. Usually this includes packaging loans into tranches grouped with like characteristics to make the tranches more attractive to potential buyers. Value is realised from the receipt of sale proceeds.	This involves working with the borrowers being administered, with particular attention being given to larger loans with better viability restoration prospects. Some loans with greater potential are granted “intensive care” status, and all loans are progressively graded in terms of recovery potential. Value is recovered from repayment and progressive recovery, although liquidation is resorted to in some cases.
Skills required:	Sale skills, asset due diligence and packaging for targeted bidders is the key skill required. The main constraint or driver of the process is timing: sale of loans usually equates to an expectation of rapid results.	Restructuring, workout and reorganisation skills are required, as well as an in-depth understanding of business and commercial issues and cashflow analysis. This is because decisions need to be made quickly regarding loan classification, and they need to be correct so the right attention is focussed in the right areas. All loans are assessed in the same way, but loans with better recovery prospects get more attention.
Performance indicators: how are they assessed?	<ul style="list-style-type: none"> • Speed of recovery and asset turnover, • Quantum of return vs. OPB or acquisition cost, • Holding costs incurred, • Discounts or prices achieved, • Distribution of recoveries (returns to originating banks). 	<ul style="list-style-type: none"> • Speed of recovery and asset turnover, • Levels of returns on NPV basis vs. acquisition cost, • Opportunity costs or funding drag (over time) and operating costs, • Proportion of negotiated workouts vs. litigated ones.

Dealing with NPL's by an AMC is comparable to a normal bank, or an equity investment institution. Assets being managed involve varying risk, and returns achieved are controlled and measured using similar techniques and approaches.



A more simplified illustration of this is on an asset basis.



As acquisition cost is less than invested funds (advanced funds), the scope for profits and losses is much greater for an AMC than for a commercial lending institution. The amount that is at risk for the AMC is the acquisition cost. The worst result that could be achieved by the AMC would be to lose the entire amount paid for the loan, and realise nothing. This risk is balanced by the potential upside, or scope for profit, which exceeds acquisition cost and accrued interest on an NPV basis. Loans with greater profit potential must be identified early, to ensure that these loans are focussed on and nurtured to ensure that wherever possible, this upside is realised.

Where NPLs are sold on to third-party investors outright, this upside or profit scope cannot be realised. Only by adopting the “incubator” approach can this be realised. The risk of the downside, however, is also then present.

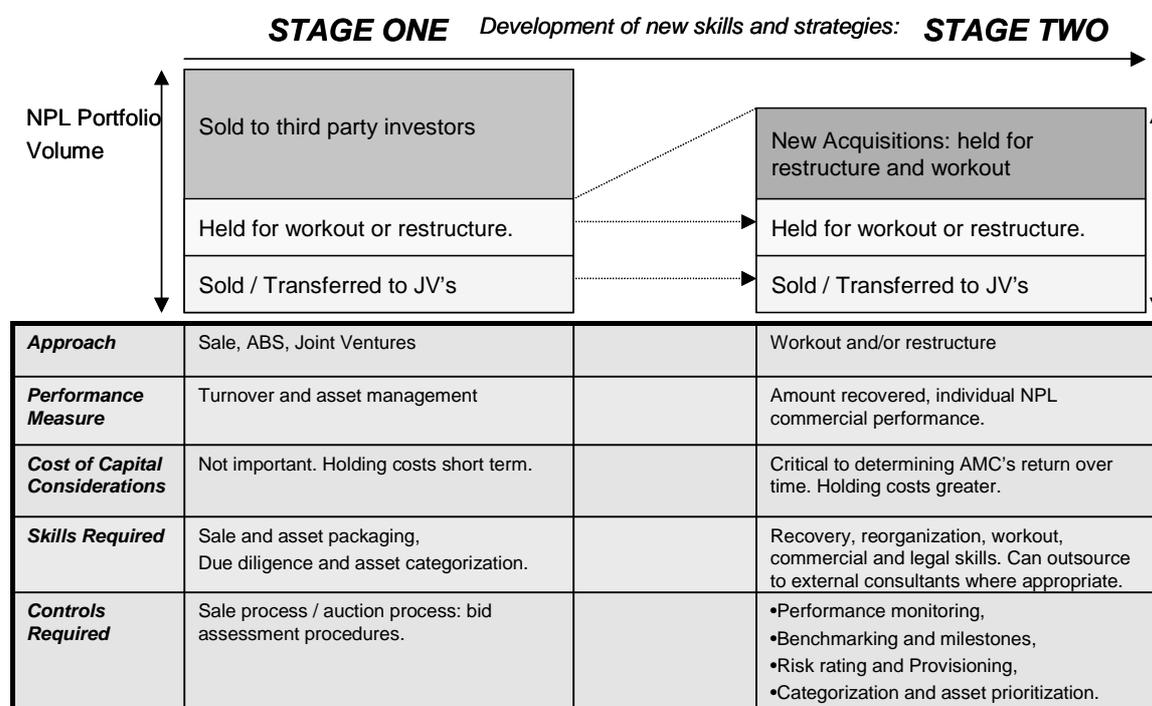
It is clear that adopting the internal management approach affords new opportunities for profit making, but also new risks. Whereas the risks of the downside-loss of acquisition cost are passed on to an investor in an outright sale but when the asset is retained for workout and restructure the risk of this loss is retained by the AMC.

