

# THE WORLD BANK

## PRINCIPLES AND GUIDELINES FOR EFFECTIVE INSOLVENCY AND CREDITOR RIGHTS SYSTEMS

April 2001

Effective insolvency and creditor rights systems are an important element of financial system stability. The Bank accordingly has been working with partner organizations to develop principles on insolvency and creditor rights systems. Those principles will be used to guide system reform and benchmarking in developing countries. The *Principles and Guidelines* are a distillation of international best practice on design aspects of these systems, emphasizing contextual, integrated solutions and the policy choices involved in developing those solutions.

While the insolvency principles focus on corporate insolvency, substantial progress has been made in identifying issues relevant to developing principles for bank and systemic insolvency, areas in which the Bank and the Fund, as well as other international organizations, will continue to collaborate in the coming months. These issues are discussed in more detail in the annexes to the paper.

The *Principles and Guidelines* will be used in a series of experimental country assessments in connection with the program to develop *Reports on the Observance of Standards and Codes* (ROSC), using a common template based on the principles. In addition, the Bank is collaborating with UNCITRAL and other institutions to develop a more elaborate set of implementational guidelines based on the principles.

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## INTRODUCTION AND EXECUTIVE SUMMARY

1. Since the 1997-98 financial crisis in emerging markets, considerable progress has been made in identifying the components of the global financial system and in articulating and applying standards and assessment methodologies for core system elements. The *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* contributes to that effort as an important milestone in promoting international consensus on a uniform framework to assess the effectiveness of insolvency and creditor rights systems, offering guidance to policymakers on the policy choices needed to strengthen them.
2. The principles in *Principles and Guidelines* were developed against the backdrop of earlier and ongoing initiatives to promote cross-border cooperation on multi-jurisdictional insolvencies, modernization of national insolvency and secured transactions laws, and development of principles for out-of-court corporate workouts.<sup>1</sup> The principles draw on common themes and policy choices of those initiatives and on the views of staff, insolvency experts and participants in regional workshops sponsored by the Bank and its partner organizations.<sup>2</sup> The consultative process on the *Principles and Guidelines* has been among the most extensive of its kind, involving more than 70 international experts as members of the Bank's Task Force and working groups, and with regional participation by more than 700 public and private sector specialists from approximately 75 mostly developing countries. The Bank also included papers and consultative drafts on its website to obtain feedback from the international community.<sup>3</sup>

### Role of Insolvency and Creditor Rights Systems

3. There are two dimensions to the global financial system. On the one hand, national financial systems operate autonomously and respond to domestic needs. On the other, national systems are tied to and interact daily with the systems of their trading partners. Insolvency and creditor rights systems lie at the juncture of this duality.
4. *The country dimension.* National systems depend on a range of structural, institutional, social and human foundations to make a modern market economy work. There are as many combinations of these variables as there are countries, though regional similarities have created common customs and legal traditions. The principles espoused in the report embody several underlying propositions:
  - *Effective systems respond to national needs and problems.* As such, these systems must be rooted in the country's broader cultural, economic, legal and social context.
  - *Transparency, accountability and predictability are fundamental to sound credit relationships.* Capital and credit, in their myriad forms, are the lifeblood of modern commerce. Investment and availability of credit are predicated on both perceptions and the reality of risks. Competition in credit delivery is handicapped by lack of access to accurate information on credit risk and by unpredictable legal mechanisms for debt enforcement.
  - *Legal and institutional mechanisms must align incentives and disincentives across a broad spectrum of market-based systems—commercial, corporate, financial and social.* This calls for an

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<sup>1</sup> The Addendum to this paper contains a brief survey of the leading initiatives in these fields.

<sup>2</sup> The *Principles and Guidelines* was prepared by Bank staff in collaboration with the African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank, International Finance Corporation, International Monetary Fund, Organisation for Economic Co-operation and Development, United Nations Commission on International Trade Law, INSOL International, and International Bar Association (Committee J).

<sup>3</sup> The papers can be accessed in the Best Practice directory on the Global Insolvency Law Database at [www.worldbank.org/gild](http://www.worldbank.org/gild).

integrated approach to reform, taking into account a wide range of laws and policies in the design of insolvency and creditor rights systems.

5. *The international dimension.* New methods of commerce, communication and technology are constantly reshaping national markets and redefining notions of property rights. Businesses routinely transcend national boundaries and have access to new types of credit. Credit and investment risks are measured by complex formulas, and capital moves from one market to the next at the tap of a computer key. Capital flows are driven by public perceptions and investor confidence in local markets. Effective insolvency and creditor rights systems play an important role in creating and maintaining the confidence of both domestic and foreign investors.

## **The Principles**

6. The *Principles and Guidelines* emphasize contextual, integrated solutions and the policy choices involved in developing those solutions.<sup>4</sup> The principles are a distillation of international best practice in the design of insolvency and creditor rights systems. Adapting international best practices to the realities of developing countries, however, requires an understanding of the market environments in which these systems operate. The challenges include weak or unclear social protection mechanisms, weak financial institutions and capital markets, ineffective corporate governance and uncompetitive businesses, and ineffective laws and institutions. These obstacles pose enormous challenges to the adoption of systems that address the needs of developing countries while keeping pace with global trends and international best practices. The application of the principles in this paper at the country level will be influenced by domestic policy choices and by the comparative strengths (or weaknesses) of laws and institutions.
7. The *Principles and Guidelines* highlights the relationship between the cost and flow of credit (including secured credit) and the laws and institutions that recognize and enforce credit agreements (sections 1 and 2). It also outlines key features and policy choices relating to the legal framework for corporate insolvency and the informal framework for consensual debt workouts (section 3), which must be implemented within sound institutional and regulatory frameworks (section 4). The principles have broader application beyond creditor rights and corporate insolvency regimes, as well. The ability of financial institutions to adopt effective credit practices to resolve or liquidate non-performing loans depends on having reliable and predictable legal mechanisms that provide a means for more accurately pricing recovery and enforcement costs. Where non-performing assets or other factors jeopardize the viability of a bank, or where economic conditions create systemic crises, these conditions raise issues that deserve special consideration. Annexes I and II to the *Principles and Guidelines* contain a discussion of issues relevant to bank exit and restructuring strategies and management of systemic financial crises, areas in which the Bank will continue to collaborate with the Fund and the international community to develop principles.

Following is brief summary of the key elements of the *Principles and Guidelines*:

8. *Role of enforcement systems.* A modern, credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. These systems must be designed to work in harmony. Commerce is a system of commercial relationships predicated on express or implied contractual agreements between an enterprise and a wide range of creditors and constituencies. Although commercial transactions have become increasingly complex as more sophisticated

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<sup>4</sup> Effective systems rest on details as well as broad principles. The Bank is preparing a companion technical paper with more detailed guidelines on aspects of this paper. Other organizations, specifically UNCITRAL (in collaboration with INSOL International and Committee J of the International Bar Association), are also developing guidelines to help legislators design effective insolvency laws.

techniques are developed for pricing and managing risks, the basic rights governing these relationships and the procedures for enforcing these rights have not changed much. These rights enable parties to rely on contractual agreements, fostering confidence that fuels investment, lending and commerce. Conversely, uncertainty about the enforceability of contractual rights increases the cost of credit to compensate for the increased risk of nonperformance or, in severe cases, leads to credit tightening.

9. *Legal framework for creditor rights.* A regularized system of credit should be supported by mechanisms that provide efficient, transparent and reliable methods for recovering debt, including seizure and sale of immovable and movable assets and sale or collection of intangible assets, such as debt owed to the debtor by third parties. An efficient system for enforcing debt claims is crucial to a functioning credit system, especially for unsecured credit. A creditor's ability to take possession of a debtor's property and to sell it to satisfy the debt is the simplest, most effective means of ensuring prompt payment. It is far more effective than the threat of an insolvency proceeding, which often requires a level of proof and a prospect of procedural delay that in all but extreme cases make it not credible to debtors as leverage for payment.
10. While much credit is unsecured and requires an effective enforcement system, an effective system for secured rights is especially important in developing countries. Secured credit plays an important role in industrial countries, notwithstanding the range of sources and types of financing available through both debt and equity markets. In some cases equity markets can provide cheaper and more attractive financing. But developing countries offer fewer options, and equity markets are typically less mature than debt markets. As a result most financing is in the form of debt. In markets with fewer options and higher risks, lenders routinely require security to reduce the risk of nonperformance and insolvency.
11. *Legal framework for secured lending.* The legal framework should provide for the creation, recognition and enforcement of security interests in all types of assets—movable and immovable, tangible and intangible, including inventories, receivables, proceeds and future property, and on a global basis, including both possessory and non-possessory interests. The law should encompass any or all of a debtor's obligations to a creditor, present or future and between all types of persons. In addition, it should provide for effective notice and registration rules to be adapted to all types of property, and clear rules of priority on competing claims or interests in the same assets.
12. *Legal framework for corporate insolvency.* Though approaches vary, effective insolvency systems should aim to:
  - Integrate with a country's broader legal and commercial systems.
  - Maximize the value of a firm's assets by providing an option to reorganize.
  - Strike a careful balance between liquidation and reorganization.
  - Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors.
  - Provide for timely, efficient and impartial resolution of insolvencies.
  - Prevent the premature dismemberment of the debtor's assets by individual creditors.
  - Provide a transparent procedure that contains incentives for gathering and dispensing information.
  - Recognize existing creditor rights and respect the priority of claims with a predictable and established process.
  - Establish a framework for cross-border insolvencies, with recognition of foreign proceedings.
13. Where an enterprise is not viable, the main thrust of the law should be swift and efficient liquidation to maximize recoveries for the benefit of creditors. Liquidations can include the preservation and sale of the business, as distinct from the legal entity. On the other hand, where an enterprise is viable, meaning it can be rehabilitated, its assets are often more valuable if retained in a rehabilitated

business than if sold in a liquidation. The rescue of a business preserves jobs, provides creditors with a greater return based on higher going concern values of the enterprise, potentially produces a return for owners and obtains for the country the fruits of the rehabilitated enterprise. The rescue of a business should be promoted through formal and informal procedures. Rehabilitation should permit quick and easy access to the process, protect all those involved, permit the negotiation of a commercial plan, enable a majority of creditors in favor of a plan or other course of action to bind all other creditors (subject to appropriate protections) and provide for supervision to ensure that the process is not subject to abuse. Modern rescue procedures typically address a wide range of commercial expectations in dynamic markets. Though such laws may not be susceptible to precise formulas, modern systems generally rely on design features to achieve the objectives outlined above.

14. *Framework for informal corporate workouts.* Corporate workouts should be supported by an environment that encourages participants to restore an enterprise to financial viability. Informal workouts are negotiated in the “shadow of the law.” Accordingly, the enabling environment must include clear laws and procedures that require disclosure of or access to timely and accurate financial information on the distressed enterprise; encourage lending to, investment in or recapitalization of viable distressed enterprises; support a broad range of restructuring activities, such as debt write-offs, reschedulings, restructurings and debt-equity conversions; and provide favorable or neutral tax treatment for restructurings.
15. A country’s financial sector (possibly with help from the central bank or finance ministry) should promote an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure—especially in markets where enterprise insolvency is systemic. An informal process is far more likely to be sustained where there are adequate creditor remedies and insolvency laws.
16. *Implementation of the insolvency system.* Strong institutions and regulations are crucial to an effective insolvency system. The insolvency framework has three main elements: the institutions responsible for insolvency proceedings, the operational system through which cases and decisions are processed and the requirements needed to preserve the integrity of those institutions—recognizing that the integrity of the insolvency system is the linchpin for its success. A number of fundamental principles influence the design and maintenance of the institutions and participants with authority over insolvency proceedings.
17. *Ongoing efforts.* Substantial progress has been made in identifying links between the corporate insolvency and creditor rights systems and bank insolvency (and restructuring) and financial crisis, and the policy issues affecting the treatment of the later. Over the coming months the Bank in collaboration with the Fund and others will engage the international community in a dialogue on principles pertaining to bank and systemic insolvency. In addition, the Bank will continue to work with its partner institutions, including UNCITRAL, on the implementation of more technical guidelines based on the principles.
18. *Next Steps.* The Bank will carry out a series of pilot country assessments in FY2001-02 in connection with the program to develop *Reports on the Observance of Standards and Codes* (ROSC), using a common template based on the principles. The criteria for the selection of countries will include regional and legal diversity and levels of financial system development. The assessments would be carried out by Bank staff supported by experts from other institutions. The assessments are expected to provide valuable inputs to future *Financial Sector Assessments*, *Country Assistance Strategies* and other Bank economic and sector work, and to eventually help governments prioritize reform needs and build capacity. The Bank will also continue to collaborate with the International Monetary fund and other organizations on the future development of complementary principles related to bank insolvency and restructuring and systemic insolvency.

## THE PRINCIPLES

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<b>LEGAL FRAMEWORK FOR CREDITOR RIGHTS</b>	
<b>Principle 1</b>	<p><b>Compatible Enforcement Systems</b></p> <p><i>A modern credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. These systems must be designed to work in harmony.</i></p>
<b>Principle 2</b>	<p><b>Enforcement of Unsecured Rights</b></p> <p><i>A regularized system of credit should be supported by mechanisms that provide efficient, transparent, reliable and predictable methods for recovering debt, including seizure and sale of immovable and movable assets and sale or collection of intangible assets such as debts owed to the debtor by third parties.</i></p>
<b>Principle 3</b>	<p><b>Security Interest Legislation</b></p> <p><i>The legal framework should provide for the creation, recognition, and enforcement of security interests in movable and immovable (real) property, arising by agreement or operation of law. The law should provide for the following features:</i></p> <ul style="list-style-type: none"> <li>▪ <i>Security interests in all types of assets, movable and immovable, tangible and intangible, including inventory, receivables, and proceeds; future or after-acquired property, and on a global basis; and based on both possessory and non-possessory interests;</i></li> <li>▪ <i>Security interests related to any or all of a debtor's obligations to a creditor, present or future, and between all types of persons;</i></li> <li>▪ <i>Methods of notice that will sufficiently publicize the existence of security interests to creditors, purchasers, and the public generally at the lowest possible cost;</i></li> <li>▪ <i>Clear rules of priority governing competing claims or interests in the same assets, eliminating or reducing priorities over security interests as much as possible.</i></li> </ul>
<b>Principle 4</b>	<p><b>Recording and Registration of Secured Rights</b></p> <p><i>There should be an efficient and cost-effective means of publicizing secured interests in movable and immovable assets, with registration being the principal and strongly preferred method. Access to the registry should be inexpensive and open to all for both recording and search.</i></p>
<b>Principle 5</b>	<p><b>Enforcement of Secured Rights</b></p> <p><i>Enforcement systems should provide efficient, inexpensive, transparent and predictable methods for enforcing a security interest in property. Enforcement procedures should provide for prompt realization of the rights obtained in secured assets, ensuring the maximum possible recovery of asset values based on market values. Both nonjudicial and judicial enforcement methods should be considered</i></p>
<b>LEGAL FRAMEWORK FOR CORPORATE INSOLVENCY</b>	
<b>Principle 6</b>	<p><b>Key Objectives and Policies</b></p> <p><i>Though country approaches vary, effective insolvency systems should aim to:</i></p> <ul style="list-style-type: none"> <li>• <i>Integrate with a country's broader legal and commercial systems.</i></li> <li>• <i>Maximize the value of a firm's assets by providing an option to reorganize.</i></li> <li>• <i>Strike a careful balance between liquidation and reorganization.</i></li> <li>• <i>Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors.</i></li> <li>• <i>Provide for timely, efficient and impartial resolution of insolvencies.</i></li> <li>• <i>Prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments.</i></li> <li>• <i>Provide a transparent procedure that contains incentives for gathering and dispensing information.</i></li> <li>• <i>Recognize existing creditor rights and respect the priority of claims with a predictable and established process.</i></li> <li>• <i>Establish a framework for cross-border insolvencies, with recognition of foreign proceedings.</i></li> </ul>



<b>Principle 7</b>	<b>Director and Officer Liability</b> <i>Director and officer liability for decisions detrimental to creditors made when an enterprise is insolvent should promote responsible corporate behavior while fostering reasonable risk taking. At a minimum, standards should address conduct based on knowledge of or reckless disregard for the adverse consequences to creditors.</i>
<b>Principle 8</b>	<b>Liquidation and Rehabilitation</b> <i>An insolvency law should provide both for efficient liquidation of nonviable businesses and those where liquidation is likely to produce a greater return to creditors, and for rehabilitation of viable businesses. Where circumstances justify it, the system should allow for easy conversion of proceedings from one procedure to another.</i>
<b>Principle 9</b>	<b>Commencement: Applicability and Accessibility</b> <i>A. The insolvency process should apply to all enterprises or corporate entities except financial institutions and insurance corporations, which should be dealt with through a separate law or through special provisions in the insolvency law. State-owned corporations should be subject to the same insolvency law as private corporations.</i> <i>B. Debtors should have easy access to the insolvency system upon showing proof of basic criteria (insolvency or financial difficulty). A declaration to that effect may be provided by the debtor through its board of directors or management. Creditor access should be conditioned on showing proof of insolvency by presumption where there is clear evidence that the debtor failed to pay a matured debt (perhaps of a minimum amount).</i> <i>C. The preferred test for insolvency should be the debtor's inability to pay debts as they come due—known as the liquidity test. A balance sheet test may be used as an alternative secondary test, but should not replace the liquidity test. The filing of an application to commence a proceeding should automatically prohibit the debtor's transfer, sale or disposition of assets or parts of the business without court approval, except to the extent necessary to operate the business.</i>
<b>Principle 10</b>	<b>Commencement: Moratoriums and Suspension of Proceedings</b> <i>A. The commencement of bankruptcy should prohibit the unauthorized disposition of the debtor's assets and suspend actions by creditors to enforce their rights or remedies against the debtor or the debtor's assets. The injunctive relief (stay) should be as wide and all embracing as possible, extending to an interest in property used, occupied or in the possession of the debtor.</i> <i>B. To maximize the value of asset recoveries, a stay on enforcement actions by secured creditors should be imposed for a limited period in a liquidation proceeding to enable higher recovery of assets by sale of the entire business or its productive units, and in a rehabilitation proceeding where the collateral is needed for the rehabilitation.</i>
<b>Principle 11</b>	<b>Governance: Management</b> <i>A. In liquidation proceedings, management should be replaced by a qualified court-appointed official (administrator) with broad authority to administer the estate in the interest of creditors. Control of the estate should be surrendered immediately to the administrator except where management has been authorized to retain control over the company, in which case the law should impose the same duties on management as on the administrator. In creditor-initiated filings, where circumstances warrant, an interim administrator with reduced duties should be appointed to monitor the business to ensure that creditor interests are protected.</i> <i>B. There are two preferred approaches in a rehabilitation proceeding: exclusive control of the proceeding by an independent administrator or supervision of management by an impartial and independent administrator or supervisor. Under the second option complete power should be shifted to the administrator if management proves incompetent or negligent or has engaged in fraud or other misbehavior. Similarly, independent administrators or supervisors should be held to the same standard of accountability to creditors and the court and should be subject to removal for incompetence, negligence, fraud or other wrongful conduct.</i>

<b>Principle 12</b>	<b>Governance: Creditors and the Creditors' Committee</b>
	<i>Creditor interests should be safeguarded by establishing a creditors committee that enables creditors to actively participate in the insolvency process and that allows the committee to monitor the process to ensure fairness and integrity. The committee should be consulted on non-routine matters in the case and have the ability to be heard on key decisions in the proceedings (such as matters involving dispositions of assets outside the normal course of business). The committee should serve as a conduit for processing and distributing relevant information to other creditors and for organizing creditors to decide on critical issues. The law should provide for such things as a general creditors assembly for major decisions, to appoint the creditors committee and to determine the committee's membership, quorum and voting rules, powers and the conduct of meetings. In rehabilitation proceedings, the creditors should be entitled to select an independent administrator or supervisor of their choice, provided the person meets the qualifications for serving in this capacity in the specific case.</i>
<b>Principle 13</b>	<b>Administration: Collection, Preservation, Disposition of Property</b>
	<i>The law should provide for the collection, preservation and disposition of all property belonging to the debtor, including property obtained after the commencement of the case. Immediate steps should be taken or allowed to preserve and protect the debtor's assets and business. The law should provide a flexible and transparent system for disposing of assets efficiently and at maximum values. Where necessary, the law should allow for sales free and clear of security interests, charges or other encumbrances, subject to preserving the priority of interests in the proceeds from the assets disposed.</i>
<b>Principle 14</b>	<b>Administration: Treatment of Contractual Obligations</b>
	<i>The law should allow for interference with contractual obligations that are not fully performed to the extent necessary to achieve the objectives of the insolvency process, whether to enforce, cancel or assign contracts, except where there is a compelling commercial, public or social interest in upholding the contractual rights of the counter-party to the contract (as with swap agreements).</i>
<b>Principle 15</b>	<b>Administration: Fraudulent or Preferential Transactions</b>
	<i>The law should provide for the avoidance or cancellation of pre-bankruptcy fraudulent and preferential transactions completed when the enterprise was insolvent or that resulted in its insolvency. The suspect period prior to bankruptcy, during which payments are presumed to be preferential and may be set aside, should normally be short to avoid disrupting normal commercial and credit relations. The suspect period may be longer in the case of gifts or where the person receiving the transfer is closely related to the debtor or its owners.</i>
<b>Principle 16</b>	<b>Claims Resolution: Treatment of Stakeholder Rights and Priorities</b>
	<p data-bbox="431 1310 1455 1486"><i>A. The rights and priorities of creditors established prior to insolvency under commercial laws should be upheld in an insolvency case to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationships. Deviations from this general rule should occur only where necessary to promote other compelling policies, such as the policy supporting rehabilitation or to maximize the estate's value. Rules of priority should support incentives for creditors to manage credit efficiently.</i></p> <p data-bbox="431 1493 1455 1770"><i>B. The bankruptcy law should recognize the priority of secured creditors in their collateral. Where the rights of secured creditors are impaired to promote a legitimate bankruptcy policy, the interests of these creditors in their collateral should be protected to avoid a loss or deterioration in the economic value of their interest at the commencement of the case. Distributions to secured creditors from the proceeds of their collateral should be made as promptly as possible after realization of proceeds from the sale. In cases where the stay applies to secured creditors, it should be of limited specified duration, strike a proper balance between creditor protection and insolvency objectives, and provide for the possibility of orders being made on the application of affected creditors or other persons for relief from the stay.</i></p> <p data-bbox="431 1776 1455 1925"><i>C. Following distributions to secured creditors and payment of claims related to costs and expenses of administration, proceeds available for distribution should be distributed pari passu to remaining creditors unless there are compelling reasons to justify giving preferential status to a particular debt. Public interests generally should not be given precedence over private rights. The number of priority classes should be kept to a minimum.</i></p>

<b>FEATURES PERTAINING TO CORPORATE REHABILITATION</b>	
<b>Principle 17</b>	<p><b>Design Features of Rehabilitation Statutes</b></p> <p><i>To be commercially and economically effective, the law should establish rehabilitation procedures that permit quick and easy access to the process, provide sufficient protection for all those involved in the process, provide a structure that permits the negotiation of a commercial plan, enable a majority of creditors in favor of a plan or other course of action to bind all other creditors by the democratic exercise of voting rights (subject to appropriate minority protections and the protection of class rights) and provide for judicial or other supervision to ensure that the process is not subject to manipulation or abuse.</i></p>
<b>Principle 18</b>	<p><b>Administration: Stabilizing and Sustaining Business Operations</b></p> <p><i>The law should provide for a commercially sound form of priority funding for the ongoing and urgent business needs of a debtor during the rescue process, subject to appropriate safeguards.</i></p>
<b>Principle 19</b>	<p><b>Information: Access and Disclosure</b></p> <p><i>The law should require the provision of relevant information on the debtor. It should also provide for independent comment on and analysis of that information. Directors of a debtor corporation should be required to attend meetings of creditors. Provision should be made for the possible examination of directors and other persons with knowledge of the debtor's affairs, who may be compelled to give information to the court and administrator..</i></p>
<b>Principle 20</b>	<p><b>Plan: Formulation, Consideration and Voting</b></p> <p><i>The law should not prescribe the nature of a plan except in terms of fundamental requirements and to prevent commercial abuse. The law may provide for classes of creditors for voting purposes. Voting rights should be determined by amount of debt. An appropriate majority of creditors should be required to approve a plan. Special provision should be made to limit the voting rights of insiders. The effect of a majority vote should be to bind all creditors.</i></p>
<b>Principle 21</b>	<p><b>Plan: Approval of Plan</b></p> <p><i>The law should establish clear criteria for plan approval based on fairness to similar creditors, recognition of relative priorities and majority acceptance. The law should also provide for approval over the rejection of minority creditors if the plan complies with rules of fairness and offers the opposing creditors or classes an amount equal to or greater than would be received under a liquidation proceeding. Some provision for possible adjournment of a plan decision meeting should be made, but under strict time limits. If a plan is not approved, the debtor should automatically be liquidated.</i></p>
<b>Principle 22</b>	<p><b>Plan: Implementation and Amendment</b></p> <p><i>The law should provide a means for monitoring effective implementation of the plan, requiring the debtor to make periodic reports to the court on the status of implementation and progress during the plan period. A plan should be capable of amendment (by vote of the creditors) if it is in the interests of the creditors. The law should provide for the possible termination of a plan and for the debtor to be liquidated.</i></p>
<b>Principle 23</b>	<p><b>Discharge and Binding Effects</b></p> <p><i>To ensure that the rehabilitated enterprise has the best chance of succeeding, the law should provide for a discharge or alteration of debts and claims that have been discharged or otherwise altered under the plan. Where approval of the plan has been procured by fraud, the plan should be subject to challenge, reconsidered or set aside.</i></p>
<b>Principle 24</b>	<p><b>International Considerations</b></p> <p><i>Insolvency proceedings may have international aspects, and insolvency laws should provide for rules of jurisdiction, recognition of foreign judgments, cooperation and assistance among courts in different countries, and choice of law.</i></p>

<b>INFORMAL CORPORATE WORKOUTS AND RESTRUCTURINGS</b>	
<b>Principle 25</b>	<p><b>Enabling Legislative Framework</b></p> <p><i>Corporate workouts and restructurings should be supported by an enabling environment that encourages participants to engage in consensual arrangements designed to restore an enterprise to financial viability. An enabling environment includes laws and procedures that require disclosure of or ensure access to timely, reliable and accurate financial information on the distressed enterprise; encourage lending to, investment in or recapitalization of viable financially distressed enterprises; support a broad range of restructuring activities, such as debt writeoffs, reschedulings, restructurings and debt- equity conversions; and provide favorable or neutral tax treatment for restructurings.</i></p>
<b>Principle 26</b>	<p><b>Informal Workout Procedures</b></p> <p><i>A country's financial sector (possibly with the informal endorsement and assistance of the central bank or finance ministry) should promote the development of a code of conduct on an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure—especially in markets where enterprise insolvency has reached systemic levels. An informal process is far more likely to be sustained where there are adequate creditor remedy and insolvency laws. The informal process may produce a formal rescue, which should be able to quickly process a packaged plan produced by the informal process. The formal process may work better if it enables creditors and debtors to use informal techniques.</i></p>
<b>IMPLEMENTATION OF THE INSOLVENCY SYSTEM</b>	
<b>Principle 27</b>	<p><b>Role of Courts</b></p> <p><i>Bankruptcy cases should be overseen and disposed of by an independent court or competent authority and assigned, where practical, to judges with specialized bankruptcy expertise. Significant benefits can be gained by creating specialized bankruptcy courts.</i></p> <p><i>The law should provide for a court or other tribunal to have a general, non-intrusive, supervisory role in the rehabilitation process. The court/tribunal or regulatory authority should be obliged to accept the decision reached by the creditors that a plan be approved or that the debtor be liquidated.</i></p>
<b>Principle 28</b>	<p><b>Performance Standards of the Court, Qualification and Training of Judges</b></p> <p><i>Standards should be adopted to measure the competence, performance and services of a bankruptcy court. These standards should serve as a basis for evaluating and improving courts. They should be enforced by adequate qualification criteria as well as training and continuing education for judges.</i></p>
<b>Principle 29</b>	<p><b>Court Organization</b></p> <p><i>The court should be organized so that all interested parties—including the administrator, the debtor and all creditors—are dealt with fairly, objectively and transparently. To the extent possible, publicly available court operating rules, case practice and case management regulations should govern the court and other participants in the process. The court's internal operations should allocate responsibility and authority to maximize resource use. To the degree feasible the court should institutionalize, streamline and standardize court practices and procedures.</i></p>
<b>Principle 30</b>	<p><b>Transparency and Accountability</b></p> <p><i>An insolvency systems should be based on transparency and accountability. Rules should ensure ready access to court records, court hearings, debtor and financial data and other public information.</i></p>
<b>Principle 31</b>	<p><b>Judicial Decision making and Enforcement</b></p> <p><i>Judicial decision making should encourage consensual resolution among parties where possible and otherwise undertake timely adjudication of issues with a view to reinforcing predictability in the system through consistent application of the law. The court must have clear authority and effective methods of enforcing its judgments.</i></p>

<b>Principle 32</b>	<b>Integrity of the Court</b> <i>Court operations and decisions should be based on firm rules and regulations to avoid corruption and undue influence. The court must be free of conflicts of interest, bias and lapses in judicial ethics, objectivity and impartiality.</i>
<b>Principle 33</b>	<b>Integrity of Participants</b> <i>Persons involved in a bankruptcy proceeding must be subject to rules and court orders designed to prevent fraud, other illegal activity or abuse of the bankruptcy system. In addition, the bankruptcy court must be vested with appropriate powers to deal with illegal activity or abusive conduct that does not constitute criminal activity.</i>
<b>Principle 34</b>	<b>Role of Regulatory or Supervisory Bodies</b> <i>The body or bodies responsible for regulating or supervising insolvency administrators should be independent of individual administrators and should set standards that reflect the requirements of the legislation and public expectations of fairness, impartiality, transparency and accountability.</i>
<b>Principle 35</b>	<b>Competence and Integrity of Insolvency Administrators</b> <i>Insolvency administrators should be competent to exercise the powers given to them and should act with integrity, impartiality and independence.</i>

## 1. ROLE OF ENFORCEMENT SYSTEMS (PRINCIPLE 1)

19. **Principle 1: Effective and compatible enforcement systems.** *A modern, credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. These systems must be designed to work in harmony.* Predictable, transparent and affordable enforcement systems play a vital role in stabilizing commercial relationships and financial systems, ensuring responsible corporate behavior and providing a means of rehabilitation or efficient exit for uncompetitive enterprises. This section addresses important points that follow from this principle to place in context the discussion in later sections, such as the relationship between enforcement and insolvency systems and policies that promote investment and credit, the need to balance policies that promote investment and credit with other important social objectives (salvaging viable enterprises, preserving employment), and the promotion of investor confidence through transparent, accountable and predictable systems.
20. *Enforcement and insolvency systems stabilize commercial relationships* by enabling market participants to more accurately price, manage and control risks of default and corporate failure. Enforcement systems provide a vehicle for resolving individual disputes between creditors and debtors, while insolvency procedures offer a means for collective resolutions when performance failures raise questions about an enterprise's viability. An insolvency system stands in the divide between the financial and corporate sectors as a disciplinary mechanism for both. An effective insolvency process encourages prudent lending and a sound credit culture by:
- Establishing a mechanism (such as rehabilitation) for the financial restructuring of firms whose going-concern value exceeds their liquidation value, thus preserving both value and employment.
  - Providing an orderly exit mechanism for failed enterprises, ending unproductive uses of business assets and transferring them to more efficient market participants (say, through liquidation).
  - Providing a final and equitable debt collection mechanism for creditors.
  - Improving the enforcement of creditor rights to expand credit flows.
21. Insolvency law affects parties and interests at every level of a society, in almost every context and in a variety of ways—some of them subtle and indirect. In economically advanced societies involving the intensive exploitation of credit or capital investment in increasingly sophisticated forms, the significance of insolvency is correspondingly magnified. Although laws on individual debtor-creditor relationships outside insolvency may appear distinct from the collectivized regimes that operate in the event of either party's insolvency, there are important connections between them. Thus the efficiency and effectiveness of the procedures for individual enforcement by creditors can have a vital bearing on a jurisdiction's approach to insolvency procedures with respect to the creditors' debtors. For example, stringent enforcement of individual debts can be balanced by the availability of insolvency proceedings to assist companies in temporary difficulty. On the other hand, insolvency law should limit adjustments of rights and interests previously established outside insolvency so as to maintain legitimate pre-existing expectations. Prominent among these is the ability of various types of security to remain effective relative to the encumbered assets despite the commencement of formal insolvency proceedings against a debtor. So, while the components of non-insolvency and insolvency law are important in themselves, an evaluation of either would be incomplete—and misleading—without reference to the other.
22. The existence or perception of weak creditor rights influences a creditor's approach to all stages of commercial relationships. Conversely, creditors who perceive that insolvency will reinforce their economic rights will exploit the process to their advantage. Thus, for example, an insolvency law that is too difficult for creditors to invoke or that too much favors debtors will tend to reduce availability of credit and raise its cost, while an insolvency law that is too easy to invoke or too harsh is subject to creditor abuse.

23. The stability of the credit culture can be undermined by imbalances in the debtor-creditor relationship. At a purely domestic level, each state can balance the interests of debtors and creditors in a way that is appropriate for the commercial relationships conducted in its markets. But such self-contained solutions cannot be readily maintained in the context of globalized commercial activities involving parties from different systems. Flexibility is essential, reflecting the challenges and responsibilities of participating in international commerce.
24. *Enforcement and insolvency systems promote responsible corporate behavior.* An effective system for enforcing creditor rights and managing business insolvency encourages high standards of corporate governance, including financial discipline. In this way, important social objectives are advanced—including the maintenance of public confidence in the corporate and financial sectors. General corporate law governs managers’ behavior prior to insolvency, but it is superseded by insolvency law at the point of insolvency or when insolvency is declared.
25. Incompetent or negligent managers may be sanctioned or divested of their duties under both non-bankruptcy and bankruptcy procedures, such as through the appointment of a receiver, bankruptcy administrator or trustee. Under the more exacting provisions of insolvency law, conduct and transactions that occurred before the start of formal insolvency proceedings (in some cases, several years before) can be reexamined in light of what subsequently transpired. Not only may certain transactions be impeachable (even at the expense of disrupting commercial certainty), but managers may be held personally responsible for part of the company’s losses. In serious cases, managers may even be subject to criminal liability and possibly barred from managing companies for a prescribed period. These sanctions—whose elements and operation vary considerably from system to system—supply a necessary backbone to the proposition that the limited liability and greater access to credit enjoyed by companies are balanced by corresponding responsibilities imposed to maintain public confidence in the credit culture in which companies operate.
26. *Insolvency systems provide an efficient exit mechanism for unprofitable businesses and help rehabilitate viable ones.* Insolvency procedures are a way of dealing with the casualties of competition in markets. When businesses are incapable of competing profitably, the logical move is to provide a means for their voluntary dissolution or exit from the market. Company laws often contain voluntary exit procedures, but such procedures are generally accessible only for solvent companies that can repay their debts from assets liquidated in the windup of the business. These laws should coexist alongside formal insolvency procedures.
27. When an enterprise cannot repay its obligations as they come due or cannot raise enough money from asset sales to repay all its obligations, assumptions about enterprise activity, governance and ownership change. When a distressed or insolvent enterprise is unable to uphold commercial agreements, market confidence falls. This situation should be resolved through a collective procedure that ensures prompt resolution and maximum recovery by creditors. This procedure must be flexible enough to provide a range of options, including rehabilitation for viable enterprises and liquidation for non-viable enterprises. Liquidation can occur by selling the business as a going concern, in productive units or through the more conventional sale of assets. Alternatives to outright liquidation may vary in terms of formality and degree of involvement of courts and other official agencies, but they share the common goal of giving the debtor an opportunity to exit from relative (or even absolute) insolvency and to enjoy the prospect of a more balanced existence for the future. For the honest casualties of competition, then, the insolvency process provides a means for being rehabilitated or an exit mechanism to quickly transfer assets and businesses to more efficient market participants.
28. **Balancing credit and rehabilitation policies.** One of this report’s key themes is the importance of meeting creditor expectations to maintain confidence in the market. This goal finds expression in

many aspects of enforcement and insolvency procedures. Among creditors, a pivotal question involves the ranking of claims and whether creditors with senior rights (such as secured creditors and title retention holders) will be able to enforce those rights without restraint. Policies encouraging strong creditor rights often collide with policies supporting the sale of businesses as productive units, or with policies for rescue or rehabilitation of financially distressed but viable enterprises. The rehabilitation policy emphasizes maximizing asset values for all creditors and salvaging jobs where possible. The policy supporting stronger rights for secured creditors must be balanced with policies affecting other creditors and with policies that encourage rehabilitation.

29. A growing trend supports the rights of secured creditors in the context of bankruptcy, while another trend is eroding priorities among other classes of creditors. It may seem odd to argue that priorities in insolvency should generally be abolished or limited while security interests—the most important priority of all—should be made more enforceable. The reason is that many other priorities are related to social welfare, for which the insolvency priority affords a minor and inadequate remedy while rendering the insolvency process much less effective. The security interest priority, by contrast, is directly linked to economic growth and is widely believed to contribute to growth. At the same time, a system of enforceable secured credit must be carefully balanced, because it contains an inherent tension. On the one hand, security makes credit available to debtors who otherwise could not obtain it, promoting entrepreneurial activity. On the other hand, security tends to tie the hands of entrepreneurs by reducing their control over their business assets, and it tends to raise the cost of unsecured credit because giving priority to secured credit forces the unsecured credit to bear a higher risk of nonpayment or nonperformance. An enforceable system of secured credit in an effective insolvency system seeks to maximize the benefits and minimize the costs.
30. An effective system of secured credit must also be balanced by a voluntary rehabilitation procedure for debtors in insolvency law, including an effective moratorium on secured creditors for purposes of reorganization. As with an efficient system of judgment enforcement, an effective secured credit enforcement system coupled with an effective reorganization law can be relied upon by secured creditors as one means of achieving predictable results more efficiently. The secured creditor's decision to enforce its interest is fully credible, so the debtor must either pay or file for reorganization, putting its affairs before the court and protecting other creditors through the public notice of an insolvency filing.
31. The larger point about rehabilitation as a balance to secured credit is that it encourages entrepreneurs to take risks. If secured parties are given too much power over debtors, entrepreneurs may be reluctant to start new businesses, and the disincentives imposed by risk-adverse secured creditors may hamper economic success. A long-term solution is the development of an efficient capital market that allows successful entrepreneurs to raise equity capital and to borrow unsecured. A more immediate balance can be achieved through a reorganization procedure that offers debtors a chance to save a business in temporary trouble, with the concurrent protection of creditors under court supervision. Effective enforcement for secured creditors coupled with effective protection for a rescue effort under insolvency law strikes an appropriate balance between debtors and creditors and gives both a strong incentive to negotiate reasonable resolutions without litigation.
32. There is a broader point about the relationship between effective secured credit systems and effective bankruptcy systems. A secured credit system can serve as a rehabilitation process. If the system encourages one creditor (typically a bank) to obtain a lien on all the assets of a debtor, that creditor can effectively become a partner in the business. In commercial cultures that permit greater secured creditor power (such as the United Kingdom), the expectation is that the secured creditor will have extensive information about the condition of the business and will provide funds as long as is reasonably prudent to prevent its failure. Thus, in such cultures, when the lender “calls in the receivers,” it may be generally accepted that the business is no longer viable and should be liquidated.



In the United Kingdom, for example, administrative receivers are frequently successful in improving the business and “hiving” it down to a specially formed subsidiary that can be sold as a clean company with assets but no liabilities. A system that adopts this approach may rely to a lesser extent on rehabilitation procedures under insolvency law. Rehabilitation systems are still required, however, to treat those financial casualties whose assets are not fully or substantially secured by a single creditor and where the procedures for rehabilitation provide a more desirable outcome for all parties concerned. At the same time, reinforcing one creditor’s rights obviously also creates the risk of exposing the debtor to that creditor’s economic pressure or even whims. Policymakers should leave the choice to market participants and the circumstances by making available both options, taking into account the particular conditions and needs of the system in question.

33. Finally, as with nearly all law development efforts, reform of one element should not occur without considering other parts of the system. This is true for the security system and the insolvency system, neither of which can be viewed in isolation. The insolvency process is an extension of the enforcement options available to creditors—but one that should be triggered in cases of insolvency or when a credit impact encompasses more than a dispute between two parties. The risk of insolvency is one of the risks of nonperformance. As such, secured lenders will take into account their rights in insolvency as part of their overall risk assessment in pricing a credit and determining the level of security needed to ensure full recovery. Inconsistencies and mismatches in the treatment of rights will lead to distortions in the application of these procedures, with potential for considerably increasing financing costs to offset insolvency risks. An event of insolvency or the commencement of an insolvency proceeding should have no bearing on the existence or priority of the secured interest. To the extent possible, insolvency laws should aim to provide a fair balance that respects secured interests and treats them in a way that promotes stable financial systems and credit markets.
34. **Transparency, accountability and corporate governance.** Minimum standards of transparency and corporate governance should be established to foster communication and cooperation. Disclosure of basic information—including financial statements, operating statistics and detailed cash flows—is recommended for sound risk assessment. Accounting and auditing standards should be compatible with international best practices so that creditors can assess credit risk and monitor a debtor’s financial viability. A predictable, reliable legal framework and judicial process are needed to implement reforms, ensure fair treatment of all parties and deter unacceptable practices. Corporate law and regulation should guide the conduct of the borrower’s shareholders. A corporation’s board of directors should be responsible, accountable and independent of management, subject to best practices on corporate governance. The law should be imposed impartially and consistently.
35. Transparency and good corporate governance are the cornerstones of a strong lending system and corporate sector. Transparency exists when information is assembled and made readily available to other parties and, when combined with the good behavior of “corporate citizens,” creates an informed and communicative environment conducive to greater cooperation among all parties. Transparency and corporate governance are especially important in emerging markets, which are more sensitive to volatility from external factors. Without transparency, there is a greater likelihood that loan pricing will not reflect underlying risks, leading to higher interest rates and other charges.
36. Transparency and strong corporate governance are needed in both domestic and cross-border transactions and at all phases of investment—at the inception when making a loan, when managing exposure while the loan is outstanding, and especially once a borrower’s financial difficulties become apparent and the lender is seeking to exit the loan. Lenders require confidence in their investment, and confidence can be provided only through ongoing monitoring, whether before or during a restructuring or after a reorganization plan has been implemented.

37. From a borrower's perspective, the continuous evolution in financial markets is evidenced by changes in participants, financial instruments and the complexity of the corporate environment. Besides traditional commercial banks, today's creditor (including foreign creditors) is as likely to be a lessor, an investment bank, a hedge fund, an institutional investor (such as an insurance company or pension fund), an investor in distressed debt, or a provider of treasury services or capital markets products. In addition, sophisticated financial instruments such as interest rate, currency and credit derivatives have become more common. Although such instruments are intended to reduce risk, in times of market volatility they may increase a borrower's risk profile, adding intricate issues of netting and monitoring of settlement risk exposure. Complex financial structures and financing techniques may enable a borrower to leverage in the early stages of a loan. But sensitivity to external factors, such as the interest rate environment in a developing economy, may be magnified by leverage and translate into greater overall risk.
38. From a lender's perspective, once it is apparent that a firm is experiencing financial difficulties and approaching insolvency, a creditor's primary goal is to maximize the value of the borrower's assets in order to obtain the highest debt repayment. A lender's support of an exit plan, whether through reorganization and rehabilitation or liquidation, depends on the quality of the information flow. To restructure a company's balance sheet, the lender must be in a position to prudently determine the feasibility of extending final maturity, extending the amortization schedule, deferring interest, refinancing, or converting debt to equity, while alternatively or concurrently encouraging the sale of non-core assets and closing unprofitable operations. The enterprise's indicative value should be determined to assess the practicality of its sale, divestiture, or sale of controlling equity interest. Values must be established on both a going-concern and liquidation basis to confirm the best route to recovering the investment. And asset disposal plans, whether for liquidity replenishment or debt reduction, need to be substantiated through valuations of encumbered or unencumbered assets, taking into account where the assets are located and the ease and cost of access. All these efforts and the maximization of value depend on and are enhanced by transparency.
39. Transparency increases confidence in decision making and so encourages the use of out-of-court restructuring options. Such options are preferable because they often provide higher returns to lenders than straight liquidation through the legal process—and because they avoid the costs, complexities and uncertainties of the legal process. In many developing countries it is hard to obtain reliable data for a thorough risk assessment. Indeed, it may be too costly to obtain the quantity and quality of information required in industrial countries. Still, efforts should be made to increase transparency.
40. **Predictability.** Investment in emerging markets is discouraged by the lack of well-defined and predictable risk allocation rules and by the inconsistent application of written laws. Moreover, during systemic crises investors often demand uncertainty risk premiums too onerous to permit markets to clear. Some investors may avoid emerging markets entirely despite expected returns that far outweigh known risks. Rational lenders will demand risk premiums to compensate for systemic uncertainty in making, managing and collecting investments in emerging markets. The likelihood that creditors will have to rely on risk allocation rules increases as fundamental factors supporting investment deteriorate. That is because risk allocation rules set minimum standards that have considerable application in limiting downside uncertainty, but that usually do not enhance returns in non-distressed markets (particularly for fixed-income investors). During actual or perceived systemic crises, lenders tend to concentrate on reducing risk, and risk premiums soar. At these times the inability to predict downside risk can cripple markets. The effect can impinge on other risks in the country, causing lender reluctance even toward untroubled borrowers.
41. Lenders in emerging markets demand compensation for a number of procedural uncertainties. First, information on local rules and enforcement is often asymmetrically known. There is a widespread perception among lenders that indigenous stakeholders can manipulate procedures to their advantage,

and often benefit from fraud and favoritism. Second, the absence or perceived ineffectiveness of corporate governance raises concerns about the diversion of capital, the undermining of security interests, or waste. Third, the extent to which non-insolvency laws recognize contractual rights can be unpredictable, leaving foreign creditors in the sorry state of not having bought what they thought they bought. Fourth, the enforcement of creditor rights may be disproportionately demanding of time and money. Many creditors simply are not willing (or do not have the mandate) to try to improve returns if the enforcement process has an unpredictable outcome. In the end, a procedure unfriendly to investors but consistently applied may be preferred by lenders to uncertainty, because it provides a framework for managing risk through price adjustment.

42. Moreover, emerging markets appear to be particularly susceptible to rapid changes in the direction and magnitude of capital flows. The withdrawal of funds can overwhelm fundamental factors supporting valuation, and (as in the summer of 1998) creditors may race to sell assets to preserve value and reduce leverage. As secondary market liquidity disappears and leverage is unwound, valuation falls further in a self-reinforcing spiral. In industrial countries there is usually a class of creditor willing to make speculative investments in distressed assets and provide a floor to valuation. In theory such creditors also exist in emerging markets. But in practice, dedicated distressed players are scarce and tend to have neither the funds nor the inclination to replace capital withdrawn by more ordinary creditors. Non-dedicated creditors often fail to redirect capital and make up the investment deficit, partly because the learning curve in emerging markets is so steep, but also because of uncertainty about risk allocation rules. The result? Markets fail because there are no buyers for the price at which sellers not forced to liquidate simply hold and hope. If risk allocation rules were more certain, both dedicated and non-dedicated emerging market creditors would feel more comfortable injecting fresh capital in times of stress. In addition, sellers would feel more comfortable that they were not leaving money on the table by selling.
43. Relative to industrial countries, developing countries typically have weaker legal, institutional and regulatory safeguards to give lenders (domestic and foreign) confidence that investments can be monitored or that creditors' rights will be enforced, particularly for debt collection. In general, a borrower's operational, financial and investment activities are not transparent to creditors. Substantial uncertainty exists on the substance and practical application of contract law, insolvency law and corporate governance rules. And creditors perceive that they lack sufficient information and control over the process used to enforce obligations and collect debts. The lack of transparency and certainty erodes confidence among foreign creditors and undermines their willingness to extend credit.
44. In the absence of sufficient and predictable laws and procedures, foreign creditors tend to extend funds only in return for unnecessarily high risk premiums. In times of crisis they may withdraw financial support altogether. Developing countries would benefit substantially if creditor rights and insolvency systems were clarified and applied in a consistent and fully disclosed manner.

## **2. LEGAL FRAMEWORK FOR CREDITOR RIGHTS**

### **2.1 Enforcement of Unsecured Rights (Principle 2)**

45. *A regularized system of credit should be supported by mechanisms that provide efficient, transparent, reliable and predictable methods for recovering debt, including seizure and sale of immovable and movable assets and sale or collection of intangible assets such as debts owed to the debtor by third parties.* Efficient enforcement of judgments is crucial to a functioning credit system, especially for unsecured credit. While the seizure of immovable or movable assets to pay debts often may not be necessary, it is the ultimate threat to a recalcitrant debtor to pay what is owed. It is far more effective than the threat of an involuntary insolvency proceeding, which in many systems requires a level of proof and a prospect of procedural delay that in all but extreme cases make the threat of bankruptcy

less credible to debtors as leverage for payment.<sup>5</sup> By contrast, the leverage that arises from the prospect of having specific property (such as land, bank accounts or inventory) seized to pay a judgment will cause a debtor who can make payment to do so rather than suffer the humiliation and considerable cost of seizure.

46. If the debtor is unable to pay, the existence of an efficient debt enforcement system will encourage the debtor to file an insolvency proceeding. In turn, an efficient insolvency system will protect the assets for the benefit of all concerned. From the creditor's perspective, an efficient enforcement system is often a more attractive remedy than the filing of involuntary insolvency proceeding, which may result in delayed recovery if the debtor contests the filing and because individual creditor interests are often subordinated to the larger goals and objectives of the collective proceeding. In short, an efficient judgment enforcement system interacts with an efficient insolvency system to force a debtor—the party with the most information about its financial condition—to pay or to file an insolvency proceeding.
47. Although effective enforcement methods vary among legal systems, some general characteristics are universal. Where laws specify, judicial mechanisms for enforcing unsecured credit should be swift and inexpensive. They should permit the seizure of property prior to completion of the court process (such as where a creditor posts security to protect the debtor's rights should the creditor's court action ultimately fail), a swift hearing process to return the goods if appropriate, or both. In addition, enforcement methods should include summary methods for obtaining judgments, where there is no real and substantial dispute about the debt, and protective measures to preserve the assets while the proceedings take place.

## 2.2 Security Interest Legislation (Principle 3)

48. *The legal framework should provide for the creation, recognition and enforcement of security interests in movable and immovable (real) property, arising by agreement or operation of law.*<sup>6</sup> While the litmus test of a security interest's strength is its efficacy in the debtor's bankruptcy, it is also an important collection tool outside bankruptcy. If laws on security interests are to meet the needs of modern business, they must embrace certain basic principles. Some of these are essential in any legal system. Other aspects of security have no one "right" solution, so the choice depends on the cultural and social mores of the country in question.
49. *The legal regime should recognize security over all types of assets—movable and immovable, tangible and intangible, including inventories, receivables and proceeds.* Certain types of assets (such as farm equipment) and debtors may call for special treatment, but these special cases should not detract from the general principle. Subject to such special cases, the availability of security should not be limited to land but should embrace all forms of movable property, tangible or intangible, including accounts receivable and intellectual property rights. In its most advanced form, these regimes may include the full functional approach (as followed, for example, in the United States and Canada), under which all use of movable property as collateral is covered by the general legal framework for secured lending, notwithstanding the form of the agreement.
50. *Lenders should be able to take security interests in future property and on a global basis.* Common law systems have long recognized a creditor's ability to take security over a debtor's future property (not necessarily identifiable at the time of the security agreement) and to treat the security interest as

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<sup>5</sup> Easing the requirements for an involuntary filing by a creditor creates a serious risk of abuse if the creditor is able to force payment of a disputed debt by threatening an insolvency proceeding that might destroy a business.

<sup>6</sup> This discussion of secured credit systems is restricted to their relationship to insolvency systems. Readers concerned with broader reform of secured credit systems should consult more detailed sources.

automatically attaching to such property after acquisition by the debtor without the need for a new act of transfer. Some civil law systems also allow this for certain types of assets. For example, German law allows the security transfer of tangible movables and the security assignment of claims, both of which accommodate security in after-acquired property. It is vital to modern financing that lenders be able to take security over a shifting pool of assets that enhances the ability to take security on a global basis, subject to satisfying requirements in relevant jurisdictions. In England the floating charge has proved a highly efficient and flexible financing tool, while in the United States and Canada similar results are achieved more directly through the floating lien embodied in Article 9 of the United States Uniform Commercial Code and the Canadian Personal Property Security Acts based on it.<sup>7</sup> Some civil law systems achieve similar effects through an enterprise mortgage, pledge or charge.

51. *Security should be available for any or all of a debtor's obligations to a creditor, present or future and between all types of persons.* Modern credit agreements provide a range of financing options and often provide optional drawing or borrowing features (such as revolver facilities). Where a credit provides for future lending, the obligations should be capable of being secured at the outset of the transaction. An all-inclusive rule on obligations and persons covered will promote more options for adapting credit facilities to the needs of customers and businesses.
52. *The law should permit both possessory and non-possessory security interests over tangible assets.* In the case of security over chattels, requiring the delivery of possession is a serious impediment. Such chattels typically are held by the debtor as equipment for use in its business or for sale as inventory. Delivering possession to the creditor would deprive the debtor of the ability to use or sell the chattels and so generate the income from which to pay the debt. Thus the law should permit not only possessory but also non-possessory security over tangible assets.
53. *Secured credit systems should encompass all types and uses of property.* Excluding certain types of property, categories of borrowers or lenders, or types of transactions should be avoided because such exclusions reduce the efficiency of the secured credit system. Not all types of collateral can be subject to the same rules. For example, it is necessary to distinguish possessory from non-possessory security interests, inventory from equipment and consumer goods, purchase-money from non-purchase money security, and security in original collateral from security in proceeds. These distinctions will affect all elements of security law: creation, perfection and priorities.
54. *Methods of notice should sufficiently publicize the existence of security interests to creditors, purchasers, and the public generally.* The requirement to specifically identify each item of collateral, still found in a number of legal systems, is cumbersome even when applied to existing assets—particularly when assets do not lend themselves to unique identification. The requirement also makes it difficult if not impossible to provide for security over future property, much less for global security. It should suffice that the description of the collateral is such that the asset over which security is asserted can be identified as falling within the scope of the security agreement. For this purpose, some commentators consider security over “all the debtor’s present and future receivables” or “all the present and future property of the debtor” to be sufficient. Others believe that such a statement should be supported by a generic description of the type of collateral in question (inventory, equipment and so on).
55. *Creation of security interests should be easy and cost-effective.* To encourage efficient credit markets, procedures for creating and taking security interests should not be overly complex. Complex procedures

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<sup>7</sup> Article 9 of the United States Uniform Commercial Code represents the first and most successful functional and integrated approach to security interests in property. It was transplanted into Canada in the form of the Canadian Personal Property Security Acts. These laws are not federal, but provincial and vary from province to province (or in the case of the UCC, from state to state). New Zealand has also adopted similar legislation.

could discourage market use because of their complexity or the costs associated with the process. Because credit costs are generally borne by borrowers, the more efficient and less costly is the system, the lower is the cost of financing. Lower financing costs promote access to credit.

56. Most legal systems require security to be created or evidenced by a writing signed by the debtor and identifying the collateral and the obligations secured. Such requirements are fairly easy to meet. Additional formalities involving inconvenience and expense, such as notarization, should be avoided. For security interests in investment securities, the move toward immobilization and dematerialization of securities has led to the abandonment of paper-based transfers and charges and the use of electronic transfer systems to effect security transactions. This move usually requires legislation to remove legal requirements for documents, writings and signatures, substituting a system of electronic documentation.
57. In the case of security assignments of debts, some legal systems require that formal notice of the security assignment be given to the debtor's debtor (called the "account debtor") (in some cases by an official in a prescribed form) not merely to prevent the account debtor from paying the assignor or to preserve the assignee's priority but as a condition of validity of the assignment. In other words, the notice is a constitutive element in the creation of the security; without notice to the account debtor, the assignment has no effect. However, notice to an account debtor, which in contrast to registration does not fulfill any effective public notice function, is impractical in the case of bulk assignments and security over ongoing streams of receivables. Moreover, the notice requirement is incompatible with the concept of security over classes of assets and security over future property, which do not lend themselves to individual specification.<sup>8</sup>
58. *A security system should set rules of priority on competing claims or interests in the same assets and minimize the number of priorities that come ahead of secured interests in collateral.* A developed regime for security interests should include rules on the priority of competing interests in collateral. For example, one option lawmakers may consider is giving priority to security interests in property acquired with financing provided for that purpose (known as a "purchase money security interest"); the prime example is trade credit extended by sellers of goods and mostly secured by retention of title or equivalent security interests for purchase money. This avoids giving the first financier a monopoly on loans to the debtor and scooping up as a windfall the debtor's acquired property financed by subsequent lenders. In some countries unpaid wages, taxes and many other debts come ahead of a security interest in the distribution of the sale proceeds of property subject to a security interest, with the result that the benefits of secured credit are unavailable. Any priority placed ahead of the secured party represents a substantial cost, which is generally transferred back to borrowers in the form of higher interest rates and transaction costs. Often the public policy represented by the priority (say, benefiting workers) receives a minor and occasional benefit at a substantial cost to the entire commercial system. Such priorities should be eliminated, reduced, and, where public policy concerns are compelling, addressed by other legal reforms that do not compromise the system for secured lending.

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<sup>8</sup> Notice to the account debtor does not feature as a constitutive element of a security assignment in the UNCITRAL Draft Convention on Assignment in Receivables Financing or in the draft chapter on assignment in the forthcoming part III of the Principles of European Contract Law prepared by the Commission on European Contract Law. Notably, in recent years, there has been a sharp move from notification to non-notification receivables financing. A requirement to give notice to individual debtors as a condition of protection against an assignor's bankruptcy creditors is a serious impediment to such financing and makes it difficult to grant security over future receivables, since the identify of the debtor may not be known at the time of the assignment. A number of civil law systems likewise have begun to adapt their laws in this regard.

## 2.3 Recording and Registration of Secured Rights (Principle 4)

59. *There should be an efficient and cost-effective means of publicizing secured interests in movable and immovable assets, with registration being the principal and strongly preferred method. Access to the registry should be inexpensive and open to all for both recording and search.* As noted, both possessory and non-possessory interests should be allowed. When a security interest is possessory, meaning the assets pledged are in the possession of the creditor or a third party, another prospective lender or buyer will be prevented from assuming that these assets are owned or can be disposed of by the debtor. But this is not the case when the interest is non-possessory, meaning the assets remain in the possession of the borrower (as with buildings, fixtures, equipment, inventory and the like). This calls for a system through which public notice can be given of non-possessory security interests, preferably by recording in a public office.
60. A registration or similar system is needed to prevent a debtor from raising further credit on the strength of his apparent ownership of the assets (the “false wealth” doctrine). Such systems enable third parties intending to acquire an interest in the assets to learn of a prior security interest. Registration also plays a central role in the ordering of priorities. For assets capable of unique identification, such as aircraft, ships and motor vehicles, it is feasible to have a registration system that names them. For other assets, registration is effected in the name of the debtor. In keeping with a policy allowing global (all assets) security, the registration system should allow global security over current and future property to be effected by a single registration. A modern registration system should be electronic and should allow registration and searching online. Experience in Canada and the United States has shown that registration and search fees can be kept to modest levels yet still allow the registration system to operate at a profit.
61. Most states have title registration systems of varying scope and efficiency for some assets, like land, ships, aircraft and intellectual property. Views differ about registration of security interests over other property (goods, intangibles). Most Canadian provinces and U.S. states have filings that aim to warn unsecured creditors of the security interest and to regulate priorities (such as double mortgages). The common law system for registering corporate charges adopted by nearly 70 jurisdictions is primarily a warning, not a priority, system, though it does have some priority effects. By contrast, some major jurisdictions such as Germany and the Netherlands have not favored this type of publicity.
62. Ideally, there should be a minimum number of registries for security interests. Most systems have a separate regime for security interests in land, because this is more complex, uniquely identifiable and lends itself to registration against the asset given in security. Security in most classes of movable property, including intangibles, is against the debtor, which is generally registered or headquartered in a specific location. Following from international conventions, most countries have separate registries for ships and aircraft. Where multiple registries exist for a specific type of assets, moveable or immovable, it is useful to establish links or redundancies between them. Registries should be open to the general public for recording and search. The required filing should be a simple notice of the most basic facts of the secured transaction (for example, the debtor’s name and address, the creditor’s name and address, the date and a general description of the collateral in which the security interest has been granted). The contract between debtor and creditor, or the terms of that contract, should not have to be filed. The notice and registration system should simply provide to a searcher a method of discovering that there is a secured party who claims security rights over existing and future assets of the type described. In an electronic system of registration, searches are dealt with by computers with no human intervention—hence the concept of notice filing, where prescribed data are transmitted to the registry but there is no filing or even presentation of security agreements or other documents. The searcher is responsible to act as it deems prudent to protect its interests, which would typically be to require more details from its prospective debtor or the secured party.
63. Registry officials should not review filings for accuracy or legality. Lenders must take the risk that any serious inaccuracy could result in the partial or complete invalidity of the record, which may lead

to unenforceability of the security interest. Consequently, a registry should be lightly staffed and inexpensive to operate. The ideal registry will be electronic, a form that will enable adopting nations to leapfrog technologically past existing Western systems to a system that is swift, cheap and accessible to all areas of the nation. Electronic filing will also facilitate links among registries if there is more than one. Consideration should be given to outsourcing operation of registries to qualified non-governmental, competitive private entities, who would act under government supervision (such as in Colombia and Romania).

## 2.4 Enforcement of Secured Rights (Principle 5)

64. *Enforcement systems should provide efficient, inexpensive, transparent and predictable methods for enforcing a security interest in property. Enforcement procedures should provide for prompt realization of the rights obtained in secured assets, ensuring the maximum possible recovery of asset values based on market values. Both non-judicial and judicial enforcement methods should be considered.* Creditor protection through a variety of security devices, such as those discussed above, affords little actual relief if it is not complemented by sound and effective enforcement mechanisms. These mechanisms include the typical methods for recovering debts, including self-help, court action and foreclosure and execution procedures. Such enforcement systems reinforce and stimulate domestic credit practices, promote foreign direct investment and discipline wayward or incompetent borrowers. In distressed markets, as in normal markets, enforcement systems play a critical role in investment decisions and serve as a backdrop against which legal rights are measured. If these rights can be enforced reliably and predictably, both borrowers and creditors may be encouraged to engage in consensual debt resolution.
65. This principle has several subprinciples. First, enforceability is easiest when the law allows parties to agree upon their own default remedies, bypassing courts, but provides adequate safeguards to the debtor, where court involvement will be required. This may include the use of self-help remedies where these can be exercised consensually without violating the legal rights of others or upsetting the peace. In the case of default by a debtor, non-judicial means of seizure and sale of collateral make a secured credit system more efficient and economically useful. Non-judicial means include self-help repossession and sale (as in Article 9 of the United States Uniform Commercial Code and in the Canadian Personal Property Security Acts) receivership (as in the United Kingdom) and non-judicial enforcement by a bailiff or marshal of executable instruments drawn up or recorded by a notary. If non-judicial methods are allowed, it will be necessary to include standards for ensuring that proper procedures are followed in seizure and reasonably fair value is obtained when collateral is sold.<sup>9</sup>
66. Where self-help remedies are unavailable, enforcement procedures should enable parties to obtain enforcement based on summary, accelerated proceedings for recovery and sale collateral, either through the judicial process or by way of public auctions. Enforcement by seizure and sale of collateral should be swift and inexpensive, with rules or incentives encouraging the recognition of good value for the collateral. Rapid recovery ensures that market values are realized and avoids the loss of value due to delayed enforcement and reinvestment opportunities. Finally, secured creditors should be entitled to apply the proceeds from the disposition of assets against their claims as early as possible. Special rules may be appropriate for intangible assets such as accounts receivables.

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<sup>9</sup> With respect to the effect of enforcement and priority in the case of insolvency, see the discussion under principle 15 on the setting aside of transactions and in principle 16 on priorities.