It is important for an AMC to ensure the profits that can be realised (NPLs with high potential for recovery and workout) are given every opportunity to perform, and focussed efforts are made to restore the debtor to financial health and viability as quickly as possible. Realised profits must exceed losses.

In order to determine the position of the AMC, the risk of losing acquisition cost must be quantified. The Recovery Risk Management and Mitigation system must:

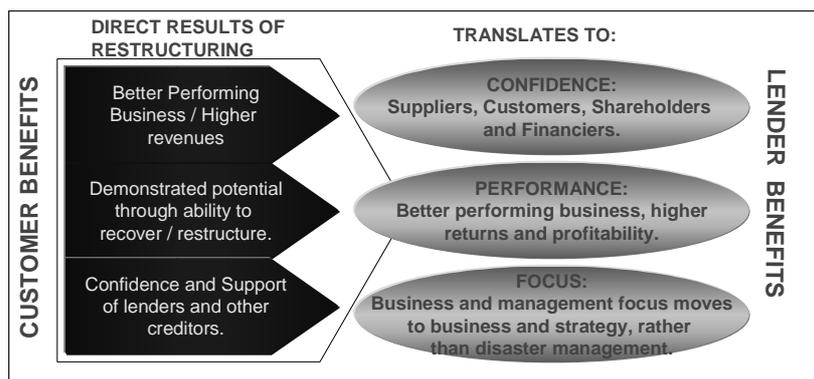
- Measure and quantify recovery risk, and changes in recovery risk;
- Assist in identifying those loans that have scope for profit, and
- Once potential losses are identified and quantified, guide account officers in deciding which course of action will minimise the loss.

This process can be described as moving from being “liquidator” to “incubator”, or from Stage One to Stage Two competency. The following diagram illustrates the differences in skill sets between the two, and the transition that can occur:



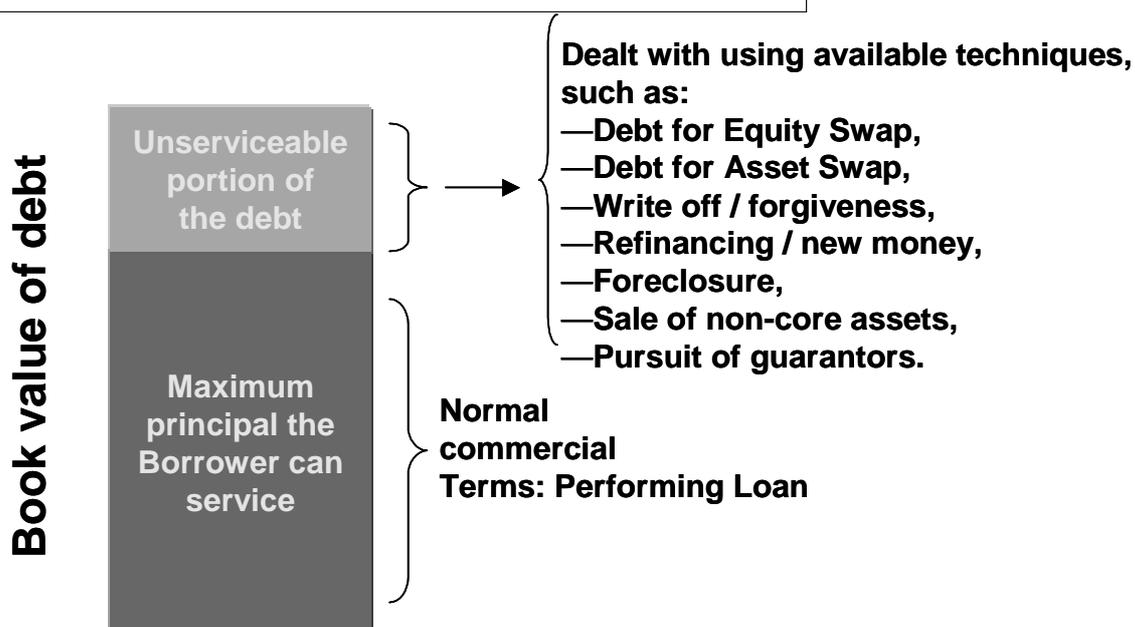
As discussed earlier, the mandate of an AMC is ultimately to either release as much cash as possible from non-viable debtors so that it can be loaned to viable ones, or to restore viable businesses to performing status, and to recognise losses when and where they have occurred. Until losses on non-viable debtors are recognised, NPL problems will not go away. Shareholders, depositors, employees and regulators cannot be confident that accounts reflect accurate asset values and are not “inflated”.

The benefits of restructuring and workout are equally beneficial to a bank or financial- institution based AMC as they are to a government agency or central AMC:



A good AMC needs to take ownership of their NPLs, and to be proactive in the NPL management process.

AMCs must educate debtors to work with them in achieving essentially the same goal, which is improvement of the cash-flows of the assets and businesses underlying NPLs.



Restructuring of NPLs needs to be conducted quickly. Too often the NPL deteriorates in value through lack of action or time wasting during the sale or holding process. Before the NPL deteriorates in value too greatly, the exercise of determining the maximum principal the debtor can manage needs to be determined, so the remaining debt can be dealt with and the loan returned to performing status as a genuine performing loan. AMC’s are uniquely placed to lead industry reform at the “grass roots” level. To achieve this, they need better awareness of:

- Successful turnaround and business improvement strategies,
- Quick wins and “business triage” skills,

- Assessment and evaluation skills,
- The ability and the will to recognise losses and deal with them,
- Regulator support and encouragement.