### 3. LEGAL FRAMEWORK FOR CORPORATE INSOLVENCY

#### 3.1 Key Objectives and Policies (Principle 6)<sup>10</sup>

67. *Though country approaches vary, effective insolvency systems should aim to:*

- *Integrate with a country's broader legal and commercial systems.*
- *Maximize the value of a firm's assets, including by providing an option to reorganize.*
- *Strike a careful balance between liquidation and reorganization.*
- *Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors.*
- *Prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments.*
- *Provide for timely, efficient and impartial resolution of insolvencies.*
- *Provide a transparent procedure that contains incentives for gathering and dispensing information.*
- *Recognize existing creditor rights and respect the priority of claims with a predictable and established process.*
- *Establish a framework for cross-border insolvencies, with recognition of foreign proceedings.*

68. **Integration.** An insolvency system must be complementary to and compatible with the legal system of the society in which it is rooted. To be properly implemented, an insolvency system's procedural and substantive rules must match the capacity of the relevant courts or agencies (judicial, professional, institutional, regulatory, administrative). As much as possible, a country's insolvency system should reflect the society's social and economic goals. Finally, the system must be continuously monitored to ensure that it is being implemented in accordance with the policies and purposes for its design.

69. **Maximizing asset values.** Maximizing asset values is a crucial objective of the insolvency process. Administrators and other stakeholders should have strong incentives to achieve higher values, because more value means that creditors will receive higher distributions and reduce the burden of insolvency. This is not an easy task given that creditors tend to act in their own self-interest. In some cases where creditors have bargained for superior rights, such as secured or *in rem*<sup>11</sup> creditors, there may be a legitimate reason to treat them differently. As a general rule, maximizing value may require that before its sale the business is operated as a complete productive unit or merely to preserve the highest value of its assets. A number of design considerations emanate from this objective, including the need to protect the business and assets against actions by individual creditors, the balance to be struck between rapid liquidations and efforts to rehabilitate the business, the amount of investment that should be made to preserve or raise value and the implications for other stakeholders, the discretion that can be exercised by qualified administrators, and the extent to which creditors should be allowed to monitor the process. Some of the design features pertain to the efficiency of procedures and the institutions that implement them. Accordingly, this objective resurfaces in the discussion of the institutional framework in section 4.

70. **Rehabilitation policy.** The modern trend supporting rehabilitation or rescue is an extension of the goal to maximize value. It is predicated on the idea that the value of the whole is greater than the

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<sup>10</sup> Most of the elements in this principle were identified as critical principles in the G-22 Report of the Working Group on International Financial Crises, pp. 16 and 44-45 (1998). Principle 24 discusses international considerations.

<sup>11</sup> Creditors holding *in rem* rights are those with an interest in property that has been mortgaged or pledged, or in which an ownership interest is retained. These are discussed in more detail under principle 16.

value of the parts. Put differently, an enterprise is more valuable as a going concern than if it is liquidated. This approach also reflects other objectives, such as preserving jobs. It is achieved by imposing a moratorium at the outset of an insolvency proceeding to prevent creditors from engaging in collection efforts or exercising enforcement remedies that dismember the enterprise for the benefit of a few. As discussed below, the moratorium should be brief to stabilize the business and determine if there is a decent likelihood of rehabilitation. The moratorium gives the debtor or the administrator a neutral forum in which to negotiate a consensual business solution, which can result in a higher dividend to creditors by salvaging an enterprise as a going concern rather than realizing value through liquidation, which is often much lower.

71. **Equitable distribution.** The principle of equitable distribution is based on the notion that in a collective proceeding, creditors with similar legal rights should be treated the same. The equity policy permeates many provisions of an insolvency law, including the automatic stay, the moratorium on payments of claims created prior to the bankruptcy, provisions to set aside claims and recapture property or value, classification and voting procedures in a rehabilitation, and distribution mechanisms. At the outset an injunction prevents the “free for all” system of individual enforcement and replaces it with one that balances the interests of creditors, the debtor and the government. Another way of expressing the equity policy is the principle of pari passu treatment for creditors, which espouses that creditors should be paid on a ratable basis and in the relative priority of their claims and interests from the proceeds of the liquidated estate.<sup>12</sup> Put differently, creditors on an equal legal footing should be treated equally, receiving a distribution on their claim proportionate to aggregate claims of the same kind. In reality, the pari passu principle and equity policy are modified by social choices on claim priorities.
72. **Timely, efficient and impartial resolution.** The objectives of timely and efficient administration support the objective of maximizing asset values, while impartiality supports the principle of equitable distribution. If the insolvency process is to have meaning, it must be fair and impartial. It must also result in genuine value if it is to provide meaningful benefit to creditors. Value reflects a number of factors, such as the ability to dispose of the business or assets promptly at fair market values, the costs incurred by creditors in realizing the asset value and the timing of distributions to creditors of value realized. If administrators or liquidators are not equipped to handle insolvency cases, they may not realize the highest value or may squander the remaining value in a hopeless search for the ideal buyer. If the institutions that render decisions are inefficient and overburdened, they may be unable to provide prompt responses on applications filed or other matters affecting the disposition of assets. The entire process must be examined at every stage to ensure maximum efficiency without sacrificing flexibility. This generally requires establishing clear but reasonable deadlines for most matters that occur within a proceeding. It may also mean providing time limits that assure secured or other creditors predictable outcomes by a certain time.
73. **Predictability, transparency and accountability.** Effective insolvency systems include rules that are reasonably predictable, transparent and hold all parties duly accountable throughout the process. There is no substitute for a clear law. A predictable law promotes stability in commercial transactions, fosters lending and investment at lower risk premiums, and promotes consensual resolutions of disputes between a debtor and its creditors by establishing a backdrop against which parties can assess their relative rights. In the same way, transparent rules and procedures promote fairness and integrity in the system and create an informed and communicative environment by which greater levels of cooperation can be achieved.

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<sup>12</sup> The “estate” or “bankruptcy estate” refers to the body of assets to be administered in the insolvency proceeding, and over which the court will exercise jurisdiction. All systems have a concept of the estate and generally define it to include all enterprise assets. But many systems exclude certain assets subject to rights or claims by particular persons. In addition, some estate assets are legal or contractual rights to recover payment or an asset, including assets or the value of assets that were transferred inappropriately to other creditors or third persons.

Disclosure of information is crucial to an accurate evaluation of the prospects for the business and to assess the rights and priorities of creditors, but the enterprise must be assured that confidential information will be properly protected. Finally, a system that holds all participants in the process accountable reinforces predictability and promotes fairness.

74. **The importance of well-balanced policies.** The design of an insolvency law is influenced by numerous policy objectives pertaining to a variety of goals, rights and interests. For example, should bankruptcy law promote discipline and seek to weed out inefficient and incompetent market players? Or should it be tolerant, and would tolerance encourage entrepreneurial activity? Should the law be pro-debtor (“debtor friendly”) or pro-creditor (“creditor friendly”), and what do these labels mean? Should the law have a wider social or collective purpose, or should it aim to achieve a just and reasonable resolution of individual competing interests? For example, should the law seek to protect employment? Should it encourage investment? Should it be biased toward rehabilitation to shield the economy from systemic collapses that are not the fault of management?
75. Insolvency laws balance the rights and interests of creditors and society by reapportioning the risks of insolvency in a way that suits a country’s economic, social and political goals. There is no universal solution because countries vary significantly in their needs, as do their laws on security interests, recordation, property and contract rights, remedies and enforcement procedures. Most insolvency systems address the questions raised above. Some laws favor stronger recognition and enforcement of creditor rights and commercial bargains, while others tilt toward rehabilitation of the debtor with its implications for workers and other constituencies. But rescue-friendly jurisdictions should not provide a safe haven for moribund enterprises. Enterprises that are beyond rescue should be liquidated as quickly and efficiently as possible.
76. The first task for any insolvency system is to establish a framework of principles that determine how the estate of the insolvent debtor is to be administered for the benefit of all affected parties. A series of choices must be made in designing this distribution system, to ensure that the law embodies goals and priorities consistent with the values of the society. The creation of such a framework and its integration with the wider legal process are vital to maintaining social order and stability. All parties need to be able to anticipate their legal rights in the event of a debtor’s inability to pay, or to pay in full, what is owed to them. This allows both creditors and equity investors to calculate the economic implications of default by the debtor, and so estimate their risks.
77. Because society is constantly evolving, insolvency law cannot be static. The law should be reappraised at regular intervals to ensure that it meets current social needs. Responses to perceived social change involve an act of judgment. The custodians of legal revision and reform should try to identify international best practices and transpose them into the system they oversee, taking into account the realities of the system and available human and material resources.

### **3.2 General Design Features of an Insolvency Law (Principles 7-16)**

78. This section and the one that follows address some key features pertaining to the design of an insolvency law. These are by no means exclusive or exhaustive. The issues addressed here represent a variety of potential policy choices and implementation practices. Each subsection begins with a principle that in most cases reflects what might be considered a best practice. The principles are split into two groups: features and issues of general applicability to all insolvency proceedings, and features specific to rehabilitation proceedings. No principle can be considered in isolation from the overall system, and each may offer a range of choices for implementation. In economies facing systemic insolvency, interim measures may be needed to take advantage of relative strengths and minimize the impact of weaknesses in the system. These interim measures may be a step toward greater alignment with international best practices.

79. **Principle 7: Director and officer liability.** *Director and officer liability for decisions detrimental to creditors made when an enterprise is insolvent should promote responsible corporate behavior while fostering reasonable risk taking.* As a general rule, directors and officers have a duty to their shareholders but not to their creditors. The relationship between the enterprise and its creditors is governed by contractual agreement. Accordingly, when an enterprise is solvent, directors and officers need not consider whether business activity will have an effect on creditors. When the enterprise becomes insolvent, however, the creditors (as opposed to the shareholders) become the real financial stakeholders of the enterprise. Because insolvency, in the technical sense, means that the liabilities of an enterprise exceed the total value of its assets, as the enterprise continues to trade, the risk of loss is borne entirely by creditors. The natural tendency of most directors and officers is to try and trade out of its losses, thereby increasing the risk of potential loss to creditors. The difficult decision for policy maker is deciding at what point directors and officers should be held accountable for the deterioration in the value of the enterprise to the detriment of its creditors. This decision is complicated even more by the fact that accounting practices are not an exact science making it difficult to determine when exactly a company has crossed the threshold of insolvency. Some criteria are more clear than others, such as general cessation of payments or inability to pay debts as they come due.
80. The best safeguards against wrongful trading or improper conduct by management are strong corporate governance and creditor rights enforcement. Strong corporate governance promotes checks and balances on the behavior of companies and their managers and owners and provides for a balance in the rights of corporate stakeholders. Similarly, strong debtor-creditor rights and enforcement systems provide an external means of monitoring credit and commercial relationships and enforcing rights among creditors and their debtors, which support incentives for proper corporate behavior. In many developing economies these complementary systems are weak, raising the question of whether the insolvency response should be more exacting and onerous. For example, should managers be held to a higher standard of conduct when an enterprise becomes insolvent? Or perhaps replaced altogether during the proceedings, while granting creditors a stronger voice in the process?
81. *At a minimum, standards should address conduct based on knowledge of or reckless disregard for the adverse consequences to creditors.* There is broad disparity in the imposition of liability on directors and officers for continuing to conduct business when the company becomes insolvent, better known as “wrongful trading” in some jurisdictions. Some countries impose criminal sanctions for this activity, others provide for onerous penalties, and still others have no liability at all. Even in countries that impose liability for wrongful trading, it is very difficult to monitor inappropriate behavior and developing countries often lack the requisite enforcement measures to give effect to sanctions or penalties. The explanation for the variance relates to competing policies that, on the one hand, encourage entrepreneurial activity, and on the other foster corporate responsibility to stakeholders. A policy supporting entrepreneurial risk taking activity may be more effective if no obligation to commence insolvency exists, which could lead to premature insolvencies. Conversely, a policy favoring stronger corporate discipline may call for more precise rules establishing a baseline case for corporate discipline when directors and officers engage in wrongful trading. The objective should be to strike a balance the design of rules and mechanisms that promote reasonable risk taking, while encouraging responsible conduct by management toward stakeholders, including engaging in early efforts to resolve financial distress through consensual workouts.
82. **Principle 8: Liquidation and rehabilitation.** *An insolvency law should provide both for efficient liquidation of nonviable businesses and those where liquidation is likely to produce a greater return to creditors, and for rehabilitation of viable businesses.* Nearly all jurisdictions have a liquidation law. Nearly all probably go further, offering an alternative procedure designed to save a business rather than terminate it. Although a variety of rescue models have been developed, efforts are constantly being made to make the rescue process more efficient and find ways to best accommodate it. This issue necessarily requires further discussion of the liquidation process and the rescue process.

How best to marry the two is a fundamental policy issue. If settled in advance, the legal framework can be plotted more easily.

83. In its strict traditional sense, liquidation refers to immediate or early cessation of a business, the sale of the business or its productive units or the piecemeal sale of its assets. In contrast, a strict view of rehabilitation refers to the restructuring of a corporation that can be restored to productivity and become competitive. But this traditional division is somewhat artificial and creates unnecessary polarization. It does not accommodate cases not easily situated at these poles—the many in-between cases where, although the corporation may or may not survive, there is still a great deal to achieve from maximizing the value of its assets. The insolvency law must provide more than a choice between a strict traditional liquidation and the harder to attain rehabilitation. Thus the concept of rehabilitation needs to accommodate a variety of arrangements. These need not be specifically detailed. It should be sufficient for the rescue regime to permit a result that would achieve more than if the corporation was liquidated. Indeed, in some cases, the rehabilitation may contemplate an eventual liquidation or sale of the business.
84. *Where circumstances justify it, the system should allow for easy conversion of proceedings from one procedure to another.* Some countries adopt a unitary approach (e.g., France, Germany) that establishes an interim period for review of the business prospects before deciding on whether to liquidate or rehabilitate the business. In countries that do not adopt the unitary approach, it is particularly important that the court and participants have the ability to request a conversion of the proceeding where, in retrospect or based on a change in the financial circumstances of the enterprise, it becomes apparent that rehabilitation can or cannot be achieved. As discussed under the provisions on rehabilitation below, conversion to liquidation might be appropriate even after a restructuring plan has been approved, if approval for the plan has been procured by fraud or the enterprise is unable to perform its restructured obligations under the plan. Typically, proponents of conversion will be those with a financial stake in the outcome of the proceeding (e.g., creditors, management, etc.).
85. **Principle 9: Commencement: applicability and accessibility.** *The insolvency process should apply to all enterprises or corporate entities except financial institutions and insurance companies, which should be dealt with through a separate law or through special provisions in the insolvency law. State-owned corporations should be subject to the same insolvency law as private corporations.* The law should clearly identify the entities to which it applies—a threshold policy decision that can have enormous economic implications because entities left outside the process will not be entitled to the benefits or exposed to the discipline of the system. With a few exceptions for special industries, this principle embraces an all-inclusive approach to eligibility for all forms of enterprises and corporations, both private and state-owned. Public interest concerns relating to certain closely regulated industries or arising by virtue of the government’s relationships with other enterprises may place these in a different category. For example, the insolvency of banks and insurance companies should be governed by special insolvency legislation or be subject to special rules of the insolvency law. Few if any jurisdictions would permit a bank (private or state-owned) to be subject to a basic corporate insolvency law without some regulatory involvement.<sup>13</sup> The extent to which foreign debtors are subject to the law is a question of increasing importance and should be considered.<sup>14</sup>
86. This principle also supports the view that state enterprises that compete in a market economy should be subject to the same regulatory, commercial and economic processes as private corporations—including the insolvency law. In cases where the treatment of state enterprises is part of a change in macroeconomic policy, independent legislation on state enterprises may be warranted. (Examples include massive privatization programs, as in transition economies.) But outside this context, there is

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<sup>13</sup> Annex I discusses in more detail a number of issues relevant to insolvency and restructuring of banks.

<sup>14</sup> See the discussion of international considerations accompanying principle 24.

no compelling reason for state enterprises to be exempt from the regular insolvency system or to be guided by separate rules. The disciplinary effects of the insolvency system provide a means for regulating state enterprises with weak corporate governance structures. Viable state enterprises should be placed under independent supervision acceptable to creditors, to avoid the conflicts often inherent in state enterprise insolvency, where the state acts in multiple capacities (e.g., shareholder, management, and judicial arbiter).

87. *Access criteria.* Debtors should have easy access to the insolvency system upon showing proof of basic criteria (insolvency or financial difficulty). A declaration to that effect may be provided by the debtor through its board of directors or management. Creditor access should be conditioned on showing proof of insolvency by presumption where there is clear evidence that the debtor failed to pay a matured debt (perhaps of a minimum amount). Like the eligibility criteria, the access criteria are instrumental in delineating which entities are brought into the insolvency process. These criteria should be designed to cover as many enterprises as possible. The law should encourage a financially distressed or insolvent corporation to voluntarily submit to the process. Although the power to initiate the rescue process may be given to creditors as well, the debtor typically initiates the process. If the law adopts a modified unitary design, attention should be given to the possibility of access by a debtor through conversion from the liquidation to the rescue process. This is particularly relevant when a creditor has initiated liquidation.
88. Access to the law should be convenient, inexpensive and quick. Overly restrictive access can deter debtors, smothering the commercial need. Delay can result in insolvent corporations that should clearly be liquidated, otherwise being left uncontrolled with a likely dissipation or waste of assets. . Delay can also cause insolvent but viable businesses to wither on the vine. Accordingly, careful consideration must be given to how the law frames the criteria required to satisfy the test for insolvency when an enterprise voluntarily submits to the process and where an involuntary petition is brought by creditors.
89. Creditor rights are a fundamental concern of bankruptcy law, and an insolvency system should enable creditors to petition for commencement of proceedings. Still, there is potential for creditors to abuse the process when their complaint is little more than a two-party dispute. The collective nature of the insolvency process requires that determinations be made on the appropriate triggers in order to balance incentives to negotiate workouts while avoiding abuses. While bankruptcy should be available to small and large creditors alike, it may be useful to establish clear guidelines for sorting out cases where the filing of a petition is the result of a single creditor action, not an instance of real insolvency.
90. **Test for insolvency.** *The preferred test for insolvency should be the debtor's inability to pay debts as they come due—known as the liquidity test. A balance sheet test may be used as an alternative secondary test, but should not replace the liquidity test. The filing of an application to commence a proceeding should automatically prohibit the debtor's transfer, sale or disposition of assets or parts of the business without court approval, except to the extent necessary to operate the business.* The two common tests for insolvency are the balance sheet test and the liquidity test. Under the balance sheet test an enterprise is insolvent if its liabilities exceed the fair market value of its assets. Liquidity is based on cash-flow criteria and relates to a debtor's inability to service its debts as they come due. The balance sheet approach can be an inaccurate measure of insolvency because domestic accounting standards and valuation techniques may give rise to distorted values that do not reflect fair market values. If domestic practices and rules do not follow international accounting principles and are not applied uniformly by qualified valuation experts, the balance sheet test as the sole measure of insolvency may invite arbitrariness, uncertainty and even corruption. The balance sheet approach is

also likely to be more costly and difficult because it generally requires an expert evaluator to review books, records and financial data to determine the enterprise's fair market value.<sup>15</sup>

91. The better standard for commencing proceedings is the liquidity test or a variant thereof. As noted, under this standard a debtor is considered insolvent if it has ceased making payments or cannot pay its debts as they come due. When debts come due is determined by the contract governing the relationship. When deciding on the trigger for commencing proceedings, consideration should be given to potential abuses by debtors or creditors. Where a debtor is using bankruptcy as a shield against a single creditor, creditors should be able to seek a dismissal of the proceeding or a conversion to another proceeding—whether liquidation or rehabilitation—when it is in their best interests. The system should also be protected from creditors intent on using bankruptcy to force viable businesses out of the market—that is, using the bankruptcy system as an extortion mechanism.
92. For creditors, the standard of insolvency needs procedural refinement to establish a threshold of evidence or proof. A reasonably convenient and objective test is a debtor's failure to pay a debt within a specified period after a written demand for payment has been made. In a voluntary case one might consider a lesser standard that might also apply—that of financial difficulty. This might be best described as a state of financial affairs that, if not dealt with, will almost certainly result in insolvency. This lesser standard is most necessary in the voluntary case, particularly if a corporation genuinely seeks a possible rescue. Presumptions of insolvency are useful in cases where the enterprise has failed to perform obligations, and shifts the difficult burden of proving solvency on the enterprise in a contested proceeding. In countries where the application of the law is less predictable, presumptions may be inadequate and may need to be replaced with objective tests that do not allow for the debtor to abuse the rebuttal process.
93. A final point is worth noting. Insolvency laws are designed to deal with business failures in a normal economic environment. The rules of the game may change in systemic financial crises, where asset and enterprise values become artificially deflated or harder to predict. Commencement criteria should not be altered to achieve desired results for market aberrations. Rather, where crises require special treatment, interim solutions should be cautiously tailored to the market in question, to maintain commercial predictability and encourage market activity.
94. **Principle 10. Commencement: moratoriums and suspension of proceedings.** *The commencement of bankruptcy should prohibit the unauthorized disposition of the debtor's assets and suspend actions by creditors to enforce their rights or remedies against the debtor or the debtor's assets. The injunctive relief (stay) should be as wide and all embracing as possible, extending to an interest in property used, occupied or in the possession of the debtor.* For reasons of principle, policy and pragmatism there must be some restraint on the debtor and creditors if a fair and orderly administration is to result and if fundamental objectives and policies of the insolvency law are to be upheld. Accordingly, the commencement of proceedings should have two main effects. First, it should impose a moratorium on the disposition of the debtor's assets (including repayment of debts that arose before the filing of the petition) except as authorized by the court. Second, it should enjoin actions by creditors to enforce claims against the enterprise's assets through collection efforts, adjudication, execution or otherwise. Both effects inhibit the disposition or removal of assets in a way

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<sup>15</sup> Fair market value is generally considered to be the reasonable value that can be obtained in a sale between a buyer and a seller where neither party is under an obligation to buy or sell. In the absence of a real sale, value is always somewhat speculative, because values are based on assumptions made about the conditions for the sale of the assets in question, and the parties must rely on other techniques for approximating market value. These values may be complicated where local accounting practices do not accord with international accounting standards.

that would undermine the ability to maximize asset values, and both promote equitable distribution among creditors<sup>16</sup> and encourage the rehabilitation of viable businesses.

95. There is nearly uniform agreement on the need to prevent improper disposition of assets by the debtor to avoid instances where the debtor or its management seek to engage in wrongful or fraudulent transfers of assets to the detriment of creditors. All systems generally impose a moratorium on repayment of debts, though there may be exceptions for setoff rights, netting of financial contracts and other important interests.<sup>17</sup> Similarly, most systems take a common approach to preventing similarly situated creditors from gaining an unfair advantage over other creditors in the enforcement of claims. Imposing a stay on creditors, however, raises one of the more difficult policy choices in designing an insolvency law. Legislators must balance policies that encourage greater certainty and predictability in commercial relationships (especially collateral enforcement rights) with those that encourage a process to maximize asset values, ensure equitable distribution and promote rescue of viable enterprises. In this context the treatment of secured creditors must be carefully considered.<sup>18</sup> Compelling state interests or rights may be exempted from the stay, but these should be clearly articulated and as limited in number as possible.
96. *To maximize the value of asset recoveries, a stay on enforcement actions by secured creditors should be imposed for a limited period in a liquidation proceeding to enable higher recovery of assets by sale of the entire business or its productive units, and in a rehabilitation proceeding where the collateral is needed for the rehabilitation.* In a liquidation proceeding, core assets of the business may be pledged or secured. Allowing secured creditors to seize these assets at the outset would defeat any prospect for a sale of the entire business or of productive units of the business, with the result that the remaining assets would have lower value. The higher risk of loss would be borne by the general creditors. At the beginning of a proceeding, it is sometimes difficult to know whether the business can be sold as a going concern, or is sufficiently viable to warrant a conversion of the case to a rehabilitation proceeding. For these reasons, the stay should extend to secured creditors, at least for a short specified duration sufficient for reasonable assessment of business prospects and to allow a fair opportunity to sale the business (in whole or part) for a higher price. Because the stay erodes the superior rights of secured creditors it should be limited to promote confidence in asset based lending and to establish a degree of predictability in the process.
97. The stay on secured creditors is even more important in the context of a rehabilitation proceeding, where typically rehabilitation would be impossible in most cases unless secured creditors were bound by the process. As discussed elsewhere, if secured creditors are enjoined from enforcing their collateral rights, there should be counterbalancing provisions that safeguard the rights these creditors by expressly limiting the duration of the stay, requiring protection of a creditor's interest in the collateral during the injunctive period and allowing affected creditors to seek to have the injunction dissolved where the collateral interests are not sufficiently protected or where the collateral is not necessary to a sale of the entire business or a productive unit of the business. Clearly, in cases where particular collateral is not essential to a rehabilitation or the sale of the business in whole or part, the rationale for enjoining collateral creditors fails.
98. Another facet of this issue relates to timing—when the moratorium on creditor actions should commence. In many jurisdictions, when a petition is filed, there may be a gap between the petition and the declaration of bankruptcy. This gap is inevitable because an involuntary commencement

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<sup>16</sup> As discussed above, the pari passu principle holds that similarly situated creditors should receive equal treatment with respect to their claims, meaning a proportionate recovery from the proceeds of sale. The imposition of a moratorium on payment to any one creditor and the prohibition on creditors from grabbing assets to satisfy their claims is designed to give effect to that principle.

<sup>17</sup> For a more detailed discussion of issues pertaining to setoff and contract cancellation, see principle 14.

<sup>18</sup> For a more detailed discussion of issues pertaining to treatment of secured creditors, see principle 16.



raises a number of potential disputes over the debtor's condition, status of payments, qualification of claims, status of creditors and so on. These facts and related legal issues must be resolved, though in some cases they are susceptible to summary dispositions. Nevertheless, in cases of a genuine petition there is a risk that the debtor's business will be altered or further deteriorate during the gap. Thus protective measures are often needed even during this period even though no declaration of bankruptcy has been made. The presumption of bankruptcy might be sufficient to impose a suspension of proceedings during the gap and to restrict the kinds of activities in which the debtor may engage. Without these measures, creditors are not prevented from exercising enforcement rights through execution procedures, which could lead junior creditors to elevate their claims over those of senior creditors, including secured creditors, during the gap. While an automatic stay may be enforced retroactively, in some cases the damage may be irreparable where seizure of key assets prevents the business or productive units of the business from being sold.

99. **Principle 11: Governance: management.** *In liquidation proceedings, management should be replaced by a qualified court-appointed official (administrator) with broad authority to administer the estate in the interest of creditors. Control of the estate should be surrendered immediately to the administrator except where management has been authorized to retain control over the company, in which case the law should impose the same duties on management as on the administrator. In creditor-initiated filings, where circumstances warrant, an interim administrator with reduced duties should be appointed to monitor the business to ensure that creditor interests are protected.* The clearest case for replacing management exists in the context of a liquidation proceeding, which is a terminal proceeding. The ultimate objective of such proceedings is to maximize estate value and pay creditors as much as possible while shifting assets to more efficient market participants. Where the enterprise's assets are to be owned and operated by someone else, the only reason for management to remain in place is to facilitate the sale of assets and the business. The prevailing rule in all known jurisdictions is to replace management with an independent officer upon commencement or declaration of a liquidation proceeding. This does not mean that all management should be replaced where an enterprise continues to operate. Incumbent honest management can enhance value by continuing to serve or advise pending the liquidation or sale of the business or assets.
100. *There are two preferred approaches in a rehabilitation proceeding: exclusive control of the proceeding by an independent administrator or supervision of management by an impartial and independent administrator or supervisor. Under the second option complete power should be shifted to the administrator if management proves incompetent or negligent or has engaged in fraud or other misbehavior. Similarly, independent administrators or supervisors should be held to the same standard of accountability to creditors and the court and should be subject to removal for incompetence, negligence, fraud or other wrongful conduct.* This decision is more complicated in a rehabilitation proceeding, where salvaging the business is the ultimate goal. In such cases, insolvency laws invest governance responsibilities in incumbent managers who retain control, or in an independent administrator who exercises all of the rights and duties of management, or combine the two approaches, retaining existing management but appointing an independent person to supervise and, if necessary, replace management. Displacing management from the outset, except in circumstances that warrant it, can cause damage and result in repercussions detrimental to the operation of the business at a critical juncture in its survival.
101. In a genuine rehabilitation effort, replacing or sharply curtailing the powers of management could create a disincentive for incumbent management to seek rehabilitation when necessary, which would be counter-productive to policies supporting director and officer liability for wrongful trading (see principle 7). On the other hand, creditors may have little or no confidence in management, and allowing management to continue in its capacity without appropriate checks and balances on its powers may make creditors less cooperative, which is vital to developing a rehabilitation plan that creditors will support. While some systems adopt this approach, it works best where management has express duties to the creditors who exercise active supervision over the process (such as, in the United

States). Weaknesses in governance rules and institutional capacity suggest that the more practical approach in developing countries is to appoint an independent supervisor to work as a liaison between management and creditors, appointing an independent administrator where management is clearly unfit or has engaged in improper conduct. As indicated in the principle, however, independent administrators and supervisors are themselves held accountable to the same standards as management; they should be subject to removal for malfeasance or incompetence.

102. **Principle 12: Governance: creditors and the creditors committee.** *Creditor interests should be safeguarded by establishing a creditors' committee that enables creditors to actively participate in the insolvency process and that allows the committee to monitor the process to ensure fairness and integrity. The committee should be consulted on non-routine matters in the case and have the ability to be heard on key decisions in the proceedings (such as matters involving dispositions of assets outside the normal course of business). The committee should serve as a conduit for processing and distributing relevant information to other creditors and for organizing creditors to decide on critical issues. The law should provide for such things as a general creditors assembly for major decisions, to appoint the creditors committee and to determine the committee's membership, quorum and voting rules, powers and the conduct of meetings. In rehabilitation proceedings, the creditors should be entitled to select an independent administrator or supervisor of their choice, provided the person meets the qualifications for serving in this capacity in the specific case. As a general proposition, creditor interests should be safeguarded by the appointment of an administrator or liquidator who serves as an officer of the court. A creditors committee provides "double protection" for creditors, giving them the ability to participate in and monitor the proceedings.*
103. Creditors have varying degrees of involvement in the decision making process of the proceedings. In some systems, such as the English model, the administrator or insolvency practitioner makes all key decisions on uncontested general matters of administration and liquidation, with the creditors playing a marginal role and having little influence. Proponents of this approach argue that the process is better handled by experienced insolvency practitioners or administrators because it avoids endless notices to creditors and approvals of creditors. The English approach is reinforced by a strong emphasis on regulation of the system and the participants.
104. An alternative approach gives creditors a stronger role in the proceedings, in some cases allowing them to select and replace the administrator in much the same way as shareholders elect directors. In these systems a creditors committee serves a vital function in the proceedings, as the primary check on the activities of the enterprise, the administrator or the liquidator. The committee serves as a voice for all unsecured creditors and should be representative. Given that the real stakeholders in the estate are the creditors, they should be afforded an opportunity to be heard on matters that affect the disposition of the case or issues that affect their rights. Where to draw the line on whether creditors have a genuine interest or financial stake in the outcome can be difficult. It makes no sense to allow creditors to be involved in the resolution of matters that have no significant effect on their recoveries. On the other hand, such interests can be affected indirectly, such as where the foreclosure of key assets of the estate by a creditor will substantially diminish the value of all other assets that are unencumbered and from which unsecured creditors expect to be paid.
105. As a general rule unsecured creditors committees should consist only of unsecured creditors. In some cases a committee of secured creditors might be justified. Some systems provide for secured and unsecured creditors to serve on the committee or to take part in decision making. Often, secured creditors have little in common with unsecured creditors, and their ability to participate in and alter the outcome of decisions by the committee may be inappropriate and not in the best interest of other creditors. By nature, the interests of secured creditors conflict with those of unsecured creditors. Secured creditors almost always favor a quick sale of their collateral, while distributions to unsecured creditors are predicated on the amount realized for the sale of assets or the business. In general, care should be taken to avoid potential conflicts of interest on the committee.