AMC culture is changing, and needs to continue evolving. AMC's need to take a more holistic and hands on approach to solving NPL problems.

LEVERAGING THE LOAN SALES MARKET TO ADDRESS NPLS: A ROLE FOR MULTILATERALS IN CAPITAL MARKET DEVELOPMENT

by

Christopher P. Beshouri¹³⁸

The prominence of NPLs in the minds of investors, bank CEOs and CFOs, and economic managers in government reflects some simple facts. Over the last five years, NPLs have been rising across the region, and in aggregate now exceed bank equity by a factor of two. Official estimates put NPLs in the 11 largest banking markets of the Asia-Pacific region at about \$865 billion at the end of 2001. The bad asset figures double when foreclosed assets and already restructured credits are added in, and nearly triple if independent estimates are used. Across the region, NPLs rose by \$150 billion or 20% since 1998, with NPL ratios increasing in 6 of 11 countries.

¹³⁸ Christopher Beshouri is the Associate Principal at McKinsey & Co. based in the Philippines.

This mountain of NPLs will exert a powerful shaping force on the banking landscape of Asia over the next 10 years. NPLs certainly will continue eating away at bank earnings. Between 1998 and 2001, almost 60% of all bank operating income in Asia was consumed by provisions. Without earnings, banks cannot pursue new opportunities or raise fresh capital. NPLs will also leave their mark on market structure. The inevitable recognition of losses by banks will trigger an industry shakeout, just as it did in Korea, where the number of banks fell from 27 down to eight in five years. The underlying conditions for consolidation are ripe: if banks were to raise provisions on NPLs to 50%, \$200 billion, or nearly half of all bank equity, would be wiped out, putting a multitude of banks on the chopping block. NPLs will also exert their influence on the real economy. As NPLs rise, credit growth stalls, and this dampens income and employment growth. Not only does that depress demand for banking services, it brings with it new corporate defaults. Nowhere is this link more apparent than in Japan.

How CEOs and their regulators deal with the mountain of NPLs and its force will go far to determine winners and losers in the banking markets of Asia. The decisions CEOs and regulators take and the speed with which they move will have implications for their growth, success in attracting foreign capital, and the structure of the markets in which they operate. What actions to take and how quickly to take them? Is aggressive and rapid action needed? Can CEOs follow a “go slow” approach and hope to grow out of the problem? CEOs have a choice to make.

At stake are options on future growth, the ability to attract financial capital and strategic partners, and the bank’s very independence. Those that get their NPL strategy right will create valuable options for themselves in this coming wave of growth: options on emerging product markets and segments; options on a “fair share” of capital flowing to the region; options in the consolidation game. Those that get it wrong will find themselves capital-constrained and out-of-the-money on new product and segment opportunities; out-of-position on capital inflows; and more likely to be “consolidated” than “consolidating”. The window of opportunity to act on NPLs is about two to three years. Smart banks will leverage this period aggressively, as Woori Bank of and others like it in Korea have, to preserve the value of their strategic growth options.

The CEO Agenda

A key prong in any CEO’s NPL strategy must be to leverage the secondary market for distressed assets. This market is relatively small thus far, but has been growing in the last year. About \$300 to \$400 billion in face value of non-performing Asian loans have been sold to investors. Most of the volume has been in South Korea and Japan, but private equity firms are actively hunting deals in Taiwan, the Philippines and Thailand. In early December 2002, investment funds bought up another \$1.5 billion in loans from 3 commercial banks in Taiwan. In the last 12 months, firms such as Lehman, Goldman, Lonestar, Cerebrus and others have made several billion dollars in commitments to develop these funds further.

The secondary market can be of enormous help to banks struggling to overcome a mountain of bad debt. DBS Thai Danu Bank in Thailand used the secondary market effectively, shedding itself of \$200 million in bad loans in April 2002. The deal lowered its NPL ratio to 10% from 35% , and freed up internal resources to work on other priorities. Although the bank had to accept a low price, the equity markets rewarded Thai Danu with a 6% rise in its share price after the deal was announced.

The Critical Issue of Price

The big sticking point for most banks in the loan sale market will be price. Bid prices typically are quite low relative to what banks are asking, requiring substantial write-offs. The low prices reflect high hurdle rates of private equity, usually on the order of 25% to 35%. The low bids also reflect weaknesses in the legal environment that can obstruct collections. For one investment bank, this is a key driver of valuation. Its offer prices in China are half of what they would be in Korea and only one-fifth of what they would offer in the U.S. Also, contributing to the low pricing is the simple fact that investment banks do not know many of the local markets well, and thus lack some of the inside information that can lead to higher recovery rates.

The wide "bid-ask" spread also reflects unrealistic expectations on the part of the selling banks. In many cases, bank boards have not or do not want to come to terms with the true value of their NPLs, which is what a sale under the typical terms in the market today would require.

Scope and Skills

Bilateral deals that we have seen also present another challenge: they are not accessible by most mid- and small-sized banks. Few of the smaller banks will be of interest to the investors currently setting up AMC proposals. The bilateral arrangements of the investors require a minimum portfolio to offset costs of bank-by-bank due diligence. The smaller institutions are also a greater challenge because of weaker information systems and smaller average loan sizes. However, these smaller institutions cannot be neglected. Not only do they account for a large part of the NPL problem – banks outside the top five have 40% of system NPLs — but they also account for 45% of commercial bank lending. Strengthening the banking system and restoring lending necessarily means finding an AMC solution accessible to smaller banks.