106. An approach that falls somewhere between these two relates to the provisional appointment of a creditor representative (such as an intervenor in some civil law systems) pending the final appointment by the creditors meeting. Under prior Mexican law, for example, the intervenor served as a representative of the creditors, fulfilling a role analogous to that of the Creditors Committee in the United States or to inspectors under Canadian practice. Interventors could bring action against the debtor, request court hearings and call extraordinary meetings of creditors. They were reimbursed from the estate. Because there is generally a gap under many systems between the date of filing bankruptcy and the date of appointing a final administrator or estate representative, it is essential that the rights and interests of creditors are protected during this interim period when vital decisions may be made.
107. In general, a committee can serve a useful function as a sounding board and in monitoring activities of the administrator, in processing and distributing information to its constituents and in organizing creditors for decisions on critical issues. Typically, before the enterprise will agree to disclose confidential information, it will require the creditors' committee to sign a confidentiality agreement, agreeing not to disclose the information to competitors or others without prior approval. Efficiency should be tempered with accountability and transparency, and greater transparency and creditor participation are generally required when regulations or institutions are weak. Consistent with the committee's role in monitoring the proceedings and representing the voice of creditors (at least unsecured creditors), the committee must have access to impartial advice to ensure that the rights of creditors are being protected. For this reason the law should allow creditors to retain an independent professional who will be compensated from the estate or from the proceeds distributed to the creditors represented by the committee.
108. *Transparency and approval rights.* It is important to distinguish between issues of transparency and management. Transparency is designed to protect creditors by giving them notice of issues that affect their interests and affording them an opportunity to be heard. Notice does not afford the right to approve or make management decisions, as discussed above. Creditors and a creditors committee can serve as an effective check and balance on the activities of an administrator or liquidator. To effectively monitor proceedings, creditors should be given an opportunity to obtain relevant, accurate and current information on the debtor's enterprise, trading activities and financial affairs. This requires that proceedings and the administrator's activities be open and transparent, and that administrators be held accountable for their conduct. While notice to the entire creditor body may not be required, notice should be obligatory for the committee, major creditors (including secured creditors) and fiscal creditors. Significant events might be published in an appropriate public journal to provide additional notice to creditors at large.
109. Finally, on significant sales, the court should take into account the views of creditors, the creditors committee or both. They should be consulted by the administrator or the judge and should be given an opportunity to oppose major actions that will affect their interests. Having an ability to veto actions outright is less significant where secured creditors have already been given the right to take their collateral. One need also consider an appropriate check on irrational creditors with unrealistic expectations. In general, creditors tend to act rationally if they have full access to information to make decisions and have a financial stake involved.
110. Rules and procedures are required to deal with such things as the calling of meetings of creditors, the eligibility of persons to attend and participate in meetings (including voting rights and establishing a quorum) and the chairing and general conduct of meetings. The committee itself should operate according to by-laws or another governing document, adopted by the committee to normalize and define the parameters of its operations and deliberations.
111. **Principle 13: Administration: collection, preservation, disposition of property.** *The law should provide for the collection, preservation and disposition of all property belonging to the debtor, including property obtained after the commencement of the case.* Fundamental to the insolvency

process is the need to identify, collect, preserve and dispose of property belonging to the debtor. Property includes all types of property, such as immovable and movable, tangible and intangible, including premises, fixtures, stock, inventories and goods, works in progress, bank accounts and accounts receivables, books and records, securities and financial instruments, contract rights, intellectual property and other kinds of property interests. Some jurisdictions exclude from the administration certain types of property or property subject to certain interests. Others require all property to be subject to the proceedings in the first instance, subject to the proof of harm or prejudice.

112. Complex issues are sometimes raised in determining whether an asset is owned by the enterprise or owned by another party but in the debtor's possession subject to use, lease or licensing arrangements. The ability to continue to use property that is subject to a contractual right should be expressly stated in the law. Likewise, the law should address whether property that has been pledged as security to a creditor is subject to the administration. Most systems provide for this result, while others may provide that such creditors are unaffected by the bankruptcy and may proceed to enforce their legal and contractual rights.<sup>19</sup> Typically, third parties asserting an ownership interest in the debtor's property must establish to the court's satisfaction that their rights and interests are superior to those of the debtor and should be enforced notwithstanding equity or reorganization policies. Finally, in keeping with the goal of maximizing the estate for the benefit of creditors, the administrator should be entitled to abandon assets with negative or insignificant value, providing the abandonment does not violate compelling public policies.
113. *Immediate steps should be taken or allowed to preserve and protect the debtor's assets and business.* As an operating business, the debtor's property may be located in various places. Debtors facing bankruptcy may be inclined to strip assets or remove books and records in an effort to conceal inappropriate transactions. Books and records are essential to understanding the business, identifying assets and establishing ownership, and identifying and characterizing contractual relationships with creditors. Even where assets are fixed, if the business continues to operate, there may be a need for an administrator to act quickly to take control of the business to ensure that unpaid creditors and employees do not cease to deal normally with the company, to continue to work, or to protect its property. Collecting the debtor's property also may require affirmative action to recover property that was improperly transferred or transferred at the time of insolvency. The justification for recovering property transferred is to protect creditors or uphold the pari passu principle of equal treatment among creditors. Most insolvency laws or legal systems provide a means of setting aside and recovering the value of antecedent transactions that result in preferential treatment to some creditors or that were fraudulent in nature or made in an effort to defeat the rights of creditors. The applicable avoidance period varies by jurisdiction. The process of recovering assets fraudulent and preferential pre-bankruptcy transfers is discussed in principle 15 below.
114. *The law should provide a flexible and transparent system for disposing of assets efficiently and at maximum values.* There are many ways in which assets may be sold. The law should provide a flexible and transparent system for disposing of assets in whatever fashion will realize the greatest value. In some cases the sale will include the entire business as a going concern, operating or productive units of the business, and sales on a piecemeal basis. Sales can occur through public auctions or private sales. In a public auction, rules and procedures should be transparent and fair. Generally the sale is preceded by public notice or advertisement. The offer selected is generally the one providing the highest and best value for the asset in question, provided the offer is genuine and the buyer is ready, willing and able to consummate the sale. Public sales are desirable when significant assets are involved. In contrast, private sales are generally negotiated between the administrator and one or more potential buyers. Because private transactions are potentially more vulnerable to abuse, careful consideration should be given to ensure proper notice to the creditors and

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<sup>19</sup> See the discussion on treatment of secured creditors under principle 16.

that the sale terms are fair. Generally all sales will be subject to court approval, but they should also be subject to notice to and review by the creditors committee and other interested parties.

115. *Where necessary, the law should allow for sales free and clear of security interests, charges or other encumbrances, subject to preserving the priority of interests in the proceeds from the assets disposed.* Often, certain assets of an enterprise will be subject to a security interest, pledge, mortgage or other collateral interest in favor of one or more creditors. If the assets or the business can be sold as a going concern or productive unit at higher prices, the law should allow this to occur while respecting the priorities of secured creditors. After deducting the sales costs, proceeds from the sale of pledged assets should be distributed promptly to secured creditors to the extent of their claims. Allowing the administrator to continue operating the business with the net sales proceeds of collateral creates a perverse incentive to administer the assets inefficiently and distorts expectations of rights among secured and unsecured creditors.

116. **Principle 14: Administration: treatment of contractual obligations.** *The law should allow for interference with contractual obligations that are not fully performed to the extent necessary to achieve the objectives of the insolvency process, whether to enforce, cancel or assign contracts, except where there is a compelling commercial, public or social interest in upholding the contractual rights of the counterparty to the contract (as with swap agreements).* Counterparties to a contract<sup>20</sup> are mainly interested in getting the benefit of their bargains by having contracts enforced according to their terms. This attitude may change for the debtor upon the declaration of bankruptcy, where the objectives of the proceeding may prevail. In a liquidation, there is less motivation to preserve contracts, except to the extent they may add value and promote the sale of the business. The dynamic is different, however, in a rehabilitation proceeding, where the ultimate objective is to enable the enterprise to survive and continue its affairs to the extent possible in an uninterrupted manner. In such cases, the interest typically is to avoid burdensome obligations (those that have negative economic value or that do not promote the rehabilitation) while taking advantage of those contracts that are beneficial and contribute value. The former would be disclaimed and the latter adopted; both options raise very unique issues and policies choices that must be balanced against other policies (such as those that support certainty in commercial dealings and that promote rescue of enterprises and preservation of jobs). Principle 14 adopts the baseline case recognized in most jurisdictions, including Europe, of allowing adoption and rejection of contracts, and to allow interference or an override of contractual obligations to the extent needed to promote other policy objectives of the system in question. For example, rehabilitation may depend on the ability to enforce contracts (including labor contracts), notwithstanding a right of cancellation in the event of insolvency, or cancellation to enable the enterprise to downsize its workforce to a reasonable level or to avoid burdensome contracts. The principle encourages policy makers to take account of other policies that may provide a compelling case for altering the commercial expectations and bargains of the parties.

117. Most insolvency laws allow the administrator to elect to continue or disclaim contracts based on a cost-benefit analysis of what is in the best interest of the creditors. All contracts constitute a set of benefits and burdens to the enterprise. Where costs exceed anticipated benefits, rejecting a contract allows the administrator to carry out his duties to maximize recoveries by minimizing losses, and fix claims that can be measured and equitably treated in the bankruptcy as of the commencement of proceedings. When the contract is disclaimed or rejected, the counterparty is entitled to assert a damage claim for breach of contract, which is given the status of an unsecured claim that arose or existed prior to the commencement of the proceedings. Even in a rehabilitation proceeding, where the intended outcome is to continue the business, rehabilitation prospects are often enhanced if the administrator is allowed to reject burdensome contracts where the cost of performance is higher than the benefits to be received or, in the case of an unexpired lease, the contract rate exceeds market rate.

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<sup>20</sup> For ease of reference, the discussion of contracts includes treatment of unexpired leases. Where the discussion relates specifically to a lease, that term is used.

As in a liquidation proceeding, counterparties of rejected contracts are entitled to assert a general unsecured claim for damages, but may have an administrative claim for unperformed obligations during the proceedings.

118. Where the benefits of a contract exceed ongoing costs, adopting the contracts enables the administrator to realize greater value in the liquidation of the estate or to enhance the prospects for rehabilitation. Adopted contracts are treated as ongoing obligations of the enterprise that must be performed. Some laws require, as a condition of adoption or acceptance, that the administrator cure any defaults under the contract and provide assurance of future performance. If the adopted contract is subsequently breached, the counterparty may then assert an administrative claim (as opposed to an unsecured claim) for damages or for amounts outstanding under the contract.
119. Many contracts contain clauses entitling one party to cancel if the other becomes insolvent. These are often called ipso facto clauses because the contract states expressly that it is cancelled as a consequence of bankruptcy. Some insolvency laws override these clauses to prevent cancellation of the contract, with the result that a party who cancels may be liable for damages to the insolvent. There are arguments for and against this override. Those supporting the practice of prohibiting cancellation include the need to keep the business together to maximize the sale value or to enhance its earnings potential, the need to reduce the bargaining power of an essential supplier and the desirability of locking-in all parties in the final disposition of the business. These arguments are more persuasive in the context of a rehabilitation proceeding. Arguments against a stay on counterparty rights to cancel contracts include:
- The insolvent can “cherry pick”—that is, claim selective performance of contracts profitable to the insolvent, but cancel others. It is unreasonable for a defaulter to have an advantage denied to the innocent counterparty.
  - The stay prevents netting,<sup>21</sup> and it is difficult to isolate contracts that should be eligible for netting from those that are not.
  - The insolvent estate is generally unable to perform, so there is no point in waiting.
  - It is inappropriate to compel a transfer of contracts to a different unknown transferee.
  - The occasional abuse should not influence a much larger policy.
120. On the whole, the approach internationally to a freeze on contract cancellations has been relatively cautious aside from the special case of real property leases. A few countries have implemented the freeze (Canada, France, United States), but it has not been a general feature of rescue statutes. In some countries there are a variety of exceptions to the freeze. The issue is exacerbated by the fact that modern life is honeycombed with the contract—not merely the ordinary contract of sale, but also leases and charters, title finance, contracts for the sale of securities or foreign exchange, transportation, construction, obligations to lend money or to subscribe for securities and licenses of intellectual property. The insolvent could be on either end of the contract—buyer or seller, lessor or lessee, constructor or employer, licensor or licensee. There is an inherent tension for policy makers in promoting the debtor’s survival, which requires the preservation of contracts, and interjecting unpredictability and extra costs into commercial dealings by creating a variety of exceptions to the general rule.
121. *Setoff and netting.* Insolvency setoff takes many approaches. In many common law countries setoff is permitted between solvent parties, but becomes compulsory on insolvency. The approach favors payment to creditors who want to be paid without deduction to maintain cash flow and to support the practice of “pay now, litigate later”. When a counterparty becomes insolvent, the same policy favors payment to creditors, who are paid by the defaulter even though they are unsecured. By contrast, in other jurisdictions, setoff is “permitted” between solvent parties but “prohibited” on insolvency (augmenting the debtor’s estate and favoring debtors). Setoff avoids circuity of payment and achieves

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<sup>21</sup> Netting is discussed below under setoff and netting.

judicial economy by avoiding multiple proceedings. But the main effect of setoff is that a creditor with a setoff is effectively secured in that the debtor's cross-claim can be paid or discharged by setting it off against the creditor's claim. Setoff is not significant until insolvency because if a counterparty could always pay, there would be no need for it. So, like security, the efficacy or otherwise of the remedy is measured on insolvency.

122. There are a number of arguments against allowing setoff. Insolvency setoff is a violation of the *pari passu* principle because a creditor with a setoff gets paid in full. Setoff is like an unpublicized security interest causing assets to disappear on bankruptcy. (Unlike the registration requirements for collateral, it is clearly not practicable to require parties who have reciprocal claims to publish that fact.) Setoff depletes an insolvent debtor's assets and inhibits a rescue. A rescue cannot succeed if the debtor loses access to its bank accounts or the cash in its bank accounts. Conversely, there are many equally compelling arguments favoring setoff. It is unjust that the defaulter should insist on payment but not pay himself. Setoff helps creditors escape the debacle and so mitigates the knock-on or cascade effect of bankruptcy. Setoff is fundamental in wholesale markets and for payments systems to mitigate systemic risk. Setoff reduces exposures and hence the cost of credit. Setoff avoids circuitry and hence reduces transaction costs. Setoff prevents the debtor from being bankrupted on a debt he does not owe if the overall position is taken into account; if he has this relief, he should not be in a better position than the creditor.
123. Netting is different from setoff because in one form it can consist of the setoff of non-money fungibles (such as securities or commodities deliverable on the same day, known as settlement netting) and because in its more important form it generally involves a cancellation by a counterparty of open contracts with the insolvent, followed by a setoff of losses and gains either way (closeout netting). So closeout netting is not just setoff: hence the importance of the question of whether contractors can cancel under an *ipso facto* clause.
124. The international position on setoff and netting is almost beyond the ability of experts to master, let alone market participants who have to use the law. Jurisdictions that did not traditionally accept insolvency setoff (which are in a minority), except for certain transaction and current account setoffs, still mainly adhere to that position. But a few have widened their transaction setoffs, and some have introduced netting statutes, though applying only to contracts within the statute (Belgium, France, Luxembourg). Among states that traditionally allowed insolvency setoff—notably those in the common law and Germanic groups, as well as Dutch and Scandinavian jurisdictions and Italy—a small minority (such as Canada) have imposed a stay in the case of rescue proceedings, though usually subject to a carve-out for financial contracts. Some recent insolvency laws do not appear to deal with the matter (as in Russia). If there is a rescue stay, then presumably markets cannot take the risk since setoff and netting require high predictability and there could just as well be a rescue proceeding as a liquidation. If there is a carve-out, then the counterparty has to check that the detail of the carve-out applies to his contract, which is often complicated.
125. *Carve-outs for financial/derivative contracts.*<sup>22</sup> Setoff and netting raise another issue that is rapidly becoming a more generalized feature of insolvency laws—the carve-out. A carve-out is an exemption from the usual bankruptcy regime in favor of a particular class of creditor or class of transactions. For example, about 20 jurisdictions, most of them major, have carve-outs in favor of netting prescribed

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<sup>22</sup> Derivatives are contracts whose market value is “derived” from the value of other securities or variables. The most common form of these are currency exchange and interest rate swap agreements, designed to limit repayment risk that is tied to a floating interest rate or to a particular currency. The former International Swap Dealer's Association, now known as the International Swap and Derivatives Association (ISDA), had developed master agreements governing interest rate and currency swaps. ISDA has been collecting legal opinions on the enforceability of these contracts in a wide-number of jurisdictions, but the total number of jurisdictions is relatively low and considerable uncertainty exists under the laws of most countries. For a more detailed discussion on the treatment of setoff in the context of bank insolvency and restructuring, see the discussion of these issues in Annex I.

financial contracts. Many developed jurisdictions have special carve-outs for security interests, repos and securitizations. The recent EC Finality Directive is another illustration. Carve-outs generally establish a better and more efficient regime. Many are essential for the safety of markets. Still, there is a wider policy involved. The carve-outs often seem quite restricted. These exemptions accumulate internationally into a web of extraordinary complexity. Not only are the carve-outs themselves often very detailed, but they can quickly get out of date. This situation can create undesirable extra risks (because the ordinary businessman cannot always be expected to comprehend two-tier systems facing both ways at once), leading to high transaction costs. The paramount importance and use of certain derivative contracts in risk hedging international transactions today demands the highest level of certainty for the international community. This is best achieved by including carve-outs for these types of contracts, even though the general commercial law of a particular jurisdiction may permit post-commencement setoff.

126. **Principle 15: Administration: fraudulent or preferential transactions.** *The law should provide for the avoidance or cancellation of pre-bankruptcy fraudulent and preferential transactions completed when the enterprise was insolvent or that resulted in its insolvency. The suspect period prior to bankruptcy, during which payments are presumed to be preferential and may be set aside, should normally be short to avoid disrupting normal commercial and credit relations. The suspect period may be longer in the case of gifts or where the person receiving the transfer is closely related to the debtor or its owners.* The transfers covered by this principle fall into two categories: fraudulent and preferential. Fraudulent transfers are those made by the debtor's management with an intent to defraud creditors, while preferences are typically payments made in the usual course of affairs but which violate the *pari passu* principle by preferring some creditors over others who go unpaid during the period of insolvency leading up to the filing. The suspect period for fraudulent transfers (1-6 years) is generally much longer than that for preferences (3-6months). The suspect period for preferences should be kept reasonably short, as the effects of setting aside preferential transfers are potentially disruptive of normal commercial activities.
127. All developed insolvency laws provide for the recapture of assets transferred by the debtor in the suspect period prior to the commencement of formal insolvency proceedings. The fundamental requirements qualifying a transaction as preferential are that it prejudices other creditors of the debtor (who receive a lower dividend in the bankruptcy by virtue of the payment made to other creditors), occurs while the debtor is insolvent or renders the debtor insolvent and occurs in a suspect period prior to the formal opening of insolvency proceedings. The first item is always required. The other two are usually required, though there are exceptions (as in the case of deliberate concealment). Justifications for this outcome include:
- *Fraud.* To prevent the debtor from fraudulently concealing or transferring his assets beyond the reach of his creditors when he knows that his insolvency is looming. This is the true fraudulent transfer and often carries an element of dishonesty.
  - *Equality.* If the debtor is insolvent, he should treat his creditors equally even though formal insolvency proceedings have not begun. Other creditors should not be prejudiced by a preferential payment or transfer to one of them, thereby diminishing the assets of the estate available to creditors generally.
  - *Debtor harassment.* To discourage creditors with special leverage or who are especially diligent from harassing the debtor to pay them off or secure them in priority to the others.
128. The conflicting policies favoring a mitigation of preference rules include:
- *Predictability.* The need for predictability and certainty that transactions with a party will be inviolable and be upheld in favor of third parties dealing with the party in good faith and for value. If all transactions could be unwound if they took place in the suspect period regardless of knowledge or guilty participation or lack of value given by the third party, there would be less safety in commercial and financial transactions. The preference rules impose equality at some



uncertain date before formal insolvency proceedings have begun and so backdate the guillotine. Insolvency becomes retroactive.

- *Avoidance of insolvency.* The second policy mitigating against an overly broad recapture is the need to occasionally give the debtor an opportunity to trade out of his difficulties. If the debtor and its directors are potentially exposed to penalties or disqualification if they prefer creditors, then the debtor may be pressured into closing up shop prematurely to the likely detriment of his creditors generally. Insolvency proceedings generally have a catastrophic effect on the value of a company's assets and usually destroy its goodwill, even if as a rehabilitation. This contrary policy illustrates the tension that always exists between encouraging debtors to stop before it is too late and allowing them to continue to rescue both themselves and their creditors.

129. While nobody objects to the avoidance of the intentional dissipation of assets, the reach of preference laws to catch the more ordinary transaction has always been unpopular. In most jurisdictions preference rules may be grouped into the following categories:

- *Intentionally prejudicial transfers.* This category is made up of transfers by the debtor intended to prejudice or defeat creditors by removing assets otherwise available to them on insolvency. This is the original Actio Pauliana, stemming from at least the 9<sup>th</sup> century and reflected in all developed insolvency laws. Its hallmark is a deliberate intention to defraud creditors. Generally there is no suspect period and the transaction is vulnerable whenever it is made.
- *Gifts.* This category calls for the avoidance of gifts by the debtor since these clearly reduce assets available to creditors. This category generally includes transactions at an undervalue where there is an element of gift, such as a sale of the debtor's assets at an undervalue. The rule may be extended to other types of undervalue transactions, such as excessive remuneration to insiders and extortionate credit transactions. There may or may not be a suspect period for gifts.
- *General preferences.* This is a general provision attacking all payments and transfers by the debtor that prejudice creditors by depleting the debtor's assets or improve the position of the preferential creditor by placing him in a better position than he would have been on the insolvency of the debtor in the absence of the transfer. Almost invariably, the general preferences in this class must occur within a specified suspect period prior to the commencement of insolvency proceedings at a time when the debtor was actually insolvent.

130. There also may be specific statutory provisions dealing with involuntary transfers by the debtor, such as creditor executions over the debtor's property and transfer or assignment of claims between creditors to build up setoffs. There may also be provisions controlling transfers of the debtor's business (commonly called bulk sales laws) and provisions restricting the payment of shareholders before creditors, such as the payment of dividends out of capital or various direct and indirect forms of repayment of share capital (such as financial assistance for the purchase of the company's shares). "Financial assistance" rules are considered burdensome in some jurisdictions. Main issues in the law of preferences include:

- The extent of creditor protections or safe harbors for general preferences, notably whether the transaction is saved if the debtor had no intent to prefer or if the creditor did not know of the debtor's insolvency at the time of the transfer.
- The protection of ordinary course of business payments. This is particularly relevant to survival workouts.
- The validity of security for preexisting debt. Common problem areas include top-up margin collateral and ordinary corporate guarantees (no new money).
- The length of the suspect period.

131. **Principle 16: Claims resolution: treatment of stakeholder rights and priorities.** *The rights and priorities of creditors established prior to insolvency under commercial laws should be upheld in an insolvency case to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationships. Deviations from this general rule should occur only where necessary to promote other compelling policies, such as the policy supporting rehabilitation or to*

*maximize the estate's value. Rules of priority should support incentives for creditors to manage credit efficiently* There are many diverse and competing interests in an insolvency proceeding. For the most part, all creditors are creditors by virtue of having entered into a legal or contractual relationship with the debtor prior to the bankruptcy. The rights of these creditors will be governed by a host of different laws. While many creditors may be similarly situated with respect to the kinds of claims they hold based on similar legal or contractual rights, others may have superior claims or hold superior rights. As discussed in section 1, the insolvency law should carefully balance the legal and commercial rights of creditors in a way that preserves legitimate commercial expectations, to foster predictability in commercial relationships. Of course, there are limits to the extent to which this can be done, given the competing goals and other interests underpinning the insolvency process. Some of the more difficult policy options are discussed below.

132. ***Treatment of secured creditors.*** *The bankruptcy law should recognize the priority of secured creditors in their collateral. Where the rights of secured creditors are impaired to promote a legitimate bankruptcy policy, the interests of these creditors in their collateral should be protected to avoid a loss or deterioration in the economic value of their interest at the commencement of the case. Distributions to secured creditors from the proceeds of their collateral should be made as promptly as possible after realization of proceeds from the sale.* While the debtor is solvent, security is of limited significance because, assuming that the debtor has not removed its assets from the reach of its creditors, they can secure satisfaction by obtaining a judgment and enforcing it against those assets. It is when the debtor goes bankrupt that the creditor has a particular need for recourse to the security. Thus it is of prime importance that bankruptcy law in principle respect the pre-bankruptcy entitlements of secured creditors and give them priority over other creditors as regards rights over the collateral. The justification for such priority is to be found in the concepts of bargain, value and notice.
133. An area of particular difficulty and contention is the extent to which secured creditors should be allowed to assert their priority and enforce their security over the general body of creditors. The contest is between the interest of a creditor who has bargained for security in exchange for value that reflects the reliance on it and the interest of unsecured creditors in the avoidance of precipitate action. The secured creditor merely seeks to take out of the estate that which it put in, while the interest of unsecured creditors is to prevent the devaluation of the business by the removal of those essential to running the business. This concern is particularly relevant in the context of a rehabilitation proceeding, where removal of assets will likely prevent the reorganization to the detriment of all creditors. The problem is less acute in a straight liquidation, where the liquidator's function is to collect and realize the assets and distribute the proceeds among creditors by way of dividend. Here the secured creditor is commonly permitted to realize its security despite the bankruptcy, except in the rare case where the liquidator can produce a better result for all creditors. The secured creditor is therefore largely outside and unaffected by the bankruptcy process. Striking a balance between the competing interests is not easy, and the topic has generated a huge literature. There are significant disparities with respect to the granting of secured rights and the treatment of such rights in insolvency proceedings, with at least two clear options.
- *Option 1: Bankruptcy has no effect on secured creditors.* One group of countries allows universal security over all the debtor's assets, allows it to reach future assets, permits the security to cover all future debt without stating a maximum amount, allows the secured creditor to sell the collateral without court intervention and permits the secured creditor privately to appoint a possessory manager or receiver to run the business without selling. This group includes about 80 common law countries that have the universal fixed and floating charge. Similarly, other jurisdictions allow universal corporate security but limit it in various ways, including Finland, Poland, Russia, South Africa, Sweden and the United States (except Louisiana). The main difference is the absence in the second group of countries of immediate possessory management through a receiver who displaces the directors.

- *Option 2: Secured creditors are stayed from enforcing their rights in bankruptcy.* Another group of countries takes a different view. These jurisdictions allow security over land, as most jurisdictions do, but make it difficult to take security over goods, receivables, contracts and investments. They may do so by prohibiting the security altogether or by limiting its effect (say, by restricting the security to existing specific assets, excluding future goods and receivables generically), by excluding security for future debt or for revolving credits, requiring a maximum amount for the secured debt, subordinating the security to unsecured priority creditors (taxes, bankruptcy costs, employees) and by restricting enforcement, such as by requiring a judicial public auction (delays, costs, interest pile-up), compulsory grace periods and in some cases freezes on enforcement in the event of reorganization proceedings.
134. *Incentives and disincentives.* A decision on which of the available options is suitable hinges on the incentives and disincentives supported by the two approaches. Option 1 creates a strong incentive for debtors to act financially responsible, at least with their secured creditors, who are more likely to be major lenders. A second argument is that this approach promotes lending on the most favorable credit terms by giving the highest assurance to the market and lenders that their secured rights are protected. This solution effectively elevates specific secured rights over those of general unsecured creditors, especially where a secured creditor is diligent in protecting its interests. Rewarding positive behavior will likely encourage more creditors to be diligent in protecting their interests. This option also could encourage a secondary market by making distressed debt more attractive to buyers, who will have greater certainty of realizing value from secured bad debt.
135. Admittedly, any constraint on the enforcement rights of secured creditors diminishes certainty in the ability to recover debt. This may translate into higher risk assessment and so higher credit rates and charges. Uncertainty can be reduced by providing time-bound rules on the duration of the injunction with clear outside limits. In some cases the risk might be turned to a secured creditor's advantage in bankruptcy where the potential to realize collateral in bankruptcy is much stronger than under nonbankruptcy enforcement procedures. Such assurances enable creditors to better price their risks of insolvency for time delays and may improve their enforcement rights where the process for execution through normal civil or commercial court procedures is attenuated.
136. ***Stay protection.*** *In cases where the stay applies to secured creditors, it should be of limited specified duration, strike a proper balance between creditor protection and insolvency objectives, and provide for the possibility of orders being made on the application of affected creditors or other persons for relief from the stay.* In a liquidation the emphasis is on selling assets, in whole or in part, so that creditors can be repaid from the proceeds as quickly as possible. Maximizing value is an overriding objective in liquidations. The difficult balance is between the competing interests of secured creditors with collateral rights and the interests of general unsecured creditors. More often than not, the secured creditors will hold a secured interest on the business's most important assets. Arguably, in a liquidation, where the interest in preserving enterprises does not exist, the balance of interests should tilt strongly in favor of upholding the contracted rights, subject to respecting the pari passu principle. In other words, there should be a strong interest in protecting secured rights and allowing such creditors to recover their collateral. Because such creditors have rights that are senior to or different than those of unsecured creditors, special treatment of such rights does not violate the pari passu principle as among unsecured creditors. At the same time, the interest in protecting secured rights should be balanced against the strong interest in maximizing value in the liquidation of the business. This often means, in the first instance, attempting to sell the enterprise assets collectively rather than piecemeal where the collective value is higher than the breakup value. It may also mean ensuring that any equity or unencumbered value in the collateral is preserved for the benefit of the estate.
137. Extending the automatic stay to secured creditors and holders of in rem interests in the debtor's property is more controversial. In the context of a rehabilitation proceeding, the issue is fairly straightforward. A business cannot be reorganized if it has no assets left to reorganize. The rationale

is that attempts at rescue may fail unless the essential assets and component parts of the property of the debtor and its businesses are maintained. Consequently, the policy supporting rescue of an enterprise necessitates that an injunction or stay of creditor actions be imposed for a reasonable period to prevent creditors from disassembling the business while the parties negotiate a rescue plan. The scope of the injunction should be all embracing, even to the extent of restraining secured creditors from exercising enforcement rights and restraining government from exercising priority rights.

138. Notably, the rationale of salvaging the business as a going concern collides with the policy of promoting credit flows by reducing insolvency risks for secured creditors. In some cases this is not possible. For example, some secured transaction rights may be so entrenched in the commercial culture that it is difficult to restrain the exercise of those rights. As a result legislation may have to provide for an exception to the restraint or afford the secured creditor the opportunity to elect whether to exercise those rights. The floating charge form of security has had to be accommodated in this respect in the rescue processes of England and Australia. In any event, the stay or suspension should be of limited duration and should not be extended without a court order.
139. Where the interests of affected creditors are inadequately protected, provision should be made to enable them to apply for relief from the stay. While protection may take many forms, the essence of the concept aims at maintaining the status quo of a secured creditors interest in property by taking measures that will either prevent the erosion in the value of the collateral or compensate the secured creditor for the loss in value. Protection might take the form of periodic cash payments during the case, providing the secured creditor an additional security interest in other unsecured assets, providing a priority in repayment to the secured creditor from other unencumbered assets, and the like.
140. *Title finance and title retention holders.* Title finance is often used as an alternative to security, and an assessment of security should include an assessment of title finance. For example, English 19<sup>th</sup> century bills of sale legislation prohibited non-possessory chattel mortgages by individuals but were sidestepped by the title finance technique of hire purchase. The result is that credit based on assets is available to consumers. In some countries financial leasing, widely used for aircraft and other large pieces of equipment, seems to have received special impetus from railroad financings, where there were problems about taking or enforcing security over rolling stock.
141. In title finance the financier has title or ownership of the asset as opposed to a mortgage or security interest. Apart from hire purchase and finance leases, other examples are trade finance forms, including retention of title and discounting or factoring or forfeiting of commercial receivables; sale and leaseback; sale and repurchase (repos—commonly used for investment securities and important in financial markets); and stock borrowings. Perhaps one might include in this bracket securitizations of receivables and repackagings of debt securities, of which there are many variations.
142. In essence, title finance often has the commercial effect of security. Indeed, many of the techniques are designed to avoid the obstacles of pledge laws. The attitude of jurisdictions toward title finance has ranged from enthusiasm to hostility. Some jurisdictions encourage the escape from the cage of mortgages and hence support form over substance. Others seek to rebolt the gate: they recharacterize the transaction as security with the result that it often fails for noncompliance with a pledge rule or is reintroduced into the regime covering security interests (such as Article 9 of the U.S. Uniform Commercial Code). Some legal systems protect one form (such as seller's retention of title to goods) but not others.
143. Reservations of title have longstanding importance in continental Europe. A reservation or retention of title clause is generally found in an agreement between a buyer and seller, and provides that the seller transferring property thereunder retains ownership of such property until satisfaction of the conditions in the agreement, such as payment in full. The reservation also extends to the proceeds of the goods if sold, to the extent traceable.
144. Retention of title devices are not confined to sellers, but also may be used by lenders or other providers of financing for the sale of property. Retention of title effectively provides a security for

payment of the purchase price. The well-recognized effect of such clauses is to confer upon the holder of the reservation of title a prior right or security interest in the goods in question. These clauses protect sellers against the rights of other secured creditors holding fixed or floating charges, as well as preferential rights. Retention of title devices often do not require registration or notice and hence may operate as a “secret lien” when such clauses may be enforced without notice or registration to any other party. Some jurisdictions (Portugal, Spain, Switzerland) require registration for the title retention to be effective.