One other issue is that bilateral AMCs will not substantially upgrade or develop the workout and restructuring skills of the banking system ("a public good"). In fact, in some cases, the AMCs will hire the units of the selling banks to manage workout. Performance improvements could come indirectly, through target setting and performance-contingent pay, as opposed to direct skill transfers. Thus, in this respect, these funds are primarily providing high priced liquidity.

A market development model: the "industry utility" AMC

There is an alternative approach that might help address all three concerns – price, scope of inclusion and skills – and thus catalyse the loan sale market in some markets where it has yet to really take off. The idea is to develop an "industry utility", run by a private management group, funded by multilaterals – such as the ADB and the IFC — and owned in part by the selling banks as well as private investors. These agencies have a special, "catalytic" role to play. A number of deals could be possible in markets such as the Philippines, Thailand, China, and India.

The AMC would operate like any other AMC — purchasing NPLs from banks in exchange for cash payment and subordinated paper. It would also run like any other AMC – professionally run, well-incentivised management team and staff to service loans and a tight governance structure including careful rules on asset disposition, incentives, valuation and the like.

However, there are four crucial differences between the alternative approach and the bilateral schemes. These differences will generate as much as 20%-30% more value for the selling banks.

1. **Lower financing costs.** The first key difference with other structures is that funding is provided by multilaterals. Because they have a mix of financial and developmental objectives, the multilaterals will provide cheaper funding. This lower funding costs is a key driver to generating more value for the selling banks. This also creates competitive pressure on the bilateral AMCs to raise their bid prices.
2. **Upside to seller.** The second key difference is that valuation would be diminished as an obstacle to doing AMC deals. This is achieved by giving only a small amount of cash upfront to the sellers, and passing onto selling banks nearly all the upside once multilaterals (i.e. creditors) are paid. This reduces upfront disputes about what assets are worth (although some indicative valuation is needed), because the cash paid is not the final payment, and any proceeds beyond funding and operating costs go back to the seller. The low upfront cash is also beneficial because it reduces the value soaked up by funding costs. There are also regulatory and accounting benefits from this structure in that subordinated debt issued by the AMC to the selling banks has inherent value.
3. **Broadly accessible.** The third key difference is that the vehicle will be available and actively marketed to institutions of all sizes. As an "industry AMC", it can achieve scale by pooling the assets of multiple banks. This makes it economic to work with the portfolios of smaller banks.
4. **Build skills.** The fourth key difference is the express objective of infusing best practice workout and organisation skills into banking systems. This can be done in several ways, one of which is to have selling banks second to the AMC members of their own bank's workout units. It would also be achieved by exporting the best practices on structure, skill development, evaluation, and compensation to the selling banks. This will help those banks upgrade their own performance and attract the best talent.

By addressing the problem of price and making itself accessible to banks of all sizes, the "private utility" model would help catalyse the loan sale market in select countries. And with its intention of upgrading skills in the banks, it helps equip institutions to handle their NPLs on an ongoing basis.

This AMC also would have lasting impact. After the first several loan sales into the AMC, the AMC would then be able to attract non-multilateral funding for subsequent deals. This funding – even though private – presumably would come more cheaply than the rates at which it is being offered today. Much uncertainty related to legal and procedural issues would have been removed by the AMC's earlier deals. The inherent value of assets also would be easier to discern based on the AMC's established track record on resolutions. As well, selling banks would be able to see the economic and management benefits of these early deals, and over time get more realistic about their selling prices.

Support needed from public and private sectors

Such an AMC would need support from several quarters. One is the central bank, which is needed to provide regulatory support to banks to sell their assets into the AMC and create the will to act on the part of the banks. The central bank would not be asked to take on any financial risk (nor would the government), assume any operational control or interfere in any bilateral way with the decisions taken by the management of the AMC. The central bank is a natural candidate for sponsorship: the market under their charge would benefit by seeing loan sales take off, especially when the public sector itself lacks the financial capability to set up a national-level AMC. The central bank also clearly will take a broad economic and industry perspective. Without such support, this initiative may not get off the ground.

As well, some oversight is needed to ensure transparency in the pricing and resolution process, manage potential asset deflation, create urgency for participant banks, insulate the AMC from political influence and signal credibility to financial markets. Also, getting the initiative started will require an agent with a broad industry perspective and willingness to invest in a “public good”.

Regulators and banks also must reach agreement with the accounting profession on regulatory and accounting treatment of the sales transaction before private equity funds can be tapped by banks. A common practice has been to allow banks to amortise this subordinated debt over many years, effectively allowing the bank to spread the losses over time. This might be called “deferred recapitalisation” because it gives banks the time to generate earnings to cover the inherent losses of their loans. The sticking point is likely to be with the accounting profession. If the subordinated debt has little inherent value, the accounting profession naturally will want that reflected in the financial statements. If it is not, banks may get qualified financials, and in this day and age, that itself has non-trivial costs.

Structural impediments

Loans sales will have trouble taking off – under any type of structure – unless certain conditions for private loan sales are put in place. Tax law imposes large costs on sales, adding to the losses banks must accept. In the Philippines, stamp duties and other taxes on asset transfers to a third-party or an AMC amount to nearly 10% of face value. The bank absorbs this, either directly or through the bid price. Such losses simply due to the transactions costs would be enough to make the selling bank scuttle a deal. The Philippines recently passed a law to suspend such transaction costs for five years to help promote the development of AMCs and the secondary market for distressed loan sales.