145. The central issue is not whether title finance is similar to security—which it often is—but the role of this safety valve. If a device is established and widely used to escape incompatible pledge and mortgage restrictions, the more sensible place to consider addressing the issue would be pledge laws. Moreover, transparency greatly helps solve the potential problems with systems that preserve a distinction between retention of title and grant of security. It is important that retention systems require some form of public registration, at least for collateral values over a stated amount, or the system will suffer most of the serious cost disadvantages mentioned in the discussion accompanying principle 4 above. If registration is not accepted for retention interests, then at a minimum retention must be narrowly defined to include only purchase-money situations rather than the grant of security interests over property already owned. Otherwise, sham transactions will abound.
146. ***Treatment of unsecured creditors.*** *Following distributions to secured creditors and payment of claims related to costs and expenses of administration, proceeds available for distribution should be distributed pari passu to remaining creditors unless there are compelling reasons to justify giving preferential status to a particular debt. Public interests generally should not be given precedence over private rights. The number of priority classes should be kept to a minimum.* The insolvency laws of many countries recognize, in varying degrees, the priority of certain categories of unsecured debt, such as taxes and unpaid wages. There is an observable tendency to increase the categories of debts enjoying such priority, for example by giving this status to each new form of tax or duty or each additional employee entitlement. Indeed, in countries with a strong tradition of worker protection there is sometimes an acute tension between the provision of safeguards for employees against the consequences of their employers’ insolvency and the need of the bankruptcy trustee to keep the business viable and, if possible, restore it to profitability, which may involve a sharp reduction in the workforce. In recent years there has been a reaction against preferential status for unsecured debt and even against the concept of unsecured preferential claims as impeding the perceived objective of insolvency law—namely, to maximize returns for creditors as a whole.
147. Another factor eroding the position of the ordinary unsecured creditor is the wide range of nonconsensual security interests found in many legal systems—for example, liens given by law to secure the payment of repair charges, port and landing dues for ships and aircraft, seamen’s wages and other maritime claims, and the like. Typically, such liens have priority not only over the claims of unsecured creditors but also over consensual security interests. And because they are often non-possessory and not readily susceptible to registration, their existence is not visible to creditors holding consensual security, who simply have to accept the risk of such liens arising. Accordingly, when a new legal regime is being devised for consensual security interests it is important that due attention be paid to the position not only of secured creditors and ordinary unsecured creditors but also to preferential creditors and those holding nonconsensual security interests.
148. Legislators should resist the temptation to create a proliferation of priority classes based on special interests rather than solidly endorsed and widely embraced social policies. All insolvency laws reflect policy choices that prioritize some claims over others in the distribution scheme. While many such policies recognize important public interests, such as preserving the state’s revenue base or ensuring employee security, these broader public interests compete with private interests and may distort normal commercial incentives. Insolvency laws should not serve as surrogate social security systems, environmental protection agencies and the like.

149. ***Treatment of employees.*** Workers are a vital part of an enterprise, and careful consideration should be given to balancing the rights of employees with those of other creditors. In liquidation, where the fate of the enterprise is terminal, one cannot reasonably make a case for preserving jobs at the expense of a defunct enterprise. Bankruptcy is generally viewed as a process of financial adjustment in the relationships among lenders and borrowers or creditors and debtors—a view that could be interpreted to overlook or marginalize the significance of employees and their rights. As a class, workers fall between the extremes of shareholders or managers and lenders or creditors. There is typically an implicit commitment between workers and the firm. If the worker continues to work effectively, the firm will continue employment and pay wages commensurate with the employee’s abilities and efforts. This commitment is necessarily qualified: if the firm’s financial fortunes decline precipitously, the worker, as well as the firm’s shareholders, bear some of the risk. The commitment is typically not explicit, simply because it is impossible to write down all the relevant conditions. Many legal systems recognize these implicit commitments. Thus in bankruptcy proceedings a payment due to workers for work already performed is given seniority over other unsecured creditors holding a priority or preference in payment.
150. There are broader, and typically unresolved, issues concerning other “obligations” toward workers (those embedded in the implicit contract) and other creditors. Depending on training and location, employees may have limited job mobility and prospects. For employees whose pension benefits derive from the ongoing operations of the business or who are vested in the stock of the company (now worthless), there are valid concerns of practical security. Employees and pensioners could have their retirement security disappear in insolvency without particular protections. These broader issues, affecting employment rights and benefits, must be taken into consideration. Such issues are even more acute in the context of systemically distressed economies, where the unemployment rate may already be elevated. The issue is compounded in many transition and developing economies where there may be a weak social safety net for unemployed workers. In times of corporate financial distress, it is not uncommon for firms to downsize their workforce considerably to become more competitive. Redundant employees may have few options.
151. Recent experience demonstrates the potential for social unrest in severely distressed markets where there is no coherent strategy for dealing with employee rights. Such issues raise difficult policy questions for the design of an insolvency law. Should the rights of employees be given priority over those of other creditors supplying essential inputs to a business? If so, businesses that are labor-intensive will represent a higher credit risk than capital-intensive businesses, which may penalize job creation.
152. ***Treatment of equity interests.*** As a general rule, the owners of the business are not entitled to a distribution of the proceeds of assets until the creditors, who are senior in priority, have been fully repaid. Accordingly, it is only in the rare liquidation case that the equity interests or owners may realize any recovery from their investment in the enterprise. In a rehabilitation proceeding, the same rule should apply, and its application quite often poses obstacles to workouts and voluntary commencement of proceedings that owners know will ultimately result in the demise of their ownership. This outcome is extremely hard to accept when owners or a family have devoted their life’s earnings and hard labor to growing the business. Accordingly, rehabilitation procedures, which adopt the same general rule on priorities, sometimes allow equity interests to negotiate to retain a stake in the enterprise.

### **3.3 Features Pertaining to Corporate Rehabilitation (Principles 17-24)**

153. Traditional forms of rescue include voluntary compositions, preventative compositions, moratoriums (long and short), arrangements with creditors, judicial management, accords and creditor compositions. These older versions of the modern rehabilitation proceeding were often grudging and subject to abuse. They often imposed high thresholds for entry or impractical requirements for

guaranteed initial payments or other restrictions. As a result they have not been used much. Creditors preferred to engage in private workouts or, if there was no further hope, to pursue liquidation.

154. Recent years have witnessed the introduction of “low entry” rehabilitation proceedings intended to rescue businesses or at least enable them to be wound down more sedately.<sup>23</sup> They are low entry because management can initiate them only by showing insolvency (or sometimes potential insolvency or even just a looming problem) plus some chance of survival, without having to assure creditors of the immediate payment typical of many traditional compositions (25-40 percent); and because the stay on creditors may be more extensive than in a liquidation proceeding to preserve the business and enable it to be sold as a going concern.
155. The process of rescue, in contrast to liquidation, has been used increasingly in many jurisdictions. In some jurisdictions rescue is akin to liquidation, while in others rescue and liquidation are vastly different. Two things stand out in the confusion. First, most jurisdictions that use the word rescue have experienced fairly recent legislative reform and development of their insolvency laws. Those developments have been centered on corporations of various juridical structures. These are the modern “merchants” or “traders,” and the law has been developed to encourage their survival rather than end their existence. The modern desire to introduce a corporate rescue process into insolvency laws has been driven by the need to respond to both economic and commercial expectations.
156. Second, few of these jurisdictions describe their new statutes under the formal heading of rescue. Rather, a variety of terms are used, such as reorganization, rehabilitation, restructuring, arrangement, administration, composition, reconciliation and even merger or acquisition. To this list of titles should be added the informal “workout” device that has also been accorded the status of a rescue method. It is employed outside of, and sometimes due to the absence of, a formal rescue process. Each of the formal rescue titles delineates a formal statutory regime that in some important ways is different from liquidation. Moreover, when contrasted with liquidation, these regimes might produce a better economic result in the administration of an insolvent corporation. This has resulted from the growing fusion of contemporary legal and economic thought to insolvency law.
157. The distinction between conventional liquidation and corporate rescue tends to get blurred, however, when maximizing value is the overriding goal. For example, if a bankruptcy or liquidation law can preserve and possibly enhance the value of an insolvent corporation’s assets, albeit in the context of transferring the business to another entity (such as through an English “hive-down” procedure), then such procedures would seem to fall within the scope of the rescue concept. In this regard rescue does not necessarily mean that an insolvent corporation is fully restored or that the main participants in the insolvency (creditors and owners) are eventually restored to their pre-insolvent legal positions. Rather, what rescue regimes seek to signal is that, through the application of various techniques and mechanisms (involving something other than the traditional methodology of liquidation), more value can be obtained than would be realized from the standard liquidation sale of the corporation’s assets. It should be emphasized that the policy favoring rescue in no way implies that every enterprise is a suitable candidate for it. Enterprises that are beyond salvage, or that should be brought to an end, should be liquidated swiftly and efficiently.
158. What the different regimes have in common is that a formal process can offer the opportunity to rationalize a corporation’s business and financial affairs. This suggests that rescue should be

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<sup>23</sup> Examples are Chapter 11 in the United States, the administration proceeding in the United Kingdom, the *redressement judiciaire* in France, the examinership in Ireland, the extraordinary administration for large enterprises in Italy, judicial management in Singapore, commercial reorganization in Canada, voluntary administration and deed of company arrangement in Australia, the aptly named legislation in India for “sick” companies, and recent equivalent procedures in Belgium, the Czech Republic, Finland, Germany, Russia, the Slovak Republic, Sweden, Thailand, and many others. Nearly all these systems were created in the past 20 years, with only a few earlier examples, such as the Spanish Suspension of Payments of 1922 and the Japanese Corporate Rehabilitation Law of 1952, the latter influenced by the U.S. Chandler Act of 1938.

principally concerned with preserving the enterprise's income-producing business and with reducing, rescheduling or extinguishing debt according to the corporation's ability to bear it. It does not necessarily follow that the corporation must be preserved and left intact. The overall aim is to provide an environment that can achieve the type of goal that contemporary economic thought and commercial expectations appear to agree on. It might also include, as a by-product, some protection for wider interests such as employees, preservation of markets for suppliers and the like. Viewed in that way, a rescue can still produce one, more or all of the following results:

- A liquidation or sale of some or all of the enterprise's assets to third parties, including an income-producing business—bearing in mind that the rescue regime creates a more appropriate market in which to obtain the best value for such an asset.
- The ultimate termination of the life of the corporation, which may come about through a later formal liquidation of the corporation.
- The total cancellation of owner equity. This interest should be secondary to the interests of creditors unless the owners are prepared to support the preservation of their interests in the corporation by injecting further capital or debt funding.
- The removal of power from and the possible replacement or dismissal of some or all of the corporation's management.
- The retrieval of rights of various classes of creditors—particularly creditors who hold security over the corporation's assets—which may have been suspended or curtailed as a result of the formal rescue process.
- A compromise or composition of debt owed to creditors. It will be rare that even a rescue that might be described as successful will result in full payment of debt. Instead, rescue may result in the transfer of ownership from the previous equity holders to creditors.

159. **Principle 17: Design features of rehabilitation statutes.** *To be commercially and economically effective, the law should establish rehabilitation procedures that permit quick and easy access to the process, assure timely and efficient administration of the proceeding; afford sufficient protection for all those involved in the process, provide a structure that encourages fair negotiation of a commercial plan, enable a suitable majority of creditors in favor of a plan or other course of action to bind all other creditors by the exercise of voting rights (subject to appropriate minority protections and the protection of class rights) and provide for judicial or other supervision to ensure that the process is not subject to manipulation or abuse.* Modern rescue procedures typically address a wide range of commercial expectations in dynamic markets. Given the disparity in legal and commercial systems, such laws may not be susceptible to precise formulas. Nevertheless, the features addressed in this principle pertain to various stages of the rescue proceedings that may be considered prescriptive of modern systems. Other essential features of the modern process include the opportunity, whether prompted by possible sanction or encouraged by possible benefit, for a corporation in financial difficulty to commence the process before it is too late; restraints on interventions by creditors (secured or otherwise) intent on pursuing individual rights against the property of the corporation at the expense of the rescue; and transparency—access to information by creditors and an opportunity for them to have a voice in the outcome of matters in which they have a financial stake. As discussed above, access to confidential information may be regulated by a confidentiality agreement between the enterprise and the creditors committee and/or independent supervisor. The proceeding should be amenable to quick resolution, and not subject to delay or exposed to extensive or uncontrolled time periods for the performance of critical parts of the process.

160. While most features of a rehabilitation proceeding are similar to those set out in section 3.2 above, there are some unique aspects of a rehabilitation proceeding that require careful consideration, such as measures taken to stabilize business operations (including the financing of operations); the importance of access to and disclosure of information; plan formulation, consideration, approval and implementation; and the significance of the discharge.



161. Detailed rules should be provided for timely and efficient advancement of the rehabilitation process. While efficient administration is always important to maximize asset recoveries, time is of the essence in a rehabilitation proceeding. Swift and reasonably rigid time limits are necessary to ensure that the process is conducted without delay. Decisions pertaining to the business operations or authorizing sales or transactions should take place, as nearly as possible, in “real time” so that the debtor’s business is not disrupted, resulting in further decline and loss of customers. Similarly, critical disputes between parties must be resolved as quickly as possible, especially where these threaten to halt the business or the use of assets. The court or tribunal responsible for the proceeding must ensure that the rules and deadlines established to promote efficiency are strictly enforced and grant extensions or deferment only on proper cause being shown. At the same time, procedures should ensure that parties receive fairness and justice.
162. **Principle 18: Stabilizing and sustaining business operations.** *The law should provide for a commercially sound form of priority funding for the ongoing and urgent business needs of a debtor during the rescue process, subject to appropriate safeguards.* One of the main problems associated with the rescue process is that often the debtor is in urgent need of liquid funds to pay for crucial supplies of goods and services to maintain its business activities. Where a genuine prospect of rescue exists, ongoing funding will often be crucial. Insolvency laws have failed to address this need, even in some developed countries. An insolvency law can and should address this situation by providing power to use existing cash that may be pledged or constitute security or to obtain new financing with assurances and safeguards for the eventual repayment of this funding. The law can do this in a number of ways, such as by recognizing the need for and authorizing such funding, and by creating a priority for its repayment to the provider. Where cash, or the proceeds of collateral is to be used, a replacement lien or additional collateral might be provided to assure repayment. Often, such protections will be inadequate of themselves and would be coupled with restrictions on the use of the funds.
163. There are various types of priority, and a flexible practical approach is best. For example, in some systems, parties who lend to the business after the commencement of proceedings are entitled to priority in repayment ahead of all creditors. Such a priority is effectively a surcharge against the entire estate and assets. Another form of priority for those advancing money or goods is an administrative priority, which gives a priority in repayment over the general unsecured creditors, but not over a secured creditor with respect to its collateral. And an intermediate approach allows for lenders and those advancing goods to take a security interest in the debtor’s secured and unsecured assets. In some instances, a senior or priming security interest or lien can be granted in exceptional circumstances. Some countries make all options available to accommodate the unique needs and circumstances of particular cases. In the same way, principle 18 allows priority financing on a flexible basis as determined to be appropriate in particular markets. Thus, if a court concludes that priority financing involving collateral is in the best interests of the creditors, and not prejudicial to the secured creditor with an interest in collateral, the court should be able to approve the financing. However, to the extent the solution developed impacts the rights of secured creditors or those holding a prior in time interest in assets, principle 18 must be interpreted in light of the general proposition upholding commercial bargains and the adequate protection requirement in principle 16. This calls for a carefully balanced approach.
164. **Principle 19: Disclosure of information.** *The law should require the debtor to disclose relevant information regarding the business and financial affairs of the debtor in detail sufficient to enable the court, creditors and affected parties to reasonably evaluate the prospects for rehabilitation. It should also provide for independent comment on and analysis of that information. Directors of a debtor corporation should be required to attend meetings of creditors. Provision should be made for the possible examination of directors and other persons with knowledge of the debtor’s affairs, who may be compelled to give information to the court and administrator.* Disclosure of a basic set of data including financial statements, operating statistics, and detailed cash flows is a requisite for sound

risk assessment. Fundamental factors underpin the determination of which option - reorganization or liquidation - provides the best and quickest return for creditors. The administrator and creditors need to assess: (1) what the company's immediate liquidity needs are and if new financing is prudent; (2) what the company's business prospects are and if the business is viable on a long-term basis; and (3) if management is qualified to continue to lead the company. Assessment of long term viability will often involve the development of a business plan based on comparable historical data.

165. Time is of the essence and speed is vital in business rescues requiring fast decisions and actions before the value of the assets dissipates. Although incentives for gathering and providing information are somewhat intangible, all parties –lenders, directors, courts, receivers/administrators - require information that is complete, accurate and reliable; provided on a timely and frequent basis; and sufficiently comprehensible to be analyzed by creditors and parties interest. The law should prescribe broadly the substance of the information to be provided and how and when that information is to be provided. As a general rule, the information should be supplied by officers and other relevant third parties. Safeguards may be needed to protect confidential information (such as trade secrets). In addition to providing the type of information mentioned above, one or more directors of the debtor should be represented and required to attend a main (possibly initial) meeting of creditors and answer questions. In cases where information is withheld, a form of 'public examination' of officers and directors or other persons may be required to compel the provision of relevant information.
166. Some jurisdictions have developed disclosure requirements to the point of standardized information schedules to be completed by the debtor or its management (with sanctions for false or misleading information) or by an independent person or administrator. Where it is proposed that the business of a debtor will continue to be conducted, important information will include projections of profits and losses, cash flow, marketing, industry trends and other information relevant to the feasibility of a successful rescue, not merely indicate possibilities. Revenue and growth assumptions should be carefully scrutinized. Although it may not be considered necessary for the law to intrude and recite exhaustively on such matters, it can be beneficial in countries that have little experience with formal (or informal) rescue techniques to spell these out.
167. Other relevant information includes the causes of the debtor's financial difficulty and a review of past transactions that may be avoided under the avoidance provisions of the insolvency law. The provision and analysis of information should not be left to the debtor alone, but should be required by the administrator and creditors' committee. Thus it is important to provide for the appointment of an independent person to review or comment on the information.
168. **Principle 20: Plan: formulation, consideration and voting.** *Formulation: the law should not prescribe the nature of a plan except in terms of fundamental requirements and to prevent commercial abuse.* Three main issues arise in the context of plan formulation: what should be the nature or form of a plan, who should devise the plan; and what opinions or comments should accompany a plan. From the creditors perspective, rehabilitation should result in higher distributions to creditors than they would realize through liquidation, due to the higher going concern (as opposed to liquidation) value of the business. With varied constituencies involved, each may have different objectives in promoting a rehabilitation (e.g., continued business with a major customer or supplier versus rapid repayment) and varying levels of risk tolerance. Some creditors may prefer to take an equity stake in the business, while others do not. From the debtor's perspective, settling on a plan with creditors requires a reasonable forecasting of future cash flows that will be the source of payment under the plan. Cash flow projections over the life of the plan are predicated on a number of business and economic assumptions that are sometimes hard to measure, which often results in a range of enterprise value. Consequently, there is typically a range of options that exist, and finding the one that most creditors will agree is the art of the process. With numerous potential options available, the law should not prescribe the nature or form of a plan. For example, the law should not limit a plan to one that is designed to fully rehabilitate the debtor; nor should the law provide that debt

cannot be written off; nor should it provide that a minimum amount must be eventually paid to creditors. In short, the law should let the market determine the appropriate commercial solution.

169. There are some issues that the law should address (for example, the priority accorded to classes of creditors). Similarly, the plan on its face should reveal how the plan is to be implemented to achieve the objectives of the plan, whether by rehabilitation or otherwise. While a “de minimus” approach is desirable that enables any of a number of possible results, typical solutions include a simple composition (agreement to pay creditors a percentage of their claims); the continued trading of the business and its eventual sale as a going concern (with the debtor then being liquidated); a form of restructuring of debt and equity and so on. The statutory regime should permit the exchange of debt for stock, which permits the transfer of ownership to creditors and can encourage the creation of a secondary market for distressed debt.
170. Who should devise a plan is generally dictated by the commercial reality that a number of constituencies have a vested interest or financial stake and will likely play a part. Certainly management (and/or owners) of a debtor should have a major and, possibly, the principal role in negotiating and devising a plan. Independent advisers should also be expected to comment on a proposed plan. Major creditors are generally closely involved in negotiating details relevant to the treatment of their claims and other important details regarding the restructuring (e.g., asset sales, changes in management, etc.). Likewise, The creditors committee, along with other important stakeholders, should have an important role in plan negotiations. The law should not intensely regulate the process of negotiation. But in the interests of certainty and efficiency, it is desirable that some statement be made and that a specified time limit be provided for the presentation of a plan. Aside from who participates in the process, creditors should be entitled to propose a plan.
171. *Plan consideration.* The outcome of the plan rests on whether it is feasible, meaning that based on facts and circumstances known and reasonable assumptions, the plan and the debtor are more likely than not to succeed. Because the ultimate success or failure of the plan affects the repayment of claims under the plan, it is important that the plan be feasible. If the plan is based on faulty assumptions or the restructuring is impartial leaving the enterprise overleveraged with debt, the creditors are entitled to evaluate these facts in deciding whether to vote for the plan. Determinations of feasibility are best left to qualified professionals, who should be obliged to report to creditors (and the court) to enable them to reasonably and fairly evaluate the plan’s proposed treatment of their claims. An independent evaluation of the plan or an objective statement from an independent adviser has the benefit of providing a credible and unbiased review. The creditors committee and other major creditors should be entitled to formulate their own opinions about a plan’s feasibility and given an opportunity to express concerns, issues or objections if they disagree with the conclusions contained in the plan or in the independent statement. The court can then take these matters into consideration along with any additional evidence submitted.
172. *Classification and voting.* The law may provide for classes of creditors for voting purposes. Voting rights should be determined by amount of debt. An appropriate majority of creditors should be required to approve a plan. Special provision should be made to limit the voting rights of insiders. The effect of a majority vote should be to bind all creditors. The three main issues that arise with respect to voting rights are whether there should be classes of creditors; what should be the voting rights and powers; and what should be the effect of a majority vote. It is appropriate to provide for classes of creditors when there are divergent legal interests that are to be treated in a different manner, although some jurisdictions appear to function quite well without an immense or any detailed structure or sophistication in this area (e.g., Australia). In jurisdictions that support classification of claims, rules governing classification should be clearly stated and designed to avoid abuse. The primary purpose for classifying claims is to satisfy the requirement to provide fair and equal treatment to creditors, treating similarly situated claims in the same manner. Classification also makes it easier to assure that claims holding priority or preference (e.g., administrative or secured claims) are treated in accordance with the priority established under the law. In some cases, classification makes it easier

to treat the claims of major creditors who opt to receive a different treatment from the general class of unsecured creditors, where such treatment is necessary to render the plan feasible; in such cases, the treatment for these creditors is generally on less favorable terms than other similarly situated creditors. Finally, classification may be a useful means of overriding the vote of a class of creditor that votes against the plan, where the class is otherwise treated in a fair and equitable manner.<sup>24</sup>

173. Voting rights should be simplified – voting by amount of debt rather than number of creditors and requiring approval by an appropriate majority. Most laws require a qualified majority of creditors (e.g., 60-66%) to vote in favor of the plan, with voting conducted en masse or by classes. In cases, where classes vote, the requisite majority may be established by class. In some countries, a hybrid test is used that requires a class approval by a requisite majority in the total number of creditors in the class and by a qualified majority of the total debt of the class. Failure of one or the other would be fatal to class acceptance. Special provision should be made to restrict or limit the voting rights and powers of ‘insiders’. Approval of a plan should bind all creditors. Likewise, failure to attain a majority vote to approve a plan should result in a conversion to a liquidation proceeding. It should always be possible, however, for a majority of creditors to vote to adjourn the decision meeting if it appears that some further negotiation on a plan might produce a favorable result. As with all areas of the process, however, only one such adjournment should be tolerated and strict time limits should apply. Adjournment for good cause should as a general rule be permitted, although this might be regulated by an appellate mechanism or other check to prevent abuse.

174. **Principle 21: Plan approval.** *The law should establish clear criteria for plan approval based on fairness to similar creditors, recognition of relative priorities and majority acceptance. The law should also provide for approval over the rejection of minority creditors if the plan complies with rules of fairness and offers the opposing creditors or classes an amount equal to or greater than would be received under a liquidation proceeding.* There are two stage of approval of a rehabilitation plan. The first is approval by a majority of creditors at a creditors meeting. The second is approval by the court. A court order approving the plan has the binding effect of a court-adjudicated order, which is necessary to give certainty to all parties on the newly formed legal rights and remedies of creditors dealing with the enterprise, including minority creditors who did not vote for the plan but are bound by its terms. At the second stage the court’s role is limited. The court does not decide whether the plan is commercially viable or whether a different plan would be preferable for creditors. Instead the court satisfies itself that the decision of the creditors has been properly obtained and the necessary preconditions were met, and investigates allegations of collusion or fraud by creditors or between the administrator and creditors. Because a plan is sometimes accepted by one or more classes of creditors and rejected by others, careful consideration should be given to designing a law that enables viable businesses to be salvaged when the rights and interests of creditors are not prejudiced by doing so. The provision to force certain classes of creditors to accept the plan even when the minimum approval for a class has not been met is reasonably tailored to the goals of rehabilitation.

175. *Some provision for possible adjournment of a plan decision meeting should be made, but under strict time limits. If a plan is not approved, the debtor should automatically be liquidated.* In some cases, circumstances may warrant a brief adjournment of the plan decision meeting, either to enable more disclosure or for parties to address unresolved disputes and issues. These periods should be kept to a minimum to encourage rapid resolution. If the plan is not approved, typically a court will direct that the company be liquidated.

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<sup>24</sup> This override, which has come to be known as a “cramdown” based on its effect, allows the court to conclude that a rejecting class should be compelled to accept the plan where the class is to be paid in strict accordance with the relative priority of creditor claims and will receive under the plan a distribution in an amount equal to or greater than such creditors would receive in a liquidation proceeding. The rationale is that these creditors cannot claim foul if their recovery is at least as good as they would receive if they prevailed in having the enterprise liquidated.

176. **Principle 22: Plan: implementation and amendment.** *The law should provide a means for monitoring effective implementation of the plan, requiring the debtor to make periodic reports to the court on the status of implementation and progress during the plan period. A plan should be capable of amendment (by vote of the creditors) if it is in the interests of the creditors. The law should provide for the possible termination of a plan and for the debtor to be liquidated.* Most plans will be executed without a great deal of need for further intervention. But sometimes it might be necessary for the implementation to be supervised or controlled by an independent person. In most systems the court maintains jurisdiction over the case or enterprise pending consummation or substantial consummation of the plan. This is critical where there may arise issues of interpretation over the performance or obligations of the debtor or others.
177. Of greater importance is what happens if execution of the plan breaks down or is found incapable of performance. Many jurisdictions provide for the possibility of a plan being amended if that is in the interests of creditors. Reorganized companies often require further reorganization despite careful provisions on feasibility. In such cases most affected parties are the same. Rather than apply the same strict gateway requirements for accessing the system, it may be more practical to enable the court or governing institution to reconsider the case subject to lower access standards. But if a plan becomes impossible to perform (through, for example, the default of the debtor), the law should make provision for the plan to be terminated and for the debtor to be liquidated.
178. **Principle 23: Plan: discharge and binding effects.** *To ensure that the rehabilitated enterprise has the best chance of succeeding, the law should provide for a discharge or alteration of debts and claims that have been discharged or otherwise altered under the plan. Where approval of the plan has been procured by fraud, the plan should be subject to challenge, reconsidered or set aside.* This principle contains two important concepts. The first supports the need for commercial certainty by giving binding effect to the forgiveness, cancellation or alteration of debts in accordance with the approved plan. The principle is particularly important to ensure that the plan provisions will be complied with by creditors that rejected the plan and by creditors that did not participate in the process. It also gives certainty to other lenders and investors that they will not be involved in unanticipated litigation or have to compete with hidden or undisclosed claims. Thus the discharge establishes unequivocally that the plan fully reconstitutes the legal rights of creditors.
179. The second aspect of the above principle concerns cases where plan approval was obtained by fraud and where creditors would not have voted on the plan had they not been defrauded. This principle is consistent with fundamental rules of contract law that contracts induced by fraud are voidable. In some instances the level of fraud may not have a fundamental impact in altering the rights or decisions of creditors, in which case the court should be entitled to consider those questions before setting aside the plan.
180. **Principle 24: International considerations.** *Insolvency proceedings may have international aspects, and insolvency laws should provide for rules of jurisdiction, recognition of foreign judgments, cooperation among courts in different countries and choice of law.* In particular, an insolvency law should provide for:
- Foreign insolvency administrators to have direct access to courts and other relevant authorities.
  - A clear and speedy process for obtaining recognition of foreign insolvency proceedings opened in accordance with internationally recognized standards of jurisdiction.
  - A moratorium or stay at the earliest possible time in every country where the debtor has assets.
  - Nondiscrimination between creditors, regardless of the nationality, residence or domicile of the parties concerned.<sup>25</sup>

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<sup>25</sup> The principle of nondiscrimination does not necessarily oblige states to accord parity of status to foreign fiscal or public claims; differential provision is also permissible in the giving of individual notice to foreign parties to ensure that they are able to exercise their rights effectively.

- Courts and administrators to cooperate in international insolvency proceedings, with the goal of maximizing the value of the debtor’s worldwide assets, protecting the rights of the debtor and creditors, and furthering the just administration of the proceedings.

The most effective and expeditious way to achieve these objectives is enacting the UNCITRAL Model Law on Cross Border Insolvency.

181. The phenomenon of cross-border insolvency, where the dispersal of the debtor’s assets and activities generates a spread of interests and claims involving the potential application of more than a single system of law, has existed for as long as human societies have permitted mobility and exchange. The diversity among domestic laws—in matters both of detail and in the fundamental approach to insolvency—make it essential that the cross-border aspects of insolvency be addressed. The globalization of trade has increased the incidence of international insolvency. Furthermore, the size and complexity of such insolvencies can be significant enough to raise public concerns about the approaches to be followed, in the interests of achieving fair and efficient solution of the problems disclosed. This has given rise to an acceleration in regional efforts to deal with cross-border insolvency and to initiatives aimed at producing a global approach to the same problems. An example of the regional approach is the Regulation on Insolvency Proceedings adopted by the EU Council of Ministers in 2000, which will enter into force in EU member states in May 2002.

### 3.4 Informal Workouts and Restructuring (Principles 25-26)

182. **Principle 25: Enabling legislative framework.** *Corporate workouts and restructurings should be supported by an enabling environment that encourages participants to engage in consensual arrangements designed to restore an enterprise to financial viability. An enabling environment includes laws and procedures that require disclosure of or ensure access to timely, reliable and accurate financial information on the distressed enterprise; encourage lending to, investment in or recapitalization of viable financially distressed enterprises; support a broad range of restructuring activities, such as debt write-offs, reschedulings, restructurings and debt-equity conversions; and provide favorable or neutral tax treatment for restructurings.* Because informal workouts take place in the “shadow of the law,” consensual resolution requires reliable fallback options through existing legal mechanisms for individual enforcement and debt collection or through collective insolvency procedures. As such, the most conducive environment for informal workouts is having effective insolvency and enforcement regimes, as reflected in the foregoing sections.