Regulators also must take action to remove legal obstacles that keep banks from collecting on or restructuring delinquent loans. In many markets, the legal system is biased against creditors, making it hard to initiate workout discussions. Even the ability for creditors to perfect a lien on collateral is suspect. In the Philippines, for example, judges are quite loose with their issuance of TROs or “temporary restraining orders” on creditors attempting to initiate collections or restructuring. One company, a manufacturer of electrical appliances, won a TRO from a judge in a jurisdiction far from where it was operating, after shopping around and being rejected by other judges. The manufacturer owed a consortium of 28 creditors \$100 million at the time, and the TRO stopped the creditors’ planned auction of plant and equipment just 24 hours before the event was to begin. The situation has gotten so severe in the Philippines that the Bankers Association of the Philippines has petitioned the Supreme Court and the Congress to issue specific guidelines on when TROs can be issued.

Taiwan provides an interesting solution. The Financial Holding Company Act of 2001 created a special arbitration panel to rule on restructuring agreements, as well as cases involving legal proceedings and NPLs, precisely for the purpose of expediting loan workouts.

Resolving these types of issues – regulatory, tax, legal – are critical to help the secondary market for loan sales to develop. These topics were less important where government-sponsored AMCs were involved, since loans had already transferred into the government’s AMCs, and thus issues on provisioning, regulatory treatment and accounting treatment did not emerge. Here, where private equity is involved, and the transaction takes place between two private entities – the selling bank and the purchasing AMC — these issues loom quite large.

Through concerted action on putting in place the right legal and tax environment, and resolving barriers to sales, the suggested approach – the creation of an industry utility with multilaterals as principal investors — can help create a viable option for resolving NPLs and open the door to private

equity funds and other specialists who can assist in the resolution of bad assets. These actions will also have a positive effect downstream by helping to promote the development of the secondary and capital markets in their countries, with positive long-term effects on intermediation.

The Philippines

THE SPECIAL PURPOSE VEHICLE ACT OF 2002: A BRIEF SUMMARY OF THE PHILIPPINES REPUBLIC ACT NO. 9182

by

*Francis Lim*¹³⁹

I. Background

There is currently a high level of non-performing loans (NPLs) and real and other properties owned or acquired (ROPOAs), [the NPLs and ROPOAs are collectively referred to as the non-performing assets – or (NPAs)], in the Philippine financial sector.

Since the onset of the 1997 Asian financial crisis, financial sectors in the region have suffered from the burden of high levels of NPLs. Data from the *Bangko Sentral ng Pilipinas* (BSP) reveal that the NPL level of the country's 44 commercial banks as of June 2002 reached P288.97 billion of the P1.600 trillion total loan portfolio of all the 44 commercial banks or 18.1%, up from P267.116 billion of the 1.575 trillion or 17.1% from June 2001. The ROPOAs of the commercial banks as of June 2002 increased to P167.786 billion from P 144.791 billion registered a year earlier, an increase of 16%. On the whole, the NPAs of the commercial banking sector increased from P 411.907 billion as of June 2001 to P456.756 billion as of June 2002. The NPA ratio of the commercial banking sector increased from 13.4% as of June 2001 to 14.5% as of June 2002. The NPAs of the entire banking system amounted to P519.986 billion, exceeding the sector's total capital base of P 389 billion, endangering the banking sector's ability to survive any further economic crisis.

This high level of NPAs is seen to pose a grave and serious threat to the stability of the Philippine banking system and ultimately, the national economy. The NPAs impair capital within the financial institutions, curtail new lending and create a continuing drag on the economy.

Recognising the need for rapid reaction to restore confidence, several Asian countries such as South Korea and Thailand, passed legislation to encourage both local and foreign investment to acquire, manage and dispose of these NPAs. To maximise investment in domestic NPAs, these jurisdictions recognised that there is a need to lift restrictive and exorbitant transaction fees and taxes and modify outdated insolvency and creditors' rights.

As far as the Philippines is concerned, banks, including government financial institutions (GFIs), have initiated discussions for the entry of foreign direct investment for the acquisition of their NPAs. However, investors are reluctant to invest in the banks' NPAs primarily because of the high amounts of transaction fees and taxes and the perceived obstacles to the enforcement of creditors' rights. To encourage foreign direct investment into NPAs in the Philippines enabling legislation was required.

To respond to this need, the Philippine Congress passed Republic Act No. 9182 otherwise known as "The Special Purpose Vehicle Act of 2002" (the "Act"), on 23 December 2002. The new law became effective on 26 January 2003. The law encourages investment, both local and foreign, in the banks' NPAs by providing incentives and mechanisms such as time bound privileges and exemptions and rules in private capital participation.

¹³⁹ Francisco Lim is a Senior Partner with Abello Concepcion Regala & Cruz based in the Philippines.

II. Characteristics of the SPV Act

The intention of the new law is to create a legislative regime that encourages investment of private capital, both domestic and foreign, into NPAs and the elimination of perceived roadblocks in the expeditious disposal of the NPAs.