183. In addition, the ability to implement a restructuring relies on having a legal framework that can accommodate the restructuring plan at a fundamental level, such as allowing debt-equity swaps, forgiveness of bank debt and taking of collateral. The legal framework must also provide incentives for the parties to accept treatment that will render the restructured business viable (for example, favorable offsetting tax treatment for debt forgiveness). Participants must be provided with sufficient information on a borrower’s operations and related financial criteria as well as the ultimate judicial or nonjudicial enforcement process. Concerns and issues relevant to informal workouts are often addressed in the context of formal frameworks for rehabilitation procedures, but are often overlooked or ignored in the context of informal arrangements. While there are a variety of different policy choices on the substantive and procedural nature of laws and the allocation of risk among participants, these rules must be clearly specified and consistently applied to encourage consensual workouts.

184. **Principle 26: Informal workout procedures.** *A country’s financial sector (possibly with the informal endorsement and assistance of the central bank or finance ministry) should promote the development of a code of conduct on an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure—especially in markets where enterprise insolvency has reached systemic levels. An informal process is far more likely to be sustained where there are adequate creditor remedy and insolvency laws. The informal process may produce a formal rescue, which should be able to quickly*

*process a packaged plan produced by the informal process. The formal process may work better if it enables creditors and debtors to use informal techniques.* While informal workouts have been used for many years, most recent procedures trace their lineage to the so-called London Approach, pioneered by the Bank of England in a largely unofficial capacity and further developed by leading English commercial banks. A similar approach has emerged in the United States and possibly become more developed among the banking, financial and insurance sectors. The reasons for the development of this process are important because they suggest that more formal “modern” rescue regimes may not always be suitable for rescue. In October 2000, INSOL International released a “Statement of Principles for A Global Approach to Multi-Creditor Workouts,” which espouses eight best practices for multi-creditor workouts. The principles are fundamental to informal multi-creditor workouts and is a useful guide for developing effective practices and procedures in this area.

185. There are a variety of explanations for the popularity of informal workouts. There is a need for something more flexible and less rigid than the process available under formal rescue regimes. Many cases of corporate financial difficulty require an earlier and more active response from key bank and financial institution creditors, which is normally not possible under formal rescue regimes. It is a much more private process and, possibly, less prone to unwanted publicity and speculation. It is less confrontational and so provides a better environment for market negotiations, both between creditors and the debtor and among creditors themselves. It is perceived to carry less stigma than the formal process.
186. An informal workout probably would not be attempted unless a number of well-defined conditions were present, including:
- A significant amount of debt owed to a number of main bank or financial institution creditors.
  - The inability of the debtor to service that debt.
  - The attitude that it may be preferable to negotiate an arrangement for the financial difficulties of the debtor—not only between the debtor and the creditors but also between the creditors.
  - The availability of relatively sophisticated refinancing, security and other commercial techniques that might be used to alter, rearrange or restructure the debts of the debtor or the debtor itself.
  - The sanction that if the negotiation process cannot be started or breaks down there can be swift and effective resort to the insolvency law.
  - The prospect that there may be more benefit for all through the negotiation process than through direct and immediate resort to the insolvency law (in part because the outcome is subject to the control of the negotiating parties and the process is less expensive and can be accomplished more quickly without disrupting the business).
  - The debtor does not need relief from trade debt, or the benefits of formal insolvency, such as the automatic stay or the ability to reject burdensome contracts.
  - Favorable or neutral tax treatment for restructuring both in the debtor’s jurisdiction and the jurisdictions of foreign creditors.
187. Of these, the most important for this paper is the presence of the sanction—the “shadow” of the insolvency law, as it has been described elsewhere. Oddly enough, despite the claimed benefits of the informal work out process, it might not have had much chance of survival were it not for formal insolvency processes. The main aspects of a workout are discussed below.
188. *Commencing the process.* The informal process essentially involves bringing together the debtor and creditors (at least the main creditors). Someone has to initiate this process. There is no law to facilitate it, which can present a difficulty. A debtor may not be willing to have a dialogue with creditors. Among creditors, some will be concerned for their own position and may not want a collective process. Well-established and widely used creditor remedy and insolvency law regimes can be used to influence the commencement and progression of an informal workout. The invitation to commence a dialogue should rarely be refused. If the opportunity is declined, the debtor faces the prospect that individual creditor remedies or formal insolvency proceedings will be pursued.

Unwilling creditors face a similar sanction. This threat is generally sufficient to initiate some type of dialogue. In countries where creditor remedy and formal insolvency regimes are suspect, it may be desirable to provide, in some semi-official way, for a facilitator to encourage the commencement of the process. This approach has been adopted, with some success, in some Asian countries. Selecting a forum in which the debtor and relevant creditors can come together to negotiate an arrangement to deal with the debtor's financial difficulty. This forum is important for both sides and for the creditors, between themselves.

189. *Engaging advisers.* Few if any attempts are made at a workout in the absence of independent advisers or experts. These may come from a variety of disciplines—accounting, finance, law, business reorganization, marketing and so on. Problems encountered because of factors such as cost, intrusion and surrender of control can impede the process.
190. *Coordinating participants.* The workout should involve all key constituencies; generally the lenders group and sometimes other key creditor constituencies who may be affected by the restructuring or are critical to the resolution. To better coordinate negotiations, a lead creditor should be appointed to provide leadership, organization, management and administration. The lead creditor typically reports to a committee that is representative of creditors (a steering committee) to help the lead creditor and to act as a sounding board for proposals for the debtor and creditors.
191. *Stabilizing the business.* As soon as possible, to allow business operations to continue, parties will need to provide for a negotiation period. This is generally accomplished by entering into a standstill agreement (a contractual agreement to suspend adverse actions by both the debtor and the main creditors) that endures for a defined, usually short, period. This is akin to the moratorium or stay under the formal rescue process.
192. *Ensuring adequate cash flow and liquidity* during negotiations and restructuring. This problem was mentioned above in the section on formal rescue processes. It may be more of a problem during the informal process because, even though there may be some sensible provision under the rescue law for some type of “super priority” for a debtor’s ongoing funding, that law will not extend to such an arrangement under the informal process. Carefully and sensibly drafted, however, it might be capable of such extension. In the absence of that, commercial people are driven to devising commercial means. This often results in an agreement among major creditors that emergency funding by one or more will rank for repayment in advance of their other entitlements in the event of a formal insolvency administration of the debtor.
193. *Access to complete, accurate information on the debtor’s business is essential* to reaching a consensual agreement, including its business activities, current trading position, general financial position and assets and liabilities. This is akin to the statutory requirement for similar disclosure found in most formal rescue regimes.
194. *Negotiating, agreeing and implementing the restructuring plan* is generally based on agreement among creditors and the debtor on the terms and conditions for the restructuring, and acceptance by a majority of creditors. The percentage approval required may vary depending on the acts undertaken during the restructuring (for example, 75-90 percent for restructuring, 75 percent for moratoriums, 66 percent for capital spending, credit draws and asset sales, and 100 percent for new money). These percentages are subject to agreement among creditors, but without agreement all such decisions would have to be unanimous. Accommodation will have to be given to accommodate creditors with valid security rights. Notably, many credit agreements or intercreditor agreements in syndicated lending arrangements already specify the level of approval required for making decisions. These should be respected to the extent possible. In the case of new money, no lender can be forced to extend new financing against its will. Where a country is facing systemic problems it should be noted that exchange movements can adversely affect foreign creditors’ positions relative to themselves and domestic creditors.



195. *Dealing with outside and dissenting creditors.* In most cases it will not be possible to include or involve every creditor in the workout process. One problem is their sheer number and diversity. Another is the inefficiency of involving creditors owed small amounts or who do not have the commercial expertise, knowledge or will to participate in the process in a constructive manner. But such creditors cannot be completely ignored or forgotten. They may be important to the continued business operations of the debtor. Moreover, because it is an informal process, there are no rules by which creditors can be compelled to accept the decision of a majority of their number.
196. Often in an informal workout, trade and small creditors recover payment in full. Although this smacks of inequality, it may make commercial sense to a group of major creditors. Alternatively, an endeavor might be made to obtain complete unanimity, such as where major creditors would agree on a rescue plan with the debtor. The plan is circulated to all creditors and their agreement is requested. It is pointed out that such a plan would be the likely result if the affairs of the debtor were to be dealt with under the formal rescue law. If unanimity is not obtained the debtor volunteers itself under that law, the plan is approved by the majority and binds the dissenting creditors. This highlights another reason for the desirability of an adequate formal rescue law. Only with one is it possible for the informal process to be transferred to the formal process.
197. *The restructuring agreement must be legally binding on all affected creditors.* The final restructuring agreement is made legally binding on a dissenting minority, provided they are party to an intercreditor agreement that binds them to the majority decision. Parties who have not bound themselves contractually would not be bound by the decision of majority creditors, which raises a risk that the restructuring could be rendered meaningless by the independent action of minority and holdout creditors. In such a situation, one would have to revert to a formal process. In formal proceedings the statute creates the mechanism for binding minority creditors.

#### 4. IMPLEMENTATION OF THE INSOLVENCY SYSTEM

198. A strong institutional and regulatory framework is crucial to an effective insolvency system. The framework encompasses three main elements: first, the various institutions with responsibility for and jurisdiction over insolvency proceedings; second, the operational system through which cases and decisions are processed; and third, the fundamental requirements needed to preserve the integrity of these institutions, recognizing that the integrity of the insolvency system is the linchpin for its success or failure. This section sets forth fundamental principles for the design and maintenance of the institutions and participants invested with authority over insolvency proceedings.

##### 4.1 Institutional Considerations (Principles 27-33)

199. **Principle 27: Role of courts.** *Bankruptcy cases should be overseen and disposed of by an independent court or competent authority and assigned, where practical, to judges with specialized bankruptcy expertise. Significant benefits can be gained by creating specialized bankruptcy courts.* The role, responsibility, organization and services of the governing judicial institution, the court, are central to an effective, efficient and fair insolvency process. A well-functioning and predictable insolvency court provides for the quick disposition of insolvency cases, preserving assets and maximizing their value. It also provides incentives for parties to attempt out-of-court workouts before seeking judicial relief.<sup>26</sup> In most jurisdictions the judiciary fulfills oversight and dispute resolution functions through general jurisdiction courts, commercial courts or specialized bankruptcy courts. In some jurisdictions nonjudicial or quasi-judicial institutions may fulfill this role. This is probably the result of historical evolution. It may also have been dictated by the need for independent and impartial adjudication, the need for justice and fairness and, in some cases, the need to satisfy constitutional requirements on property rights. Some countries (Colombia, Peru) have nonjudicial administrative

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<sup>26</sup> See also the discussion on out-of-court workouts accompanying principles 25-26 in section 3.4 above.

procedures that may be practical where the judicial system has fewer resources than another administrative agency or where court capacity is weak, provided that appropriate safeguards are put in place to protect the rights of participants and to assure due process. Careful consideration must be given to how the functioning of the administrative agency interfaces with the legal framework in resolving disputes and affording a right of appeal. In addition, agencies serving in this role should be subject to the same principles and standards applied to the court system.

200. Sometimes judges are specialized and have exclusive responsibility for insolvency proceedings. In other jurisdictions judges may have wider jurisdictional authority. Given the specialized nature of enterprise insolvency and the issues that arise in bankruptcy proceedings, there is significant value in having independent, specialized commercial and bankruptcy courts or specialized insolvency judges within general jurisdiction courts. The insolvency process is highly complex and demands a specific understanding of and familiarity with financial and business arrangements and with commerce and finance standards and practices. Specialization ensures greater competence and higher-quality decision making, quickens the pace of proceedings and decision making, and promotes consistent decision making on similar issues and situations. In addition, specialization tends to decrease unnecessary litigation by increasing predictability in the outcome of decisions. Where there is no expertise on the bench and decisions are inconsistent, parties are often tempted to litigate in hopes of gaining a different or novel decision. The same can be said of appeals courts that have no expertise in insolvency.
201. The caseload in many countries may not justify the additional expense of creating an independent insolvency court system. Where this is not possible, the optimal approach is to have a pool of judges trained in insolvency who are equipped to deal with the real-time litigation demands of insolvency proceedings, which likewise should be governed by independent rules and procedures designed to accommodate the unique needs of insolvency. Finally, consideration should be given to the attributes of the bankruptcy court, or comparable alternative judicial authority, relative to other administrative or regulatory bodies that govern the insolvency process. This will involve a determination on the appropriate interface between the judiciary and other regulatory institutions that round out the insolvency system.
202. *The law should provide for a court or other tribunal to have a general, non-intrusive, supervisory role in the rehabilitation process. The court/tribunal or regulatory authority should be obliged to accept the decision reached by the creditors that a plan be approved or that the debtor be liquidated.* In a rehabilitation proceeding, a court or tribunal must ensure that the process is efficiently conducted. The law should establish clear time-bound procedures for events that afford some flexibility but avoid delay. In this regard, the court acts as a case manager to move the process forward. In addition, the court should ensure that the process is conducted fairly and in accordance with proper procedures. This requires that creditors or others who claim that they have been prejudiced or affected by the non-observance of proper formalities and rules have the right to apply to the court for appropriate redress. One of the main functions of the court will be to resolve problems or disputes that develop. Even the most detailed of legislative procedures cannot hope to provide for every eventuality or avoid problems in application or interpretation of applicable law. A court or tribunal, acting sensibly, can avoid or overcome technical and non-material problems and difficulties. Finally, the court presides over the plan process to determine whether a plan meets the criteria established in the law for approval and to investigate abuses by parties in the process. In this regard, the court's role provides a balance of power for creditors that may wish to challenge a plan or attack the means by which it was procured (for example, by the influence of fraud or 'insider' votes).
203. Bright-line rules can be an effective way of improving the efficiency in the system, both where court capacity is technically weak due to lack of training or external influence or because the costs of delay are asymmetrical benefiting the debtor and not the creditor. Consideration can be given to limiting bright-line rules to strict time limits in which specific steps should be taken. While such rules

limit discretion and introduce a measure of arbitrariness, it may be justifiable to signal to users of the system the expectations of timeliness and inform the judge what should be done.

204. **Principle 28: Performance standards of the court, qualification and training of judges.** *Standards should be adopted to measure the competence, performance and services of a bankruptcy court. These standards should serve as a basis for evaluating and improving courts. They should be enforced by adequate qualification criteria as well as by training and continuing education for judges.* General standards for measuring competence, performance and services would include ready access to the court, efficiency and timeliness of court actions, integrity and independence in court decisions and treatment of parties, transparency in court decision making and operations, and public trust and confidence in the court. Standards should be reviewed regularly to ensure that they keep pace with economic and social changes.
205. Evaluation procedures should be elaborated and courts should be regularly evaluated based on the standards. A body of judges—perhaps supplemented by professional and other users of insolvency proceedings—should be charged with designing and implementing evaluation procedures. This procedure should not compromise judicial independence.
206. The integrity and effectiveness of courts and the insolvency system depend on the quality and skills of judges. There should be clear criteria for qualification and selection of judges. Personal qualifications should prevail over political considerations. A good knowledge of commercial practice and basic principles of business and finance, as well as specific knowledge of insolvency legislation, are desirable minimum standards.
207. The quality and skills of judges, newly appointed or existing, are reinforced by continuing training. Training should include basic and more sophisticated insolvency concepts and techniques, related commercial law subjects, and accounting and finance concepts and techniques that are important in insolvency. Training should also focus on techniques for conducting research, court administration and case management.
208. **Principle 29: Court organization.** *The court should be organized so that all interested parties—including the administrator, the debtor and all creditors—are dealt with fairly, objectively and transparently.* Control and management of such items as the court’s budget, internal finances, personnel, facilities and administration and technical support systems should be vested within the court system to the extent possible or be regulated with substantial input from the court system. In judicial functions the judge should be paramount and preeminent. In matters of case management the judge should have broad discretion in managing the docket and cases, but court administrators should manage the system on a daily basis. For court administration the judiciary should be integral and active, but operating primarily in a cooperative and oversight capacity.
209. *To the extent possible, publicly available court operating rules, case practice and case management regulations should govern the court and other participants in the process.* The insolvency law should be supplemented by sensible, predictable and flexible rules and regulations to better manage cases and streamline procedures. That way all parties to an insolvency case (administrator, debtor, creditors, professionals) will have a recognized guide to facilitate their roles, responsibilities and activities in case management and court procedures. Because of the need for insolvency cases to be dealt with quickly, normal court procedures for civil and criminal activity may be unsuitable.
210. *The court’s internal operations should allocate responsibility and authority to maximize resource use. To the degree feasible the court should institutionalize, streamline and standardize court practices and procedures.* This separation of court administrative functions could help centralize and foster specialization in nonjudicial responsibilities; allow for better administration of the court and the cases, and more coordination and continuity in court activities; improve efficiency and maximize use of available (usually limited) resources; increase accountability; and pinpoint responsibility.

211. In addition, courts should be able to appoint other officials to deal with matters calling for special expertise or outside technical knowledge or, alternatively, to handle less complex matters so that the court can focus on substantive decision making. For example, a judge should have the power to have a qualified and independent person appointed as an officer of the court for a special task—say, to liquidate the estate of the bankrupt and distribute the proceeds, to act as a receiver and manager in a reorganization (or be the watchdog of the reorganizer), to make inquiries on a subject and report back, or to act as a neutral go-between to negotiate a working arrangement. Any such appointment carries the authority of the court as well as the responsibility to be neutral and to provide a full account to the court and other interested parties. Such appointments allow the court to be more effective in its decision making, dispute resolution and supervision on insolvency proceedings.
212. Uniform court rules, case practice and management regulations would augment the insolvency law and would streamline bankruptcy processes in and out of court. The complex matters inherent in bankruptcy, coupled with the sometimes overwhelming number of cases, require an organized methodology for handling matters. Maintaining predictable regulations can facilitate the court’s business, expedite court decisions and enhance parties’ participation in the process and satisfaction with the institution. Moreover, increased continuity between and standardized practices among courts will improve courts’ procedures and judges’ effectiveness.
213. **Principle 30: Transparency and accountability.** *An insolvency system should be based on transparency and accountability. Rules should ensure ready access to court records, court hearings, debtor and financial data and other public information.* Transparency and accountability are vital to establishing public trust in the insolvency system. The system should support transparency at every stage. Relevant features include adequate notice through dissemination of information, notice to creditors and interested parties of hearings and activities that affect their interests, notice for filing claims and pleadings, and disclosure and publication of court decisions, court records and public information.
214. Transparency is a key element of accountability. While accountability includes holding persons—including judges—responsible for their conduct, it does not include influencing decisions or impinging on a judge’s independence. Hearings should be conducted in public according to a publicly available, pre-announced schedule, and court files should be made available for inspection and copying, subject to rules of confidentiality. Transparency allows the public to form opinions on the insolvency system through the media and other outlets.
215. **Principle 31: Judicial decision making and enforcement of orders.** *Judicial decision making should encourage consensual resolution among parties where possible and otherwise undertake timely adjudication of issues with a view to reinforcing predictability in the system through consistent application of the law. The court must have clear authority and effective methods of enforcing its judgments.* Consensual resolution of cases prior to final court resolution is almost invariably beneficial to all concerned. Alternative techniques such as arbitration or mediation can also resolve disputes. This approach can conserve resources, expedite case disposition, foster compromise and cooperation, ameliorate the adversarial nature of disputes and moderate the risk of failure of enterprise rescues.
216. Judicial decision making should be separate, distinct and defined to distinguish it from that of other parties involved in insolvency. Consistent decisions facilitating predictable disposition of cases are invaluable in establishing an effective court. Whether by using cases as precedent, by disseminating judicial opinions or simply by striving for continuity in decision making, important goals can be achieved such as increasing prospects for negotiated settlements in lieu of litigation, making better use of scarce judicial resources and reducing the cost and delay of court intervention, trials and formal dispute resolution.
217. Timely access—indeed, in some cases immediate access—to the court is essential to successful bankruptcy cases. Problem-solving and dispute resolution by the court as events occur—real-time

litigation—is often a necessary feature of bankruptcy administration. This can apply to trial courts as well as appeals courts.

218. **Principle 32: Integrity of the court.** *Court operations and decisions should be based on firm rules and regulations to avoid corruption and undue influence. The court must be free of conflicts of interest, bias and lapses in judicial ethics, objectivity and impartiality.* The court, including judges and court employees, must meet these standards and be perceived as doing so by parties and the public alike. Clear legal rules should establish remedies to address improprieties, including complaint and investigation procedures. Written standards, guidelines, advisory opinions, complaint and investigation procedures, and tools to redress impropriety should all be vested in an independent and respected judicial or ancillary authority.
219. The organization of the court—and the nature, degree and extent of direct and express judicial contact with the press, television and public—is an important and delicate issue. It may be largely affected by the traditions and legal culture of the country. The court itself needs to establish a structure, orderly framework and procedures to effect public access to court decisions, access to court files and records, and transparency of its operations to the public. Within that framework, a judge’s direct exposure to the press should be defined to avoid any compromise in the judge’s integrity, objectivity and fairness
220. **Principle 33: Integrity of participants.** *Persons involved in a bankruptcy proceeding must be subject to rules and court orders designed to prevent fraud, other illegal activity and abuse of the bankruptcy system. In addition, the bankruptcy court must be vested with powers to deal with illegal activity or abusive conduct that does not constitute criminal activity.* Alleged fraud and other criminal conduct related to bankruptcy should be dealt with promptly, firmly and uniformly by referring the matter to an authority vested with powers to investigate and take appropriate measures. Misconduct short of criminal conduct should be addressed promptly by the bankruptcy court, which should be vested with powers to investigate and take appropriate measures, including imposing sanctions.
221. An insolvency system should provide firm and public rules and regulations to avoid corruption and undue influence that would undermine public confidence in the system. Preferably an independent but accountable department, committee or body should be responsible for establishing, monitoring and enforcing standards of conduct for judges and other participants. Maintaining ethical and professional standards for judges and, where appropriate, other court employees is essential for instilling public confidence in the bankruptcy court.

## 4.2 Regulatory Considerations (Principles 34-35)

222. **Principle 34: Role of regulatory or supervisory bodies.** *The bodies responsible for regulating or supervising insolvency administrators should be independent of individual administrators and should set standards that reflect the requirements of the legislation and public expectations of fairness, impartiality, transparency and accountability.* The regulatory or supervisory body may be a government department or agency, a separately constituted body, a professional body (or bodies) or some combination, provided their roles, duties and responsibilities are clearly spelled out.<sup>27</sup> It is essential where a professional body is involved that its independence from its members is clearly demonstrated through its constitution, mechanisms and processes, and through its staff. That may

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<sup>27</sup> For example, in some jurisdictions (Australia, Canada, the United States) registration and regulation are government functions. The United Kingdom has a statutory framework requiring the licensing of administrators, with the power to grant and remove licenses delegated to seven recognized legal and accountancy professional bodies within that framework. Finland has no insolvency licensing system, but administrators are invariably members of the national bar association and their administrations are overseen by an independent ombudsman. The Netherlands has no formal system of government licensing but administrators, invariably lawyers, are overseen by the courts and the professional body.

require a legislative framework or statutory oversight—but not necessarily involvement in individual matters—by a government department or agency or separately constituted body.

223. How the regulatory or supervisory body is established partly depends on what systems exist for recognition and regulation of lawyers, accountants and other professionals appointed as administrators; for setting standards; for monitoring performance; and for taking regulatory action. Some of those systems may need to be refined for insolvency to reflect the differences between a lawyer, accountant or other professional undertaking the public interest responsibilities of an administrator and acting in pursuit of private interest on behalf of a client.
224. Where there is a system for licensing individuals or recognizing bodies, identifying suitable persons to act as administrators is much simpler for the courts, the creditors or whoever has the power to appoint. Inquiries on the proposed administrator's qualifications are generally not necessary, avoiding delay and cost in making an appointment. It may be useful to be able to identify individuals' experience with particular industries or businesses (say, an engineering company or property business) or with different procedures (liquidation, rehabilitation) and to consult key parties where specialized knowledge and skills are likely to be required. Licensing requirements vary from jurisdiction to jurisdiction based on the particular duties to be performed, but may include another professional license (such as in law or accounting), business or economics degree, a minimum level of experience, and specialized training as an insolvency practitioner or administrator.
225. Professional bodies may not have a specific statutory, regulatory or supervisory function relative to the insolvency system and those who administer cases within it. But many have recognized the increasing importance and complexity of insolvency and have established their insolvency qualifications and relevant professional and ethical standards, best practice guidance and continuing professional education for members specializing in insolvency. They have also adapted their monitoring, complaint handling and discipline procedures to reflect the nature of insolvency. Professional bodies can provide an essential pillar in the development of a regulatory framework.
226. In most jurisdictions the oversight of individual cases is seen as the responsibility of creditors (or their representatives) and the court—to receive reports, approve proposed actions, give directions, sanction payments and fix remuneration and fees, as set out in legislation, specified by creditors or the court or as appears necessary to the administrator. In some jurisdictions the regulatory or supervisory body may be responsible for ensuring that cases are administered properly and in the best interests of creditors. The different points and levels of oversight will depend on who made the appointment and constructed the checks and balances in the system and on the nature, complexity, costs and risks of the proposed action.
227. **Principle 35: Competence and integrity of insolvency administrators.** *Insolvency administrators should be competent to exercise the powers given to them and should act with integrity, impartiality and independence.* Those who administer insolvencies<sup>28</sup>—whether appointed by creditors, the court, a government department or agency, a public or statutory authority or the debtor—are given powers<sup>29</sup> over debtors and their assets, and they have a duty to protect them and their value. The nature of the appointment in some jurisdictions is seen as that of, or closely resembling, a trustee exercising public interest powers and undertaking functions on benefit of the creditors and the debtor. But with those powers and functions go responsibilities and mechanisms for ensuring their proper discharge. The nature of those duties is very much underlined in jurisdictions

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<sup>28</sup> Insolvency administrators may be referred to as trustees, liquidators, administrators, supervisors, receivers, curators, official or judicial managers, commissioners or promoters. The insolvency administrator may be an individual, or in some jurisdictions may be a corporation or other separate legal entity.

<sup>29</sup> Powers of the administrator generally include the right to manage the business and make business decisions regarding the assets (subject to review and approval in some cases), to negotiate and enter into agreement with creditors and to bind the company, to collect and dispose of assets, including to bring legal actions to recover assets transferred, to hire professionals needed to assist the administrator in carrying out his responsibilities, and so on.

where the administrator is defined as or deemed to be an officer of the court (whether appointed by the court or not).

228. Those appointed as administrators come from a range of backgrounds and may not be exclusively involved in insolvency work. In many jurisdictions administrators are lawyers or accountants, usually but not necessarily members of a professional body recognized in that jurisdiction. Thus they will have been subject to formal training, examination and qualification, and to some form of professional regulation. Or those appointed as administrators may hold some other qualification considered relevant, such as an economics or law degree; or have a particular specialization, such as property or business management; or hold no special qualification but be appointed based on experience.
229. In some cases the selection of the administrator may be predicated on particular skills required to deal with the circumstances of the case—be it the nature of the debtor’s business or other activities, the type of assets or the market in which the debtor operates or has operated; the special knowledge required for understanding the debtor’s affairs; or some other special reason. The focus in a particular case may be on unraveling complex financial transactions, continuing a manufacturing business or dealing with stock, commodity or futures market transactions. Whatever the type of insolvency, the highest professional and ethical standards for the administrator are of paramount importance. The interests of those involved in and affected by the insolvency and the public interest override the administrator’s private interests.
230. The administrator needs to be able to handle novel and contentious issues where time is invariably short and where commercial considerations have to be balanced with legal requirements. In all this it is appropriate for the administrator to call on specialists for assistance. What is essential is that the administrator has a practical understanding of insolvency and other relevant legislation and (with the increasing emphasis on rehabilitation) experience with business issues.
231. All that points to the need for an insolvency qualification exam for administrators. Some legal, accountancy and other degrees may already cover insolvency and related legislation. But insolvency is not a matter of general principles, and general qualifications will not provide the technical knowledge and practical understanding that is needed. Moreover, experience—particularly in jurisdictions where insolvency legislation is relatively new—may be limited. Once they are licensed, it is equally important that administrators maintain their knowledge through continuing education or experience that covers the range of insolvency issues at both technical and practical levels.

## ANNEX I: BANK INSOLVENCY AND RESTRUCTURING

1. This annex discusses some basic issues related to the regulatory treatment, rehabilitation and liquidation of insolvent banks, both individually and as part of the restructuring of a banking system. Many of the aspects covered elsewhere in this report for non-banks also apply to banks. Thus this annex focuses on what distinguishes the treatment of insolvent banks from that of insolvent enterprises and is intended as an input for the work currently being undertaken by the Bank, in cooperation with the Fund and other international institutions and through various forums, aimed at developing principles in these areas. Those principles will be the necessary complement to the ones presented in the main part of this paper.

### 1. What Makes Banks Different?

2. **Special treatment of banks.** In a market economy, banks are subject to special licensing, regulation and supervision rules known as prudential regulation. Banks are treated differently from other enterprises because a safe and sound banking system is indispensable for sustainable economic growth and because the nature of banking activities makes banks and the banking system vulnerable to destructive panics caused by a sudden loss of public confidence.
3. Market economies cannot function properly without an efficient banking system, which intermediates between public savings and investments and provides other essential financial services to the state and the public. For example, a sound banking system is needed to conduct monetary policy and to operate payment and securities transfer systems.
4. Because of their traditional role of intermediating between short-term demand deposits and medium- and long-term loans, banks are vulnerable to a sudden loss of confidence in their financial soundness on the part of their depositors, causing a run on the bank. If a bank cannot meet the demand for deposit withdrawals and becomes illiquid, the public may lose confidence in other banks as well. Bank failures may affect the financial health of other financial institutions, including banks that are counterparties of the failing banks. Failures may even impair the operations of financial markets and payment and securities transfer systems. Thus interbank contagion and loss of public confidence can quickly snowball into runs on otherwise healthy banks that may ultimately bring down the entire banking system. Moreover, it is hard to contain a banking crisis within the borders of the country where it originates. Due to growing business connections between banks in different countries, a banking crisis in one country can trigger a financial crisis in another.
5. Prudential licensing and supervision of banks is essentially driven by the need to avoid panics and by concern for the safety of public savings deposited with banks. In countries with public deposit insurance, there is also a need to protect the deposit insurance agency and indirectly the state treasury that may guarantee its solvency.
6. Although bank supervision addresses the safety and soundness of individual banks, the most compelling reason for prudential bank regulation is concern for the safety and soundness of the banking system as a whole—and ultimately the national economy. Even the objective of protecting public savings is inspired not just by social goals but also by the fear that a loss of public confidence would lead to wholesale withdrawals of savings from the banking system. Thus the prudential regulation of individual banks must essentially be driven by systemic considerations.
7. **Differences between bank insolvency law and general insolvency law.** In many countries the general insolvency law applies to banks. But in several countries the banking law includes special rules, administered by the bank regulator, for the restructuring and forced liquidation of banks. In most cases there is similarity between the broad policy objectives served by general insolvency law and those pursued by the restructuring and liquidation provisions of banking law. But there are some



fundamental differences between the rehabilitation of nonbank enterprises (referred to hereafter simply as enterprises) under general insolvency law and the treatment of banks under banking law.

8. The first and most obvious difference is that restructuring under banking law is a broader concept than rehabilitation under general insolvency law, in both time and functional scope. Enterprise rehabilitation under general insolvency law typically commences only if the enterprise has been declared insolvent based on strict statutory standards. Bank restructuring, by contrast, is usually part of a continuum ranging from regulatory enforcement of prudential law to receivership. Thus bank restructuring generally begins at a much earlier stage than does enterprise rehabilitation.
9. The differences between enterprise rehabilitation and bank restructuring have important consequences for the legal rights of creditors and owners. In a general insolvency procedure such rights are protected by procedural safeguards written into the law and by judicial administration of rehabilitation and liquidation proceedings. Fewer safeguards are available in bank restructuring because it is often carried out under the control of the bank regulator, without judicial administration. The bank regulator and its agents, such as provisional administrators and receivers, are subject to principles of administrative law that protect bank owners and creditors against regulatory abuse. Still, the appeal of regulatory decisions is often time-consuming and does not suspend the regulatory decision under review. Moreover, even when the agents appointed by bank regulators are experienced and licensed insolvency practitioners, they are rarely familiar with administrative law.
10. Are the systemic reasons for the special treatment of banks strong enough to justify exempting them from the principle that the rehabilitation and winding up of insolvent institutions should be submitted to judicial administration under general insolvency law? An extra-judicial regulatory process is often more efficient than a court-administered process, an important advantage if immediate action to close or transfer a bank's business is required for systemic reasons. But granting a regulator the power to act expeditiously and to avoid the delays inherent in court administration has a significant cost: excluding the courts deprives bank owners and creditors of the procedural and substantive safeguards of a court-administered proceeding. This question comes to a head when a bank becomes insolvent and when bank restructuring measures must be particularly intrusive. In some countries (United States) the law grants the bank regulator sweeping powers to take control of insolvent banks without judicial administration. Other countries (Germany, United Kingdom) require the bank regulator to turn the proceedings over to the courts for bank restructuring and ultimately for liquidation of the bank under general insolvency law.