The following are the salient points of the Act:

1. The Special Purpose Vehicle — The special purpose vehicle (“SPV”) for the acquisition of NPAs must be in the form of a stock corporation. If the SPV will acquire land, at least 60% of its outstanding capital stock must be owned by Philippine nationals pursuant to the Foreign Investments Act (R.A. 7042). The SPV shall have a minimum authorised capital stock of P 500 million, a subscribed capital stock of P125 million, and a paid-up capital stock of P31.25 million.
2. Investment Unit Instruments — SPVs may issue Investment Unit Instruments (“IUIs”) for the purpose of raising funds to acquire NPAs. Any person, including non-Filipino citizens or entities, may acquire or hold IUIs in the minimum amount of Php 10 million.¹⁴⁰
3. True Sale — The transfer of the NPAs from a Financial Institution (“FI”) to a SPV must be in a concept of a true sale. “True sale” refers to a sale wherein the selling Financial Institution transfers or sells its NPAs without recourse for cash or property to a SPAV with the following results: (a) the transferor relinquishes effective control over the transferred NPAs; (b) the transferred NPAs are legally isolated and put beyond the reach of the transferor and its creditors; (c) the transferor FI shall not have direct or indirect management over the transferee SPV; and (d) the selling FI does not possess a claim of beneficial ownership of more than 5 % in the transferee SPV.¹⁴¹
4. Prior Notice to Borrowers – The transfers of NPLs require prior notice to the borrowers and to the persons holding prior encumbrances upon the assets mortgaged or pledged. The borrower and transferring FI are given a period of at most 90 days to restructure or renegotiate the loan.¹⁴²
5. Certificate of Eligibility — The transfer of an NPA from an FI to an SPV requires a prior certification of eligibility (“COE”) from the appropriate regulatory authority having jurisdiction over the operations of the FI to the effect that the asset is really non-performing.
6. Assumption of Rights and Obligations — After the transfer to the SPV, the SPV assumes all rights and obligations of the transferring FI, including the right to enforce contractual obligations and the obligation to recognise the rights of the borrowers, as well as to prosecute and defend suits relating to the acquired assets.¹⁴³
7. Tax Incentives and Privileges — The transfer of the NPAs from the FI to a SPV, and from a SPV to a third party or dation in payment by the borrower or a third party in favour of the FI or in favour of the SPVs shall be exempt from the following taxes:

¹⁴⁰ Section 11, R.A. 9182

¹⁴¹ Section 3 (1), *id*

¹⁴² Section 12, *id*

¹⁴³ Section 14, *id*

- Documentary stamp taxes;
- Capital gains taxes imposed on the transfer of properties treated as capital assets;
- Creditable withholding taxes imposed on the transfer of land/buildings treated as ordinary assets;
- Value added taxes;

The above transfers shall be subject to the following reduced fees:

- 50% of the applicable mortgage registration and transfer fees;
- 50% of the foreclosure filing fees; and
- 50% of the land registration fees.¹⁴⁴

All sales or transfers of NPAs from the FIs to the SPV or transfers by way of dation in payment by the borrower to the FIs or to the SPVs shall be entitled to the aforesaid exemptions for a period not exceeding two years from the effectivity of the implementing Rules of the Act. All transfers from SPVs to a third party of NPAs acquired by the SPV within such two year period shall enjoy the tax exemptions for a period of not more than five years from the date of acquisition by the SPV.¹⁴⁵

The SPV shall also be exempt from income taxes on net interest income, documentary stamp tax and mortgage registration fees on new loans in excess of existing loans granted to borrowers with NPLs that have been acquired by the SPV. The SPV is also exempt from documentary stamp taxes in the event of capital infusion to the borrower by the SPV. These additional exemptions apply for a period of not exceeding five (5) years from the date of acquisition of the NPL by the SPV.¹⁴⁶

1. Net Operating Loss Carry Over — Any loss incurred by the FI as a result of the transfer of the NPAs shall be treated as an ordinary loss. The loss may be carried over for a period of five consecutive taxable years immediately following the year of such loss.¹⁴⁷
2. Penalties — The abuse of the tax exemptions granted under the Act is punishable by imprisonment and/or fine. In addition, the offender shall be made to refund double the amount of the tax exemptions and privileges availed of, plus an interest of 12% per annum.¹⁴⁸
3. Applicability — The provisions of the Act apply to assets which have become non-performing as of 30 June 2002.¹⁴⁹

¹⁴⁴ Section 15, *id*

¹⁴⁵ *Id.*

¹⁴⁶ Section 16, *id*

¹⁴⁷ Section 17, *id*

¹⁴⁸ Section 18, *id*

¹⁴⁹ Section 25 of the Act

It is still too early to determine if the new law will achieve its objectives. From the amount of controversy that the Act has generated, there appears to be great interest in the disposal of the banks' NPAs. While not perfect, the proposed legislation is a step in the right direction.

Chinese Taipei

NON-PERFORMING LOANS – THE CHINESE TAIPEI EXPERIENCE

by

Howard N.H. Wang¹⁵⁰ and Philip W.Y. Chen¹⁵¹

1. How have bulk sales of NPLs /distressed assets been approached across the region?

NPLs in the Taiwan banking system have risen sharply since the 1997 “Asian Financial Crisis”. In view of this increasing NPL ratio, the Taiwanese banks have strengthened credit risk management and made use of the provision of loan loss reserves to write off bad loans in recent years. The NPLs written off by domestic banks amounted to US\$4 billion in 1999 and US\$4.7 billion in 2000. However, NPLs have continued to increase dramatically in recent years. The Taiwanese government decided to assist banks to reduce their NPL ratios in order to prevent a financial crisis. Government has tried to solve NPL issues in various ways.