## **2. Bank Regulators and Policies**

11. **Requirements for bank regulators.** Bank regulators should be operationally and financially autonomous, accountable to the public, transparent in their activities and staffed with qualified and experienced personnel. These features promote public confidence in the regulator—essential for a safe and sound banking system. Without public confidence, a single bank closure may grow into a banking crisis if the public questions the safety and soundness of banks that the regulator allows to remain open.
12. The law should endow the bank regulator with operational and financial autonomy. Bank supervision should be based on technical criteria and should not be subject to political considerations or undue influence from the political establishment or the banking industry. With financial independence, the regulator can avoid the risk of political influence peddling in exchange for financial support. Financial independence can normally be sought by assigning bank supervision to an autonomous central bank or to an independent supervision agency whose financial autonomy is provided by levies from the banking industry.
13. Accountability advises that prudential regulation be assigned to a single authority for each category of banks. But in some countries prudential responsibilities are divided between several agencies. Bank licenses are typically issued (and revoked) by the minister of finance, while bank supervision is

entrusted to the central bank or another bank regulator even, in some cases, to the deposit insurance agency. Although such arrangements may work in countries with a strong tradition of interagency cooperation (United States), in others they tend to promote negligent forbearance and to weaken accountability by giving the authorities an excuse for blaming one another when a bank fails.

14. Equitable treatment, transparent policy and predictable decision making are key characteristics of a good bank supervision system. They help ensure a level playing field where regulatory costs rest evenly on all banks, and they help build the moral authority and credibility of the bank regulator—prerequisites for public confidence. Transparent regulation reduces the risk of unexpected regulatory action and so lowers transaction costs for the banking industry. Transparency is promoted by submitting draft bank regulations for public comment before their adoption, by rendering all regulatory decisions rationally and impartially, and by promptly publishing all generally applied prudential regulations and regulatory decisions.
15. **Exit policies.** *The law must include explicit exit policies for insolvent banks.* Unsafe and unsound banks pose risks to the entire banking system. Thus explicit exit policies should be in place and promptly enforced to limit those risks. Exit policies need not be limited to the delicensing and liquidation of insolvent banks, but may include, among other actions, their merger with, or the transfer of all or part of their assets and liabilities to, other banks.
16. The bank regulator is supposed to protect the banking system—not save every insolvent bank. Allowing banks to fail is in the interests of the banking system because it shows the owners and managers of other banks that unsafe or unsound banking practices have a price. Conversely, a regulatory climate of bank bailouts or negligent forbearance creates moral hazard. The expectation of official assistance or tolerance encourages failing banks to take excessive risks because the perceived likelihood of failure is low and because vanishing capital tempts bank owners to increase the leverage of their diminishing stake. Such unhealthy practices eventually undermine the banking system.
17. There are, however, exceptional situations where the interests of the banking system require the rescue of one or several failing banks especially if their failure is expected to do irreparable harm to public confidence in the banking system or to the financial sector's ability to serve the economy.
18. **Official financial support.** *Official financial support to banks should be based on a careful cost-benefit analysis, weighing the cost of moral hazard against the benefit of systemic risk reduction.* Usually, two types of official funding are available to banks facing difficulties: lender of last resort support from the central bank and exceptional official financial assistance.
19. Lender of last resort support traditionally consists of liquidity support in the form of a collateralized loan provided in exceptional circumstances by the central bank to a failing bank if the bank is still solvent. But liquidity support can also take other forms or be provided by another agency. In countries with deposit insurance, the deposit insurance agency is often authorized to provide early liquidity support to insured banking institutions, ostensibly to reduce the risk of loss to the agency.
20. By definition, lender of last resort support is available only to solvent banks whose assets have a value that exceeds the aggregate nominal amount of their liabilities. But in practice, the central bank may be prevented from reaching a reliable judgment on a bank's solvency without spending time on a bank audit, which the urgency of the situation does not allow. Thus it could be suggested that the burden of proof of insolvency be turned around so that banks requesting lender of last resort assistance are presumed to be insolvent unless they prove otherwise.
21. Exceptional official financial support (sometimes called open bank assistance) is typically provided to an insolvent bank to rescue it or to prepare it for sale when its failure is judged to have serious consequences for the banking system—for instance, because the bank is too big to fail, or when such assistance is required in a systemic banking crisis. Exceptional financial support is usually corrective in the sense that it provides remedial assistance aimed at preserving the bank's franchise in one form or another.

22. The justification for providing exceptional financial support to insolvent banks comes from the systemic consequences of withholding it. The use of public funds to recapitalize a bank and the provision of liquidity support to ensure continued functioning of the payment system, are steps taken to avoid or mitigate the broad disruption in the real economy that might result from the failure of one or more systemically important banks. Such actions should only be taken when the costs of disruption exceed the costs of extraordinary measures. The burden of proof for such measures to deal with problem banks should be very high, leading to a presupposition against the use of public funds in normal times. This burden of proof is more readily met in a banking crisis, where there is an evident need to preserve part of an insolvent banking system to provide core functions for the real economy.
23. Exceptional official financial support to an insolvent bank may take several forms. It may come, among other modalities, as a loan from the central bank, the state, the deposit insurance agency or commercial sources, as a guarantee for loans provided by others, as a bond swap or as an equity contribution. Such support is typically provided within the framework of provisional administration (conservatorship) to ensure that it is used for its intended purpose.
24. The law may require that open bank assistance be the least-cost solution relative to other bank resolution strategies. This is often taken to mean that the assistance has the lowest financial cost to the fiscal authorities. But the solution with the lowest financial cost is not necessarily the one with the lowest economic cost. Thus it remains open the question whether the law should provide a safety valve permitting open bank assistance in cases where rescuing a bank is motivated by systemic considerations even though other solutions would carry a lower financial cost. Abuse of this exception can be curtailed by prescribing a restrictive decision making process with participation by the political establishment, which ultimately must pay for the operation.
25. The law must provide that the price of official financial support first be borne by the bank's owners and managers. Charging the costs of a bank's failure to its owners—by devaluing their equity stake, suspending dividend payments or imposing civil or criminal penalties—ensures that the owners do not benefit from official assistance and reduces the moral hazard that a rescue operation poses to other banks. Bank managers guilty of negligence or worse should be removed and made to pay penalties. Such sanctions would not be appropriate where bank failures occur solely as a result of circumstances beyond the managers' control, such as a general economic crisis, war or natural disaster.

### **3. Bank Administration Procedures**

26. **Bank insolvency procedures.** *The law should provide clear authority and procedures for taking control of insolvent banks.* In general two types of procedures are used to take control of an insolvent bank. Bank administration procedures, set forth in the banking law, consist of regulatory administration (control by a regulator, directly or through a provisional administrator or receiver, without judicial involvement) or judicial administration (control by a provisional administrator or receiver, appointed and supervised by the court, usually in cooperation with the bank regulator).
27. Judicial insolvency procedures are governed by a general or special insolvency law and carried out under judicial administration. In addition to a formal bankruptcy regime, general insolvency law may offer an extensive rehabilitation procedure, including a combination of provisional administration and receivership for banks (England, France). Where the general insolvency law applies to banks, the law often includes special provisions for banks, recognizing their unique position, the role of the bank regulator and the public interest in a safe and sound banking system. For example, the law may involve the bank regulator in the judicial ruling on a petition for opening insolvency proceedings against a bank.
28. Several countries subject banks to bank administration procedures under the banking law and to judicial insolvency procedures under the general insolvency law (Australia, Austria, Denmark, France, Netherlands, Switzerland) or under a special insolvency law for financial institutions

(Canada). In such countries the law should exclude or regulate concurrent proceedings. In some other countries banks are excluded from judicial insolvency procedures and may be subject only to regulatory bank administration under the banking law (Italy, Norway, United States) or judicial administration under the banking law (Luxembourg). In yet another group of countries only judicial insolvency procedures apply to banks, to the exclusion of bank administration procedures (Belgium, England, Germany).

29. **Role of judiciary.** *The role of the judiciary in instituting and supervising provisional administration and receivership for insolvent banks should be calibrated by law to reflect the competing interests of bank owners and creditors and the bank regulator, the need for prompt action in cases of urgency and the socio-juridical traditions of the country concerned.* Taking control of a bank is invasive and restricts or eliminates the right of the bank's owners to control the bank's management and thus raises questions about the need for judicial involvement. The issue is not whether owners of an insolvent bank should lose control of their bank; clearly they should. At issue is whether the judgment that the bank is insolvent should be left to the discretion of the regulator without judicial oversight. Regulatory decision making processes generally lack the legal safeguards offered by judicial proceedings. Even when bank owners can appeal decisions of the regulator or administrator to the courts, appeals are often time consuming and do not suspend the regulatory decision while they are under review. A similar argument can be made for the rights of bank creditors after the regulator has taken control of the bank. Although judicial administration offers greater safeguards to bank owners and creditors, it is time consuming and often fails to meet the systemic need for prompt regulatory action when a bank is found to be insolvent. Moreover, in certain countries the judiciary cannot be relied on to mediate impartially the competing interests of bank regulators, bank owners and bank creditors.
30. In weighing these considerations, some countries give preference to systemic interests and authorize the regulator to take control of insolvent banks without judicial involvement. In others, with independent judiciaries, receivership (and sometimes provisional administration) are deemed so invasive and their effects on shareholder and creditor rights so serious that the law submits them to judicial administration under the banking law or judicial insolvency proceedings.
31. Achieving the proper balance between concern for the soundness of the banking system, which in most instances requires the authorities to act with extreme speed and high levels of confidentiality, and the need to protect the interests of bank owners and creditors should drive the choice between regulatory receivership and judicial receivership. Regulatory receivership would be justified only if systemic considerations outweigh owner and creditor interests. In countries where immediate court action cannot be obtained in urgent cases, extra-judicial regulatory action would be justified if a bank fails unexpectedly and a receivership could transfer the bank's business quickly to another bank in a sale or merger. Efficiency and speed are at a premium, and the operation protects the interests of the bank's creditors as well. The same justification holds if there are urgent reasons for taking immediate control of a bank in order to stop criminal activities (money laundering) or to secure its assets to prevent their dissipation by dishonest owners or managers. In contrast, where fast-track judicial proceedings are available, the systemic justification for extra-judicial action by the regulator loses much of its force.
32. As insolvent banks move closer to liquidation and the chances of a quick transfer or a restructuring of their business diminish, the argument begins to favor protection of creditor rights under a judicial receivership. The case for ex ante judicial oversight is even stronger where liquidation is administered by a deposit insurance agency (Norway, United States). As a major bank creditor, a deposit insurance agency should not be expected to make unbiased decisions about the rights of other bank creditors.
33. **Criteria for bank insolvency.** *The law should define in a manner appropriate for banks when a bank is to be regarded as insolvent and may be brought under the control of an administrator or receiver.* The main statutory grounds for taking control of a bank are often based on a bank's actual or

imminent insolvency. In banking law, three types of tests are used to determine a bank's insolvency. Under liquidity insolvency, which is built on general insolvency law, a bank may be deemed insolvent when it is established that it is unable to pay its obligations as they are due and has no prospect of being able to do so. Under balance sheet insolvency a bank may be deemed insolvent when its balance sheet shows a deficit. Because the distress signals produced by both tests come too late to be appropriate for banking regulation, regulatory insolvency tests are used as an early warning sign. Thus a bank may be deemed insolvent when it no longer complies with the lower levels of prudential capital adequacy standards, which provide banks with a financial safety margin.

34. Because the effect of the regulatory insolvency test is felt well before a bank would meet traditional insolvency criteria and become unable to meet its obligations, the law should ensure that any regulatory action is proportionate to the seriousness of the shortfall in regulatory capital. This can be achieved by prescribing a series of graduated remedial steps for increasingly grave levels of noncompliance. The most invasive remedies, such as taking control of a bank through a provisional administrator or a receiver, should be reserved for the most serious shortfalls in regulatory capital.
35. **Powers and responsibilities of provisional administrators and receivers.** *The law should clearly define the powers of administrators and receivers appointed for insolvent banks* Administrators and receivers appointed for insolvent banks should be required to prepare and follow action plans. Having a plan of action that defines the nature and scope of the powers and activities of the administrator or receiver helps ensure their consistency with the prudential considerations supporting the decision to take control of the bank. It also increases the administrator or receiver's accountability for its activities.
36. After assessing the insolvent bank's financial condition, the administrator or receiver would present to the bank regulator or the court a report on options for treatment of the bank. The main options would be restructuring the bank, transferring the bank in whole or in part on a going-concern basis to another institution in a sale or merger, or liquidating the bank. Each option would include an assessment of its probability of success, a cost-benefit calculation (economic, social, financial) and an estimate of the time required to execute it. If the report proposes state budgetary assistance, it would need to be discussed with the government. A bank restructuring plan may require the concurrence of the bank's owners if their consent is needed for a recapitalization plan. Since taking control of a bank is done for systemic reasons, systemic considerations should guide the choice between saving a bank as a going concern and closing it; an insolvent bank should be saved only if its failure would have significant systemic consequences. This systemic objective should be weighed against the interests of the bank's creditors, including the deposit insurance agency. Generally, bank creditors may expect to be paid as much as they would receive in a traditional liquidation of the bank.
37. In several countries (Canada, France, Italy, Luxembourg, Netherlands, United States) the banking law offers both provisional administration and receivership for taking control of insolvent banks. In others the banking law offers only provisional administration (Australia, Austria, Portugal, Switzerland) or receivership (Denmark, Norway).
38. Provisional administrators and receivers must be required by law to take prompt physical control of the assets, books and records of the banks for which they are appointed, if necessary with police assistance. Otherwise, there are fundamental differences in the powers and duties of administrators and receivers that reflect their different objectives and degree of judicial supervision.
39. Provisional administration usually consists of the appointment of one or more provisional administrators to manage the bank to comply with prudential requirements or to preserve the value of the bank while it is prepared for liquidation or for transfer to another institution in a sale or merger. Because a provisional administrator operates within the corporate structure of the bank, a key consideration in defining the powers of the administrator is the extent to which these powers supersede those of the bank's owners and managers.

40. At a minimum, the banking law should provide that the provisional administrator assume all the powers of the bank's management. The owners of banks under provisional administration typically retain their rights, but with some exceptions. The law may restrict the exercise of ownership rights by authorizing the provisional administrator to veto decisions of shareholders and authorizing the bank regulator to submit decisions of shareholder meetings for prior approval by the provisional administrator. The law may empower the courts to order bank owners to dispose of their shares or to decide that shareholder voting rights will be exercised by a trustee appointed by the court (France). It may provide that the order appointing the provisional administrator has the general effect of suspending the functions of shareholder meetings (Italy). Or it may simply transfer the powers of the bank's owners to the provisional administrator (United States).
41. In many countries provisional administration is a form of regulatory administration (Australia, Canada, Italy, France, Netherlands, United States). Provisional administrators are appointed by the bank regulator, and their activities are not subject to judicial oversight. In other countries provisional administration is instituted and supervised by the courts (Austria, Luxembourg, Switzerland). In countries where the general insolvency law applies to banks, that law may include rehabilitation procedures that provide for a judicial form of provisional administration.
42. Under bank receivership a receiver generally takes full control of the bank to restructure it pending its transfer in a sale or merger, or to close and liquidate it. The objective is to minimize systemic effects of the bank's failure while maximizing the value of the bank for its creditors, whether by preserving the parts of the bank's business that are important for the banking system or by liquidating the bank if its continued operation is not needed.
43. Bank receivership effectively terminates the rights of the bank's owners to their bank, if not legally in some cases, then in an economic sense. This is done not only to deny owners a free ride at the expense of the state budget but also, by dispensing with the need for shareholder consent, to facilitate financial measures, including transfers of the bank's business, to maximize the bank's value for its creditors.
44. Accordingly, the receiver generally assumes the powers of the bank's owners as well as its management. Thus the law may provide that the powers of the organs of the bank be exercised exclusively by the receiver or that the bank's organs be suspended or rendered inoperative and the receiver assume the authority vested in them. In some countries the receiver's powers include such superpowers of a trustee in bankruptcy as the authority to transfer liabilities and to bind the creditors concerned, without their agreement, to the decisions made about the assumption of debt obligations (Italy, Netherlands, United States). In several countries receivership may be carried out under regulatory administration (France, Denmark, Italy, Norway, Spain, United States). In others it is subject to judicial administration (Luxembourg, Netherlands).
45. **Special bank insolvency provisions.** *If insolvent banks are submitted to general insolvency procedures, the general insolvency law should include provisions serving the special interests of the financial system.* If banks are subject to general insolvency proceedings, the law should provide that this be done only at the request or with the concurrence of the bank regulator, to avoid insolvency proceedings against banks that should be rescued for systemic reasons. The law could specify that such consent may be withheld only for systemic reasons and only if the monetary authorities ensure that exceptional financial support is available to cover the bank's deficit.
46. *Effects of bank insolvency decrees on payment systems.* Unless the law provides otherwise, a court decision opening insolvency proceedings against a bank—and the resulting statutory prohibition on disposal of the bank's assets—typically take effect at the beginning of the day on which the decision is made. Payments and securities transfers made during that day by the bank and its agents, including the execution of payment and transfer orders given earlier, are, in principle, void or voidable under the law. So that voided or voidable payment and transfer orders are not executed by payment and transfer systems that are unaware of the insolvency decision, requiring the system to reverse the

transactions and creating major problems for net settlement systems, the law should ensure the continued effectiveness of payment and securities transfer orders entered into a payment or transfer system before the insolvency decision is handed down regardless of when they are carried out. Additional protection may be provided to orders entered into the system after the insolvency decision is handed down provided they orders are executed on the day of the decision and the payment and transfer system operators were not aware of the decision (European Union Directive 98/26/EC).

47. *Setoff and netting.* A growing portion of banks' business is with other banks (including nonbank financial institutions). This business is often conducted within the framework of long-term business relationships. Much of this business takes the form of spot, swap, options and forward foreign exchange and interest rate transactions that banks conclude with other banks for their own account and risk or for the risk of their customers, requiring both parties to the transactions to exchange payments. These exchanges can be harnessed in bilateral arrangements, one for each bank and each bank counterparty, to offset or otherwise net out the mutual rights and obligations of each pair of banks. That reduces the mutual debt exposure at any time for each pair of banks to a single net balance payable by one bank to the other. Such arrangements often take the form of a master agreement specifying categories of financial transactions and the terms and conditions for the netting and settlement of the payments between the two banks. The agreements provide rules for contract termination and closeout netting in the event of a default or bankruptcy of one of the banks.
48. These arrangements reduce banks' exposure to each other and the risk of default to payment systems by converting what otherwise would have been two streams of payments between the two banks to one net payment of one bank to the other. This reduces the risk to a payment system of failure of one of the banks from a large number of payments for a large aggregate amount to a single net payment of a much smaller amount.
49. The law of setoff usually provides that mutual obligations due and payable simultaneously are discharged ipso facto. Consequently, mutual debts between two banks that become due and payable and are therefore discharged by setoff before insolvency proceedings are opened against one of the banks would normally not be covered by the insolvency proceedings. But master agreements between financial institutions often go beyond the general rule of setoff and also net out, under closeout netting covenants, payment obligations that would have become due and payable after the opening of insolvency proceedings against one of the institutions. This raises the issue of whether such extended closeout netting arrangements can be upheld in a bankruptcy or whether general principles of insolvency law would call for each leg of such mutual obligations to be disconnected from the others in order to run separately to and from the bank's estate. The issue is of practical significance because without closeout netting the creditors of insolvent banks would have to pay the full amount of their debt to the estate while they would usually receive only a fraction of their claim from the estate. Conversely, if closeout netting arrangements are immune from the legal effects of insolvency, a creditor would be permitted to net out the full amount of its claim against the amount of its obligation to the estate, leaving only a net balance due to or from the estate.
50. Exempting closeout netting from the effects of insolvency requires amending the insolvency law, as several countries have done (Australia, Austria, Belgium, Canada, France, Germany, Luxembourg, Norway, Switzerland, United States). Although these provisions afford protection to payment and banking systems, they create a special class of preference for claims of creditor banks and other financial institutions over the claims of other types of bank creditors. Financial creditors benefiting from netting agreements may use the aggregate amount of their claims on an insolvent bank to reduce their obligations to the insolvency estate, while other creditors with matching obligations and claims on the bank's estate must pay their obligations in full when due, while expecting only partial payment on their claims at some future date. This inequality of treatment between financial and nonfinancial creditors of failing banks can be justified only by systemic risks that otherwise would be uncovered, and then only to the extent required to cover those risks.

#### 4. Bank Resolution Procedures

51. **Bank mergers.** *The law should provide for bank resolution procedures that include bank mergers, purchase and assumption transactions, the creation and use of bridge banks, and forced liquidation.* A bank merger consists of the sale of the ownership interests in one (insolvent) bank to another (solvent) bank. The chief advantages of a bank merger are that it builds on the fact that the acquisition of an existing banking franchise is attractive to other banks that want to expand their operations; that the activities of the failing bank can largely continue, albeit under the corporate roof of another institution, avoiding disruptions in banking services and in payment, clearing and settlement systems; that the sale price for the bank can include its franchise value or goodwill that could not be recovered if the bank were liquidated; and that the packaged transfer of assets and liabilities is more efficient than a traditional bank liquidation in which assets and liabilities are processed separately. The chief risk of a bank merger is that an otherwise sound bank will be significantly weakened by the purchase of an undercapitalized or insolvent bank. Thus mergers of insolvent banks may have to be aided by the monetary authorities through financial arrangements that compensate for some of the risks of acquiring an insolvent enterprise.
52. **Purchase and assumption transactions** are possibly the most common technique for realizing a going-concern value for the creditors of an insolvent bank. Whereas a merger is done through a sale of equity shares, a purchase and assumption transaction consists of a sale of bank assets and a transfer and assumption of bank liabilities, each of which may require different legal steps.
53. A purchase and assumption transaction may require that certain incentives be offered to the buyer. The deposit insurance agency may have to cover deficits between the assets and liabilities of the failing bank, less its franchise value. In some cases no institution can be found to acquire a failing bank's assets and liabilities because the transaction is done too soon to permit their appraisal and banks are understandably loath to acquire open-ended liabilities. Two techniques have been developed to address such concerns. One is the so-called clean-bank purchase and assumption transaction, in which only "clean" assets and "known" liabilities are transferred. "Dirty" assets and open-ended liabilities may be transferred to an asset management corporation, also called a bad bank, to be processed separately. The other technique has the deposit insurance corporation write a put option to the acquiring bank that entitles it to return to the corporation, within a specified period, certain assets at an agreed price.
54. Purchase and assumption transactions include the transfer and assumption of a bank's liabilities. The law of obligations generally provides that the assumption of liabilities by a third party will not bind creditors without their consent. Obtaining the consent of all of a bank's creditors under a wholesale purchase and assumption transaction would cause substantial delays before the transaction could be closed. Thus the law normally authorizes the receiver of an insolvent bank to transfer the bank's liabilities or provide for a procedure whereby such transfer can be made—without creditor consent.
55. **Bridge banks.** Bridge banks are used in some countries as part of the receivership process. When one or more banks are insolvent or in danger of becoming insolvent, the deposit insurance agency may organize a new bank that the bank regulator is required to charter (bridge bank). This authority can be used to facilitate sales of large banks that were first intervened by the regulatory agency. Once established, the bridge bank continues to operate the business of the failed bank, while the owners of the failed bank are left with an empty corporate shell. Depositors and other bank customers face a seamless transition between the failed bank and the bridge bank because, in a practical and economic sense, the doors of the bank never closed.
56. Bridge bank powers enable the deposit insurer to stabilize a large bank suffering from a depositor run, clean its balance sheet through the use of a receivership, and enter into bidding through which interested parties can do due diligence prior to making an offer for the bridge bank, either in a whole-bank or clean-bank purchase and assumption transaction and without the interference of the owners of the failed bank. The bridge is then closed a second time; if the bridge bank was sold in a clean-bank



transaction, the deposit insurance agency administers a second receivership for the unsold assets and liabilities.

57. **Forced liquidation.** Forced bank liquidation winds up all or part of an insolvent bank that cannot be rehabilitated or benefit from one or more of the preceding bank resolution procedures. Forced liquidation is generally carried out through the liquidation of assets and the discharge of liabilities. The forced liquidation of insolvent banks should be governed by rules consistent with those in the general insolvency law.
58. **Operating license.** *The law should grant the bank regulator the exclusive authority to issue and to revoke a bank's operating license.* The bank regulator generally has exclusive authority to revoke banking licenses. There are good reasons for this setup. Enabling an agency other than the bank regulator to revoke banking licenses tends to weaken accountability. And if that agency is a member of the political establishment, the system risks political interference. In some countries the law tries to compromise by requiring that a banking license be revoked only on the recommendation of the bank regulator. But the problem is not that too many banking licenses are improperly revoked, but that too few are revoked that should have been. Controlling the bank regulator's authority to revoke banking licenses by making it subject to the consent of another authority is equally objectionable. Although shared responsibility may be effective in countries with strong political discipline, it is rarely effective in most other countries.
59. Insolvency does not always provide sufficient justification for revoking a banking license. Neither does a court order opening insolvency proceedings. The reason is that the bank might still be rescued or transferred to another institution. Thus the issue remains open whether the law must provide discretion to the bank regulator by including broadly phrased grounds for license revocation and leaving room for judgment based on the circumstances of each case. Even if a bank is found to be insolvent, it may be argued that the bank regulator should have the authority to let it keep its license—as when the bank is deemed too big to fail or when, in a systemic banking crisis, mindless application of the rules would lead to the closure of the entire banking system.

## ANNEX II: SYSTEMIC INSOLVENCY AND CRISES

1. Systemic crises require sufficient public resources; deep changes in institutions, rules of the games and attitudes; an early and systematic evaluation of the size of the problem; design of an overall strategy; and prompt action. The approach needs to be comprehensive and repair both the flow and stock problems of weak and insolvent banks and corporations. Exit policies and procedures—for firms and financial institutions—need to be revamped and appropriately enforced. The government might have to provide capital to viable banks, but this should not inhibit private equity injections. Extraordinary mechanisms— institutionalized out-of-court schemes, structured loss absorption mechanisms—may be needed to accelerate corporate restructuring. Shifting nonperforming loans from bank balance sheets to loan recovery agencies can ease the banks’ stock problem, but it has risks. Regulatory changes need to balance the need for fundamental reforms with political and social realities.
2. Systemic restructuring is difficult and often leads to moral hazard. Appropriate design depends on a country’s circumstances, including its macroeconomic environment, fiscal standing and external financing, and the quality of its institutions. While there is no universal solution, there is no alternative to a comprehensive and integrated solution. Crucial in any financial crisis is building social and political consensus to carry programs through. Systemic restructuring involves redistributing wealth and control and deciding how the costs will be shared among government, shareholders of banks and corporations, and foreign investors and lenders. And that is inevitably a major political and social issue.

### 1. Conditions of Systemic Crises

3. Since the late 1970s there have been at least 112 systemic crises in 93 countries. The fiscal costs of these episodes have been huge both in terms of GDP and in other social and economic costs . The crises have had many causes. A significant proportion of the crises were caused by cronyism (excessive political interference, connected lending), and correlated excess borrowing. Panics by foreign investors played a role in the Latin American crises of the 1980s and the East Asian crisis of the 1990s, and premature liberalization could be cited in many cases. Macroeconomic problems have also been common, especially terms of trade declines or recessions. Still, crises are typically manifestations of weaknesses in the financial and corporate sectors that make the country prone to such events. When the weaknesses are combined with a lack of political will to take the measures necessary to correct the situation in a timely fashion the result is a systemic crisis that impacts the public, in general, and the poorest sector, in particular.
4. In the financial sector, besides the failure of owners to discipline managers (particularly of state banks), incentives for prudential banking are typically weak. Lending limits are poorly designed and weakly enforced. Asset classification systems and loan loss provisioning rules fall short of international standards. And there is no clear exit policy for troubled financial institutions. Countries with systemic crises often have huge holes in their regulatory, supervisory, accounting, auditing and disclosure frameworks and practices. Information and financial statements are often unreliable or out of date. And enforcement of laws and regulations can be pitifully weak.
5. Weak financial systems often protect poorly performing firms by continuing to provide loans. Thus a crisis may be preceded by an extended period of debt-financed overinvestment in low-margin or loss-making businesses and markets. Corporate profitability and returns may be low and falling, leverage increasing and interest coverage deteriorating. When a systemic crisis hits, it typically involves simultaneous distress among many corporations. Currency and interest rate fluctuations, steep drops in demand and other economic shocks may precipitate the crisis or soon follow its onset and worsen

corporate performance. The sudden suspension of corporate debt payments will quickly decapitalize financial institutions, and the value of corporate assets—and bank collateral—will plummet. Desperate efforts by financial institutions to preserve liquidity by calling in loans and refusing new loans or loan rollovers may cause a credit crunch. All this may threaten the survival of both strong and weak corporations. Despite emergency efforts to preserve liquidity, rapid decapitalization may threaten many financial institutions with insolvency.

## 2. Issues and Conditions for Systemic Restructuring

### FINANCIAL SECTOR RESTRUCTURING

6. **Containment phase.** *During the containment phase while a systemic crisis is unfolding, special measures are needed to protect the financial system and limit the fiscal cost of resolving the crisis.* In the early stages of any crisis, crucial choices must be made that affect the stability of the financial system and determine the scope for further restructuring and the fiscal costs of resolving the crisis. International experience offers guidance on the steps to be taken during this containment phase: Don't provide liquidity to a bank on an ongoing basis until oversight is more than adequate. Don't close a bank in the middle of a systemic crisis unless there is a credible policy on resolution. Don't announce a blanket deposit guarantee if depositors are merely running to quality within the system. And don't act aggressively except in the context of a coherent and workable plan. Rather, governments should impose rational constraints on financial institutions and alter lending practices.
7. *Suspensions, guarantees and limits.* It is often not feasible or economically sensible to close or suspend a large segment of the financial sector. Abruptly closing banks in a climate of widespread uncertainty can prompt depositors to flee further and faster from banks. Such a move also disrupts relationships between banks and borrowers, shutting off new lending or inducing borrowers to stop servicing old loans. Nor should authorities resort to the quick fix of giving guarantees to depositors and creditors to stem the loss of confidence without assessing all the factors involved. Guarantees may not even work if the problems are big enough and the government lacks the resources and capacity to back them up—which can turn a depositor run into a currency panic.
8. A legal and institutional infrastructure for prompt corrective action and for intervention in insolvent institutions should be in place before a crisis to provide clarity on any intervention, including the priority of claims and procedures for transferring performing loans. Short of that, failed banks cannot be allowed to return to business as usual without adequate capital, nor should shareholders be indemnified against losses. Instead, countries should appoint a conservator of failed banks or hammer out contractual arrangements through which the government holds some of the capital for a transitional period.
9. *Liquidity support.* At the outset of a crisis, it is important to stop the flow of new financing to bank borrowers in default and new lending to insolvent institutions should only be allowed when required for the continued functioning of the payments system. Managerial and shareholder incentives shift when a financial institution becomes insolvent: managers have no incentive to run the institution on a viable basis, and they often speedily drain away resources—including liquidity support from the central bank. Costs rise when the authorities are unable (or unwilling) to stop the transfer of resources from long-insolvent financial institutions. Intense regulatory oversight is needed to stop what may amount to looting by managers and owners.
10. **Systemic restructuring.** *Systemic crises require active but balanced public support, using a comprehensive medium-term plan based on proper diagnosis and third-party inputs, all in a context of sound macro-economic policies.* Experiences in many countries point to clear principles for systemic restructuring of financial systems. Without systemic and accelerated restructuring, usually involving government financial support, problems in the financial and corporate sectors are unlikely to be resolved. Insolvent banks will be tempted to gamble or will sharply reduce lending in an attempt

to build up capital. Undercapitalized, the financial system will remain dysfunctional. Prompt action and large up-front investments by the public sector—through bank recapitalization—may lead to lower costs because the moral hazard of repeated bailouts may be avoided and, more generally, because there are large benefits in getting credit flows and economies moving again. But to avoid moral hazard, these interventions need to be preceded by some fundamental reforms.

11. *Prompt, comprehensive and credible action.* Fast action is essential for successful systemic restructuring. Prompt action on financial sector restructuring is also needed to maintain credit discipline for borrowers. Borrowers often take the attitude that their creditors are less likely than they are to be around in the future, making them less likely to repay even when they can. Minor fixes, such as increasing loan rates or imposing an inflation tax to restore profitability and recapitalize banks, do not work. Banks that try such methods only reduce the demand for financing and the number of sound firms able (or willing) to pay the higher costs, at severe costs to the economy and to financial development.
12. *A coherent medium-term strategy.* A coherent, realistic and comprehensive approach to the crisis, steadfastly applied, is crucial. In a systemic crisis it is not enough to address only the problems of a handful of the most affected institutions. Unless credible action covers all (or most) financial institutions that are ailing or failing, market uncertainty may be heightened rather than reduced. Asset prices will continue to languish or fall. And without a credible policy, government can become vulnerable. Systemic bank restructuring needs to be driven by a well-articulated, medium-term vision for the financial (and corporate) sector, to be developed by the government in collaboration with the private sector.
13. *Diagnosis and third-party inputs.* The development of the medium-term strategy begins with diagnosing the problem, which requires rigorous monitoring and scrutinizing of financial institutions, including detailed portfolio reviews by reputable outside (preferably international) auditors. The crisis calls for immediate focus and high-level attention, including designation of a dedicated, top-notch crisis team to coordinate the government's response. The team should develop basic principles to tackle the crisis and develop an immediate action plan. Most pressing is greater empowerment of a single restructuring agency—whether in the central bank, ministry of finance or elsewhere—to avoid gaps and conflicts in approaches and actions. The rehabilitation and restructuring plans of individual banks and financial firms can be given more credibility with, for example, the participation of independent parties, including international experts. More generally, there is often a need for more third-party inputs and technical assistance at various stages of restructuring. These include diagnostic audits of financial institutions, loan workouts to create viable restructured assets and investment banking to sell restructured assets.
14. **Loss allocation and use of public resources.** *Losses should first be allocated to private shareholders and creditors. The public resources typically required in a systemic crisis should complement—not displace—private sources, and their use should minimize moral hazard.* Restructuring starts with allocating losses to shareholders of insolvent financial institutions. Corporate and insolvency laws establish the seniority of claims and the order in which they can be written off, with equity at the top of the list. Thus if a bank (or corporation) is still solvent but is in dire need of debt relief from creditors or public support, shareholders' equity (and voting power) should be diluted. And when a bank (or corporation) is insolvent, the claims of shareholders and subordinated debt-holders should be written down before public money is forthcoming.
15. Financial discipline can be strengthened by allocating at least some losses to creditors and depositors who should have been monitoring the bank. Allocating losses to creditors or depositors will not necessarily lead to a run on banks or end in the contraction of aggregate money and credit, and output, though the situation should be carefully assessed before decisions are made in this area. In past crises—most notably in the United States (1933), Japan (1946), Argentina (1980-82) and Estonia (1992)—governments have imposed losses on depositors with little or no adverse macroeconomic

consequences or flight to currency. Economic recovery was rapid, and financial intermediation (including household deposits) was restored within a short time. Financial discipline was further strengthened when management was changed and banks were restructured. In some of the most comprehensive bank restructurings (in 1995 in Argentina, for instance) shareholders, nondepositor creditors and sometimes depositors have sustained losses without significantly undermining confidence in the restructured system.

16. *Public resources.* Government's instinctive response to a crisis is to allocate too few public resources. Unsure of the amount of help available, financial institutions tend to hide the extent of their problems. Existing and potential shareholders will not put up new capital because they are uncertain about the government's capacity to protect against losses. More generally, the crisis undermines the confidence of depositors and investors. In short, countries need (or must be perceived) to have sufficient resources to deal with the large costs of a systemic crisis. But public capital injections should not bail out existing shareholders. Rather, the aim is to allocate losses transparently and minimize costs to taxpayers while preserving incentives for the infusion of new private capital.
17. Some countries have opted not to rely on private injections—and they eventually suffered. They resolved their financial crises partly through partial or full public bailouts, which reinforced the perception of an implicit government guarantee on deposits and other bank liabilities, to the detriment of market discipline. In some cases bank management was not even changed as part of the restructuring, which further undermined incentives for prudent behavior. The lingering effects of such policies often contributed to new crises.
18. Badly designed recapitalizations using public resources have failed, with one recapitalization following another. Efforts focused on fixing balance sheets, with little attempt to correct underlying problems. Repeated recapitalization led to moral hazard; with an implicit government guarantee there was little incentive for prudential banking. Several countries had to recapitalize its banks several times before they got it right; others repeatedly restructured their banks. Even rich countries have not been immune to recurrent recapitalizations. Mergers can help, but only when they make commercial sense to the acquirer. Merging two weak banks will compound the problem, making the bigger bank a bigger problem down the line. Reprivatizing banks hastily is not advised.
19. *The need for private contributions.* Government can take several steps to help clean up banks' balance sheets—rehabilitating assets, sharing losses, reducing debt and injecting new capital. Wherever possible, undercapitalized banks should seek private capital at the same time public support is offered. Banks that choose not to participate on the terms offered are either sound or, more likely, have weak portfolios with private owners unwilling to put up new capital. Such banks should be closed. Assisted banks should be required to draw up a business plan, verified by third parties, disclosing capital and operational restructuring to reduce costs and improve profit prospects without taking on additional risks. Tight and regular monitoring and supervision, onsite and offsite, are needed to ensure that banks do not subsequently become undercapitalized.
20. *A bank restructuring program should be supported by detailed and transparent provisions of bank restructuring law.* The law governing the bank restructuring corporation must use clear, comprehensive and unambiguous language and must be comprehensible to bank owners and managers, potential investors in and buyers of restructured banks and their assets, and the general public. Transparency is especially important in defining the grounds and procedures for referring and transferring a failing bank to the bank restructuring corporation, the legal effects of the transfer on the powers and rights of bank owners and managers, the content and scope of the powers of the bank restructuring corporation, and the circumstances under which banks referred to the corporation must be liquidated and their licenses revoked. In addition, if the statute of a bank restructuring corporation grants rights, powers and procedures that conflict with or override other laws (such as company, bankruptcy, securities, real property and employment laws), the hierarchy between the statute and other laws should be clearly stated in the organic law of the bank restructuring corporation.

21. The agencies involved in bank restructuring are usually government agencies, so their acts are governed by administrative law, including procedures for administrative review. With the urgent and exceptional nature of banking system restructuring, there is justification for curtailing the rights of interested parties to administrative review of such acts - at least to the extent necessary not to suspend bank restructuring or liquidation.
22. The bank restructuring law should have sunset provisions that limit its life and that of the bank restructuring corporation, to avoid using the same regime to restructure banks under circumstances unrelated to the banking crisis for which it was created. But sunset provisions have an important disadvantage. Once a law has expired, its revival in response to a new banking crisis would require a full-fledged legislative procedure, delaying bank restructuring. Keeping restructuring legislation on the books would avoid such delays. This can be achieved, without risking that the restructuring law would be applied outside crisis situations, by limiting sunset provisions to a suspension of the law's operation and by providing that the law may be reactivated only under certain conditions pursuant to a simplified legislative process, such as a resolution of parliament or a government decree issued with the advice and consent of the legislature.
23. **Supporting reforms.** *Financial sector restructuring after a systemic crisis must be done in tandem with fundamental reforms—including strengthening regulation and supervision and enhancing private sector monitoring.* Fundamental reforms initially involve strengthening prudential regulation, adopting internationally accepted accounting, auditing and financial reporting standards and practices, and toughening compliance and regulation. After that, institutional and legal tools must be forged to resolve failed institutions and dispose of their assets. While these reforms are often started in a crisis, they are hardly ever completed. Bank supervision, for example, typically falls short of international best practice; bank regulators are often not truly independent. Predetermined procedures and corrective actions are needed for early intervention and resolution when banks and financial institutions are distressed but not insolvent. The aim is to put them on a sounder footing and avoid insolvency, closure or forbearance. Most countries fall far short of this ideal, however.

#### **CORPORATE SECTOR RESTRUCTURING**

24. **Corporate restructuring framework.** *Effective corporate restructuring requires a conducive general framework, enabling creditors to induce restructuring on debtors and ensuring realistic loss recognition by financial institutions.* Given the excess corporate debt typical of a systemic crisis, corporate viability cannot be restored without workouts with creditors—debt maturity extensions, debt-equity swaps, debt forgiveness and so on. During a systemic crisis much of this corporate restructuring will need to be done like case-by-case corporate restructuring under non-systemic circumstances. But the scale of corporate distress and the difficulties of getting parties to act in a systemic crisis require special attention. Three conditions must be present for effective medium-term restructuring of distressed companies and to avoid imprudent corporate investment. First, tax, legal, regulatory and other rules must be conducive. Second, creditors must be able to induce corporate restructuring and impose losses on debtors. Third, governments must be able and ready to induce domestic financial institutions to take losses on corporate restructuring.
25. *An enabling environment.* Corporate restructurings are often delayed or derailed by tax, legal, regulatory or other impediments. Countries typically have to ease corporate restructuring by improving the enabling environment—including better accounting, financial reporting and disclosure standards, speedier foreclosure procedures, and changes in tax and accounting rules. Other measures often include liberalizing foreign investment rules, revamping merger and acquisition policy, opening markets and implementing other tax reforms. Investment in the financial and corporate sectors needs to be liberalized because foreign investment can provide much-needed capital and expertise. Tax and regulatory changes may be needed to facilitate debt-equity conversions and ease asset sales. Over the medium term, biases in the tax treatment of debt and equity often need to be redressed.

26. *Ability to induce restructuring and impose losses on debtors.* Controlling shareholders and managers of distressed companies may naturally seek to avoid the downsizing of operations, forced asset sales, dilution of equity ownership and diminution or loss of management control. The ability of creditors to seize ownership or control of a company—through receivership or special administrator—encourages debtors to cooperate with out-of-court workout efforts. This includes a credible foreclosure threat that provides incentives to debtors to subject themselves to (court-supervised) rehabilitation. The absence of such “sticks” will delay corporate restructuring. A weak insolvency regime may impose big losses on the creditors of financial institutions or lead to a standoff between corporate debtors and financial institution creditors. Furthermore, a credible threat of foreclosure and court receivership can help forestall systemic crisis by discouraging imprudent corporate investment.
27. *Ability to induce losses by domestic financial institutions.* For corporate restructuring to be effective and timely, governments must be able to induce domestic financial institutions to accept losses from corporate restructuring. Losses to financial institutions are inevitable given the close link between corporate restructuring and financial sector restructuring. Typically, however, financial institutions prefer to postpone corporate restructuring and their losses from it. Government policies need to quicken the pace of loss recognition by financial institutions and thus the pace of corporate restructuring. Policies that accelerate loss recognition include the application of standard forward-looking criteria for classifying corporate debt and corresponding provisioning rules, and the prompt closure of weak financial institutions.
28. **Framework enhancements.** *Governments need to undertake further specific actions in a systemic crisis to preserve asset values and to induce corporate restructuring.* Even with these elements in place, exclusive reliance on the market to solve corporate problems may lead to loss in asset values and be insufficient in a systemic crisis. In the containment phase of a crisis, preservation of asset values may call for across-the-board rescheduling of principal or interest (or both) for small and medium-size enterprises, as well as special financing schemes. Working capital or trade finance may be needed to prevent potentially viable enterprises from going out of business. Because of the breadth, severity and complexity of corporate restructuring and systemic crises, and because enforcement and insolvency systems are often not fully effective, special guidelines for corporate restructurings can be necessary and desirable.
29. In a systemic crisis, insufficient restructuring is typically the biggest problem. Though it may be adequate for normal times, the (revamped) bankruptcy and restructuring framework might not be sufficient for a systemic crisis given the various coordination problems and weaknesses in other aspects of the institutional framework. Courts will not be able to handle all restructurings due to the scale of the problems and the general lack of experience and other weaknesses that often led to the crisis in the first place. Given the difficulty in determining economic prospects and asset values, creditors and equity holders will not want to recognize losses and instead will be waiting for better times—and, often, for more public support. The dispersion of claims and interests among many creditors makes coordination difficult. In such an environment the framework may need to be enhanced to induce restructuring outside formal reorganization and bankruptcy procedures.
30. *Enhancing the corporate restructuring framework.* The government may want to create a more institutionalized framework for corporate restructuring, as was first done in Mexico in 1995. Following Mexico’s example, some Asian economies (Indonesia, Korea, Malaysia, Thailand) moved in 1998 toward out-of-court but institutionalized procedures to complement in-court procedures. These frameworks take as their starting points the so-called London rules, principles for corporate reorganization first enunciated in the United Kingdom in the early 1990s. But the London rules were not designed for systematic corporate distress, and countries have had to enhance them (box A.1). In most cases these frameworks have established voluntary arbitration mechanisms and professional services. In addition, further enhancements have taken place through an out-of-court accord, under regular contract or commercial law, to which all (or most) creditor institutions (are coerced to) sign on. With such an accord, agreements reached among the majority of creditors can be enforced on

other creditors without going through formal judicial procedures. In addition, arbitration with specific deadlines—and specific penalties for failure to meet deadlines—can be made part of the accord, avoiding the formal judicial process to resolve disputes.

**Box A.1 Developing institutionalized, out-of-court approaches to corporate restructuring**

Several factors should be considered in deciding whether to adopt and how to formulate an institutionalized, out-of-court approach to corporate restructuring.

*Principles under which the approach will operate.* Beyond the objective of accelerating restructuring, other principles to be decided include: Will the new approach try to maximize creditor recovery, or will it favor corporate restructuring? Will the program use as its basis generally accepted corporate restructuring principles? While a variety of policy goals are possible, the more market-based restructuring principles are abandoned, the more the government will entangle itself in restructuring. This poses serious risks and requires a careful evaluation of the credibility and professionalism of the proposed government decisionmakers, as well as the value of the goals to be achieved through their involvement.

*Determining how substantive decisions are made.* One of the most important issues is whether and under what circumstances institutional decisionmakers will substitute their judgment for that of private parties. Involving the institutional program in substantive debt restructuring can provide credibility and leverage, and can help to overcome the reluctance or inability of the parties to engage in good-faith negotiations. But involving emerging market governments in debt restructuring discussions is fraught with risks. In many countries it was the close “cooperation” between the corporate and government sectors that caused economic problems in the first place.

*Using mediation mechanisms.* Though the institutional program may not assume the role of substantive decisionmaker, it may nevertheless provide substantive (and procedural) guidance through a mediation mechanism. Trained mediators can provide substantive opinions to the parties and can bridge cultural gaps, improving communication. But the decision to include a mediation mechanism must be made in light of the cost of the professionals involved, their skills, and the need to provide guidance to participants.

*Determining the leverage available to the program.* An additional policy choice is whether the institutional program is designed to operate on a voluntary basis or whether those administering the program are empowered to punish parties who refuse to participate or who participate in an unsatisfactory fashion. If so, what type of sanctions should be available, and what discretion should those administering the program have over their use? A voluntary program will require adequate funding and staff capable of developing and maintaining market credibility. When sanctions are built into the institutional restructuring program, the professionalism and dependability of those responsible for its operation, as well as the level of discretion left to them, will need to be assessed to avoid the improper use of powers.

*Choosing a rigid or flexible procedural system.* A flexible system favors adaptability and can enable decisionmakers to tailor restructuring procedures to the needs of each case. But in many developing countries a lack of certainty and experience merits the institutional program in the first place, so strict rules on restructuring (including timeframes and steps to be taken) may be important.

*Striking a balance between real and financial sector restructuring.* In any corporate restructuring, immediate cash settlements may come at the expense of long-term recovery. But a predictable, workable and quick corporate restructuring system can reduce process risk. The institutional approach will have to balance these competing objectives.

31. The enhancements have varied by country, reflecting different policy objectives and country circumstances. In East Asia, Thailand’s framework seems to have been the most conducive to out-of-court restructuring, followed by Korea and Malaysia. Indonesia’s framework was the least conducive. These differences seem to explain part of the variations in the speed of corporate restructuring in these four countries. Regardless of their precise design features, out-of-court frameworks need to have a legal backing to force debtors to participate, to allow foreclosure of collateral and to avoid having small creditors obstruct negotiations and hold out for more generous treatment. Thus proper bankruptcy and foreclosure procedures are important for the success of these approaches.



32. *Further special measures.* Whether additional special measures for distressed companies are needed in a systemic crisis is less clear. Some observers have argued for a general moratorium on debt service or a “super Chapter 11” to apportion losses from systemic corporate distress among shareholders, financial institutions and national treasuries and taxpayers. Before concluding that some special regime is needed, governments should ensure that creditors are able to impose losses on debtors, that domestic financial institutions are forced to recognize losses from necessary corporate restructuring in a timely manner, and that no other major tax, legal, regulatory or political obstacles thwart immediate corporate distress resolution and follow-on operational restructuring. Without considering these factors, a special regime could create moral hazard, encourage a resumption of excess leverage and investment, preserve nonviable companies that should be liquidated, and tie up capital and assets in less productive enterprises.
33. **Lead restructuring agency.** *In general, private sector solutions for corporate restructuring seem to be preferable. Publicly owned asset management corporations have had limited success in developing countries.* Successful operational and financial restructuring of corporations requires proper valuation of distressed assets and the right incentives for restructuring. These factors depend on the agent selected to lead the corporate restructuring. Possible choices are banks and other financial institutions, governments and existing or new corporate shareholders (foreign or domestic). The choice will determine not only the depth and sustainability of restructuring, but also the medium-term financing and governance structures of the corporate sector. In general, private sector solutions should be adopted where feasible. Privately managed assets will yield higher returns (or smaller losses) than those managed by government. This is especially so in emerging markets, given the historically large role the state has played in allocating resources, with mixed success.
34. *Decentralized and centralized approaches.* Workouts can be decentralized through internal workout units in banks, through “bad” banks (separately capitalized banks with bad loans that are managed by the good bank with other investors or spun off to new investors) or through separate asset management companies that are subsidiaries of banks. Workout units in banks should be financially and organizationally separate from other parts of the bank, and it is inadvisable to make the same bank officer who made the (now) distressed loan responsible for restructuring it. Further segregation, through bad banks or asset management companies, can clarify the bank’s financial situation and avoid skewed incentives and drains on managerial effort. Segregation will be necessary in any case if government support is provided. But there are risks. Transferring loans to a separate asset management company can break the link between the bank and a corporation—a link that may have value given the bank’s privileged access to corporate information. Other issues are the price to be paid for distressed assets and the additional time needed to organize an asset management company and transfer assets to it. In addition, restructuring often requires new lending, and an asset management company may not have the capacity to lend.
35. Alternatively, under a centralized approach, a single publicly owned asset management company, restructuring agency or deposit insurance agency takes over bad assets from many financial institutions and centralizes the management of them. Recovery on centrally held financial assets can benefit from economies of scale—as with the centralization of management workout skills and information technology—and can help with the securitization of assets. Moreover, distressed loans are removed clearly, quickly and completely from banks, which can help rebuild confidence in failed banks. To perform the asset resolution role more effectively, the public asset management company can be given super-administrative powers to seize collateral and take over the management of debtor companies. But there are risks as well, mainly related to the incentive structure of the management of a public asset management company.
36. *Different countries, different choices.* During their systemic crises, Norway and Spain adopted variations of an internal workout, while the United States opted for a government agency (the Resolution Trust Corporation). The choice between the two approaches is complex. The decentralized approach requires a strong framework and proper incentives for private agents to undertake

restructuring. A review of decentralized restructuring in seven countries shows that the success of this approach depends on the quality of the institutional framework (including accounting and legal services) and on the initial conditions (including the capital positions of banks and ownership links).<sup>30</sup>

37. Publicly managed asset management companies have mixed track records. In several documented cases the companies have not expedited bank or corporate restructuring. In some cases (Mexico, Philippines, some transition economies) the establishment of a public asset management company actually delayed problem resolution. When given extrajudicial powers not available to other creditors, a government asset management unit may make decisions on immediate cash settlement and long-term recovery that do not always maximize corporate values. Experiences in Spain and the United States suggest that asset management companies can be effective, but only for narrowly defined purposes of resolving insolvent and nonviable financial institutions. And even achieving those objectives required many ingredients: professional management, political independence, a skilled resource base, appropriate funding, adequate bankruptcy and foreclosure laws, good information and management systems, transparency in operations and processes, and—importantly—political will.
38. . A review of country experiences with asset management companies shows a very mixed record, with more success in industrial countries than in emerging markets.<sup>31</sup> Much of this disparity arises from the much larger systemic crises in developing countries, which make asset management companies not easily replicable. Total assets handled by the U.S. Resolution Trust Corporation, for example, accounted for about 7 percent of GDP—while in many emerging markets nonperforming assets have equaled 20 percent or more of GDP. Moreover, capital and other financial markets are typically better developed in industrialized countries than in emerging markets, allowing faster disposal of assets, and qualified personnel are more widely available.
39. Thus private sector actors are preferable as lead agents for corporate restructuring. But in a systemic crisis, foreclosure, liquidation and court-supervised reorganization procedures are often weak. Without reliable means for imposing losses on debtors, private actors will have a hard time resolving corporate distress in a timely and effective manner that restores corporate health and deters further imprudent behavior. Because it can be difficult to strengthen a country's insolvency capabilities in the midst of a crisis, countries should rely more on hard budget constraints to force corporate restructuring and avoid leakage of government support for the financial system. Hard budget constraints can vary from close oversight of weak financial institutions to lending limits on certain types of corporations. They can also include reserve requirements that force financial institutions to direct new deposits to safe assets, such as government bonds, rather than onlend these funds to weak corporations.
40. If a centralized unit is used, it must be set up quickly with a clear pricing mechanism for transferring assets. The market value of loans should be recognized early on—using international principles and verified by independent accountants and auditors—and loss provisions made accordingly. Any agency must be well funded and have the authority and incentives to place assets in the private market as quickly as possible. Selling assets quickly establishes floor prices that promote a speedier recovery from the economic crisis. For example, the U.S. Resolution Trust Corporation sold most of its \$450 billion in assets within three years. An asset management company cannot be used to hide the size of losses and should be audited regularly, with third-party validation of asset quality. Finally, it must be established with a clear mandate and a short life—no more than three to five years.

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<sup>30</sup> Dado, Marinela, and Daniela Klingebiel, “Decentralized Creditor-Led Corporate Restructuring: Cross-Country Experience,” World Bank, Washington, D.C (2000).

<sup>31</sup> See Daniela Klingebiel, “The Use of Asset Management Companies in the Resolution of Banking Crises: Cross-Country Experiences,” World Bank, Washington, D.C. (1999).

## ADDENDUM: SURVEY OF OTHER INITIATIVES

### Cross-border insolvency

International work on multi-jurisdictional business and bank insolvency has focused on the need for access, recognition and cooperation. Initiatives have included the European Union's 1995 Convention on Insolvency Proceedings, adopted as an EU regulation in May 2000 after 40 years of groundwork.<sup>32</sup> The United Nations Commission on International Trade Law (UNCITRAL), in collaboration with INSOL International, began work in 1994 on a Model Law on Cross Border Insolvency, adopted in 1997. Like the EU regulation, the UNCITRAL model law contains choice of law provisions and provides for access, recognition and cooperation in cross-border insolvencies among countries that adopt it. In 1998, in response to the Barings Bank failure, the Group of Thirty released a report titled "International Insolvencies in the Financial Sector." The G-30 recently commissioned a further examination of the extent to which globally active financial institutions take cross-border insolvency risks into account in their private risk management calculations.<sup>33</sup> And in 2000 the American Law Institute completed its Transnational Insolvency Project, which aims to develop principles and procedures for managing enterprise failures among members of the North American Free Trade Agreement.<sup>34</sup>

### National insolvency law reform

Throughout the 1990s the Bank and other international financial institutions helped transition economies develop insolvency and creditor rights systems to facilitate the transfer of state property to the private sector and to smooth the exit of loss-making enterprises. As these economies mature, they are being swept by a new wave of reform that takes a more comprehensive, market-oriented approach to the role of insolvency and creditor rights systems in promoting and stabilizing commerce. After the East Asian crisis, a G-22 study underscored the importance of these systems in preventing, managing and resolving systemic crises.<sup>35</sup> This led to a range of responses from international financial institutions. In 1998 the Asian Development Bank (ADB) began providing technical assistance for insolvency law reform in Asia and the Pacific.<sup>36</sup> Its final report, released in 2000, identifies 16 standards for insolvency laws. In 1999 the International Monetary Fund issued a report titled "Orderly and Effective Insolvency Procedures," identifying key features of an insolvency law and discussing the policy considerations underpinning the design of a modern insolvency law.<sup>37</sup> In 2000, building on work by the Bank and others, UNCITRAL began developing legislative guidelines for a formal corporate insolvency law. This work is expected to be completed in 2003.

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<sup>32</sup> Effective in May 2002, the EU regulation establishes a choice of law framework for cross-border insolvencies within EU member states. Preparatory work began in 1960 and resulted in two drafts of 1980 and 1984 which then member states found unacceptable. Work resumed in 1990.

<sup>33</sup> Group of Thirty, "Reducing the Risks of International Insolvency: A Compendium of Work in Progress" (2000).

<sup>34</sup> American Law Institute, "Principles of Cooperation in Transnational Insolvency Cases among the Members of the North American Free Trade Agreement" (2000).

<sup>35</sup> Group of 22, "Report of the Working Group on International Financial Crises" (1998). The G-22 study endorses a short list of principles for insolvency and debtor-creditor regimes but makes no specific recommendations on strengthening national systems in these areas.

<sup>36</sup> Asian Development Bank Regional Technical Assistance Program for Insolvency Law Reform (TA No. 5795-REG).

<sup>37</sup> The IMF report concentrates on the legal framework and procedures for an insolvency law, which are addressed in Section 3 of this report.

## **Initiatives on secured transactions**

Among international financial institutions, interest in secured transactions began with the Bank, European Bank for Reconstruction and Development and Inter-American Development Bank projects in the early 1990s.<sup>38</sup> The EBRD, among the first to recognize the importance of secured lending, pioneered principles for a modern secured transactions law that have received a measure of acceptance among developing countries in Europe and Central Asia, where they are often used to modernize secured transaction legislation.<sup>39</sup> In Asia and the Pacific the Asian Development Bank is providing technical assistance on secured transactions law reform, complementing its work on insolvency law reform.<sup>40</sup> And in Latin America the Organization for American States has begun work on a model secured transactions law.

## **Informal corporate workouts**

In October 2000 INSOL International released a “Statement of Principles for A Global Approach to Multi-Creditor Workouts.” The principles derive from the London Rules approach to informal workouts and espouse eight best practices for multi-creditor workouts. Because informal workouts take place in the “shadow of the law,” consensual resolution requires reliable fallback options through existing legal mechanisms for individual enforcement and debt collection or through collective insolvency procedures.

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<sup>38</sup> The reforms of the United States and Canada, dating from the 1950s, set out fundamental principles for a modern secured transactions law that have been relied upon as a model for current initiatives.

<sup>39</sup> This report’s principles 3-5 on creditor rights and enforcement are largely consistent with the EBRD’s 10 core principles on secured transactions. For a discussion of these principles, see [www.ebrd.com/english/st.htm](http://www.ebrd.com/english/st.htm).

<sup>40</sup> Asian Development Bank Regional Technical Assistance Program for Secured Transactions Law Reform (TA No. 5773-REG).

## GLOSSARY<sup>41</sup>

**Administrator:** A person or entity appointed in place of a debtor's management to administer an insolvency proceeding and who is accountable to the court, tribunal or agency with jurisdiction over insolvency cases. As used in this paper, the administrator refers to a qualified and competent office holder or professional who is knowledgeable of business matters. This term, as used in many countries, is not susceptible to a consistent meaning. Generally it refers to one appointed to manage the affairs of a business with a view to rehabilitating it. In this paper, the term is used generically to encompass a liquidator as well, even though the term "liquidator" generally refers to one charged with liquidating (as opposed to rehabilitating) the enterprise. In systems where a debtor's management is not replaced by an administrator, the debtor's management is typically responsible for carrying out the duties of an administrator (as with a "debtor in possession" in the United States). Other terms often employed with variances in meaning and duties include trustee, supervisor, examiner, receiver, insolvency administrator.

**Bankruptcy judge:** A judge designated to handle bankruptcy cases. The bankruptcy judge should be specialized, even if there is no specialized bankruptcy court. In jurisdictions where a bankruptcy court is not the preeminent bankruptcy authority, the person or insolvency agency with equivalent powers may serve a comparable role.

**Bankruptcy proceeding:** A proceeding conducted according to established law wherein an enterprise or entity is rehabilitated or liquidated for the benefit of its creditors and others. Bankruptcy proceeding is often used to refer to a liquidation proceeding, whereas insolvency proceeding is more often used to refer to both liquidation and rehabilitation proceedings. In this paper the two terms are used interchangeably to represent all court-supervised (or agency-supervised) proceedings, while liquidation and rehabilitation are used specifically.

**Charge:** Used in a generic sense to encompass the various forms of a possessory or non-possessory security. In some countries the term refers only to a non-possessory security interest. Generally, the charge confers a priority entitlement to the proceeds of assets given as security. The English "floating charge" is distinctive in that it gives the enterprise a right to dispose of assets in the ordinary course of business free from the charge.

**Collateral:** Assets or property, movable and immovable, for which a security interest has been granted to a creditor. If an obligation is not satisfied, the collateral subject to a security interest may be recovered or held, or the value realized, by the creditor holding the security interest.

**Court:** A tribunal or judicial authority that, as an independent and objective agent, is responsible for resolving insolvency cases. If final authority for insolvency cases is not lodged in a court, then an insolvency agency may serve a comparable role.

**Debtor:** An enterprise or legal entity that is indebted to a creditor. In the context of a bankruptcy proceeding, whether liquidation or rehabilitation, the term debtor is used to refer to the insolvent.

**Lien:** A generic term used in the United States to refer to a charge to secure payment of a debt or performance of an obligation, whether consensual, judicial or statutory. Under English law the term refers to a passive right arising by operation of law to retain the chattel until paid.

**Liquidation:** The process of assembling and selling a debtor's assets in an orderly and expeditious fashion in order to dissolve the enterprise and distribute the proceeds to creditors according to established

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<sup>41</sup> The definitions in this Glossary have been adapted to the usage of terms and concepts in this paper. They do not necessarily have the same meaning that may be applied in a specific jurisdiction or country. Some of the definitions on security draw from those used in the EBRD's model law on secured transactions.

law. A liquidation can include a piecemeal sale of the debtor's assets or a sale of all or most of the debtor's assets in productive operating units or as a going concern.

**Liquidator:** The person or professional designated to handle the liquidation of an enterprise.

**Mortgage:** A transfer of assets by way of security under the express or implied condition that ownership will be transferred back to the debtor on discharge of the obligation. The term is most often used to refer to security in real or immovable property. The term *hypothec*, used in other systems, is equivalent.

**Pledge:** In a generic sense, a pledge refers to a possessory security. Still, it is often used to refer to both possessory and non-possessory securities.

**Rehabilitation:** The process of reorganizing (restructuring) an enterprises' financial relationships to restore its financial well being and render it financially viable. This process may include organizational measures and the restructuring of business and market relationships through debt forgiveness, debt rescheduling, debt-equity conversions and other means. It can also involve selling the business as a going concern, in which case the procedure may be equivalent to similar sales under a liquidation proceeding.

**Security:** Generally used to refer to the right taken as a guarantee of the fulfillment of a debtor's obligations—and more specifically, to the asset given as a guarantee. In secured transactions the term is distinct from debt or equity securities that may be traded on securities markets

**Security interest:** A right or interest granted by a party's commitment to pay or perform an obligation. Whether established voluntarily by agreement or involuntarily by way of legal process, a security interest generally includes, but is not necessarily limited to, mortgages, pledges, charges and liens.

**Secured transaction:** A transaction that involves giving a security interest to a creditor to grant that creditor a right or interest in specified collateral. Commonly used in the United States to cover a wide range of transactions, including any transaction intended to create a security interest in personal property or fixtures, including goods, documents and other intangibles.