The first measure taken by the government included the Central Bank’s announcement of the decrease in the reserve ratio on deposits for banks in February 1999. This was followed by a tax reduction for banks. The Ministry of Finance reduced the gross business receipt tax (GBRT) for banks from 5% to 2% in July 1999. The GBRT rate will be further reduced to zero effective as of January 2006. The additional income derived from lowering the required reserve ratio and the decrease in the GBRT, estimated to be NT\$35 billion (or equivalent to US\$1 billion) per annum, has been earmarked exclusively for the write-off of bad loans.

In addition to the above, the government has created a friendly legal environment conducive to the disposition of banks' non-performing assets. The Merger Law of Financial Institutions (MLFI) was enacted on 24 November 2000. The Law provides the legal framework for the establishment and operation of the Taiwan Financial Asset Service Corporation (TFASC) and Taiwan Asset Management Corporation (TAMCO). Commercial banks may dispose of NPLs through TAMCO and an independent third party, TFASC, without going through lengthy court procedures.

In order to provide the financial sector with a high-quality operating environment, the government also set up a quasi-Resolution Trust Corporation (RTC) mechanism. The Statute for the Establishment and Management of the Financial Restructuring Fund was enacted on 26 June 2001. The Statute provides for the establishment of a Financial Restructuring Fund in the amount of NT\$140 billion (or US\$4.1 billion). Of the NT\$140 billion, NT\$120 billion or US\$3.5 billion will be generated from the collection of the current 2% GBRT on financial institutions over the next four years, with the remaining NT\$20 billion or US\$0.57 billion to be generated from the proceeds of increased deposit insurance premiums over the next ten years. The Fund will purchase the bad assets of distressed financial institutions. In September 2001, the government used part of the Fund to restructure and liquidate NPL assets of 36 community-based financial institutions.

The current size of the quasi-RTC fund is insufficient to deal with Taiwan’s distressed loan situation. Taiwan Executive Yuan tried to increase the scale of the quasi-RTC fund to 10% of

¹⁵⁰ Howard N.H. Wang is Executive Vice President, Central Deposit Insurance Corp, Chinese Taipei

¹⁵¹ Philip Chen is a Partner with Deloitte and Touche, Chinese Taipei

Taiwan's GDP to clean up the banking sector. However, the final decision is still pending for approval.

The following describes the nature of the financial crisis and the measures undertaken to date to resolve the crisis in Taiwan.

Causes	Measures Taken and Outcome
<ul style="list-style-type: none"> • Over-banking and extreme competition caused credit quality to decline. • Excessive dependence on mortgage of real estate, which declines in value in recent years. • Taiwan trading business was declining as a result of global economic downturn. In order to save costs and to approach the Mainland China market, many companies moved their bases to China, but still financed from the Taiwan banking system. 	<p>The RTC system is already in operation. As for the AMCs, TAMCO and TFASC were incorporated (by 33 financial institutions) in 2001. The First NPL transaction was completed in March 2002. NPLs with a total book value of US\$ 6.2 billion were sold in 2002. Most deal prices fell between 20%~40% of UPB for transactions completed.</p>

Bulk sales of NPLs completed by Taiwan banks in 2002 and expected bulk sales in 2003 are listed in the following tables:

NPL Seller	Bid Date	NPL Sales Amount (expressed USD in millions)
First Commercial Bank	March 2002	122
	27 March 2002	383
	30 July 2002	1,638
Cathay United Bank	22 March 2002	55
Fubon Commercial Bank	End of May 2002	145
Cosmos Bank, Taiwan	June 2002	417
Taiwan Business Bank	5 July 2002	174
China Bills Finance Corp.	15 July 2002	136
En Tie Commercial Bank	September 2002	140
Ta Chong Bank Ltd.	End of September 2002	174
Chiao Tung Bank	September 2002	597

United World Chinese Commercial Bank	24 October 2002	232
Jih Sun International Bank	Early November 2002	210
Chang Hwa Commercial Bank	4 December 2002	690
Taiwan Business Bank	11 December 2002	727
Cosmos Bank, Taiwan	11 December 2002	179
Land Bank of Taiwan	12 December 2002	145
Co-operative Bank of Taiwan	December 2002	75
Grand Commercial Bank	7 March 2003	229
Chin Fon Commercial Bank	18 March 2003	197
Hua Nan Commercial Bank	Anticipated 2003	638
Shin Kong Life Insurance Co., Ltd.	Anticipated 2003	348-377
The Farmers Bank of China	Anticipated 2003	170
Bank of Overseas Chinese	Anticipated 2003	170
Far Eastern International Bank	Anticipated 2003	230
The Chinese Bank	Anticipated 2003	130

2. *What factors are affecting buyer/seller interest in bulk NPL sales?*

The factors that affect the value of loans will also affect buyer/seller interest in NPL bulk sales. Such factors include the degree of risk, length of time that the loans have been overdue, and level of the completeness of information. The following factors should be considered by banks if they are to obtain favourable prices from bulk sales of NPLs:

1. Degree of risk. The purpose for investors investing in NPLs is to make profits from future cash flows. Sources of future cash flows include the sale of collateral, repayments of principal and interest by debtors, and formal or informal restructuring/reorganisation. Therefore, the quality of collateral and the likely difficulties of liquidating the collateral are all factors that affect debtors' revenue and costs. In addition, the difficulties of negotiation between debtors and other creditors can also become risk factors affecting the sale of the loans.
2. Length of time that the loans have been overdue. Generally, the longer period the loans are overdue, the lower the possibility of recovery. Further more, it is unlikely to obtain complete updated information regarding the obligors. Such limitations affect the selling price negatively.

3. Degree of information completeness and transparency. If, during the period of review of the loans files, investors have a thorough understanding of all relevant information, and are able to evaluate the degree of risk of loans more clearly, investors will bid more aggressively and will be more willing to acquire loans at higher prices.

3. *What are the benefits/dangers of bulk sales at the micro level (for the parties involved) and at the macro level for the economy and economic recovery?*

Benefits	Micro	Macro
Creditor	Lower NPL ratios for banks Cash flow injection Improved financial structure	Overall improvement in the financial industry and general economy
Borrower	Lower financial burden on the repayment of principal and interest Opportunities for restructuring	<ul style="list-style-type: none"> • Overall improvement in the general economy • Positive industry outlook
AMCs	Acquire assets at a lower price	Increase flexibility of assets transactions

Dangers	Micro	Macro
Creditor	Sales of NPL at lower prices	Deteriorate value of collateral
Borrower	Resistance of borrower in dealing with new parties/creditors	Formation of price subsidy and result in unfair competition
AMC	Acquisition of worthless assets	Deteriorate value of collateral

4. *How have AMCs been involved?*

In Taiwan, TAMCO commenced operation on 2 November 2001. Its services include three areas: the purchase of NPLs from financial institutions, the management of NPLs entrusted by financial institutions, and other related activities. The details of the activities are indicated as follows:

Purchase of NPLs from financial institutions

In accordance with the Law Governing the Merger of Financial Institutions, there are two methods for financial institutions to sell their NPLs. The first method is to sell (via auctions) to AMCs after an appraisal has been performed by a third-party auctioneer (TFASC) and the second method involves financial institutions negotiating prices with AMCs directly. (Please refer to the diagram of handling NPLs below).

Management of NPLs that have been entrusted to AMCs by financial institutions

TAMCO'S paid in capital is currently NTD17.62 billion, which is insufficient to acquire a large amount of NPLs. Therefore, TAMCO primarily handles NPLs with collectability classified as doubt or loss and residential mortgage loans entrusted by banks, and it assists financial institutions to restructure distressed companies, and dispose of collaterals. Although TAMCO handles NPLs entrusted by financial institutions, the ownerships of NPLs are not transferred, but still belong to the banks.

TAMCO is assigned or entrusted to manage the real estate collaterals of the NPLs. When the collateral has not been auctioned successfully after compulsory enforcement, TAMCO will accept such collateral if TAMCO estimates that the collateral will be profitable. TAMCO will provide management services to enhance the quality of the real estate property. TAMCO may also subsequently dispose of the property or lease it in order to maximise returns.

Other related activities

In addition to the core activities stated above, TAMCO will participate in other related activities. These activities include appraisals, provision of financial advisories (corporate restructuring, reorganisation, planning of financial management, and real estate investment consulting), general advertising services (i.e. advertisements of financial institutions' compulsory enforcement and leasing activities collectively).

5. What structures for AMCs have been successfully? What are the keys to their success/failure?

There are currently three types of AMCs in Taiwan with various structures. These include a joint venture formed by several banks, sole proprietorships formed by foreigners, and wholly owned subsidiaries formed by single banks. However, since the AMCs only commenced operation in 2002, it is difficult to conclude at this point in time which structure is the most appropriate.

6. What have been the successful/unsuccessful ingredients in the establishment and operation of AMCs?

Common factors that contribute to the success of AMCs include a sound supporting legal and regulatory environment; strong leadership, operational independence, appropriate and structured incentives, and commercial orientations. In addition, the operations should be guided ultimately by the objective of profit maximisation (or loss minimisation), taking into full account market conditions as well as the funding cost to the AMCs. Experience has shown that AMCs with clearly defined, focused, and consistent goals are more likely to be effective.

7. *How have RTC type bodies and restructuring funds been involved? What do you see as their future?*

The Taiwan government is still evaluating the merits of the restructuring funds. Please refer to Question 1 and the paper of Ms. Jean Chiu of Bureau of Monetary Affairs.

8. *Has there been too much focus on disposal and inadequate focus on restructuring?*

The Taiwan AMCs operate with a focus on the disposal of NPLs. These AMCs functioned as rapid disposition vehicles that quickly selling assets to the private sector. In all cases, the goal is to dispose of the asset as quickly as possible so as to avoid further deterioration in value and to minimise the burden of the government.

In other countries, governments set up vehicles with a focus on restructuring. In some cases, the emphasis was on restructuring the non-performing loans so as to make them marketable. In others, the goal was to achieve broader corporate restructuring of the borrowers and the government-owned banks.

Successful bank restructuring entails preserving the payment system, assuring that they are functioning banks, and that the residual troubled assets are managed and disposed of appropriately. While loan workouts are part of the normal banking business, if the size of the distressed assets reaches systemic proportions, there are a number of reasons for the necessity of setting up separate AMCs, not the least of which is to assure that corporate restructuring occurs. When AMCs hold a large percentage of the financial sector assets, corporate workouts and restructuring should become a key part of their mission.

9. *What will be the next development in use of the above techniques?*

Proper management and disposition of NPLs is one of the most critical and complex aspects of successful AMCs and speedy bank restructuring. The government's overarching objectives should be to maximise the value of the impaired assets in the system, while at the same time preventing the credit discipline of borrowers from deteriorating. AMCs, with proper governance and incentive structures and practical operating strategies, could play an essential role in achieving the government's objectives.