Promoting Orderly and Effective Insolvency Procedures

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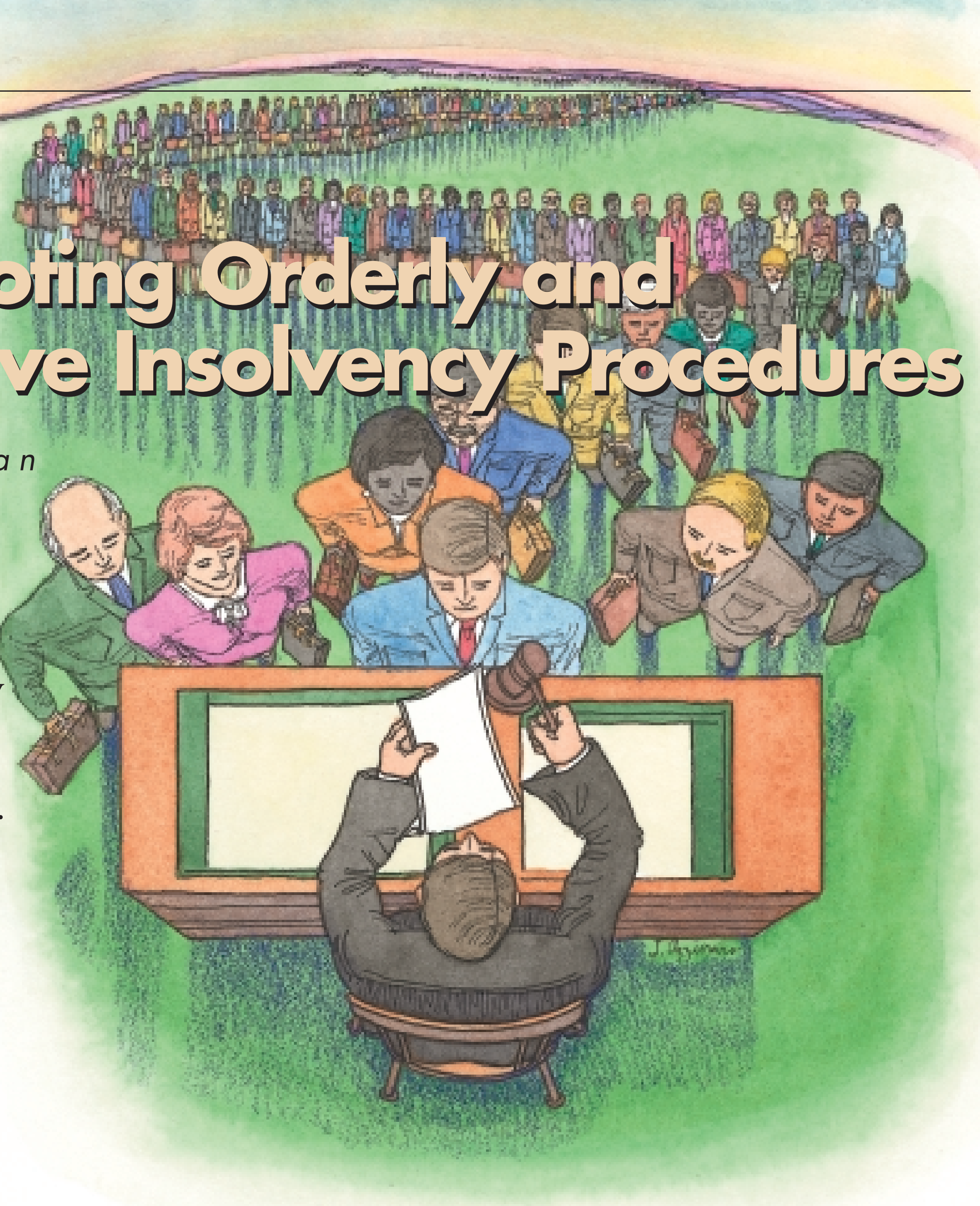

Insolvency laws are still viewed by many merely as mechanisms for cleaning up economic trash. However, they play a far more important role. If effectively designed and implemented, they can boost confidence in an economy, thereby fostering growth and helping to prevent or resolve financial and economic crises.

EFFECTIVE insolvency systems facilitate the rehabilitation of enterprises and also provide an efficient mechanism for the liquidation of those enterprises that cannot be rehabilitated. The reform of the insolvency system has become an important component of IMF-supported economic programs in many countries because of the impact such reform can have on a country's economic and financial system.

In economies in transition, for example, making state-owned enterprises subject to insolvency laws sends a clear signal that there is a limit to the amount of public financial support these companies can count on. Moreover, under the rehabilitation procedures included in most insolvency laws, creditors can be required to participate in the resolution of state enterprises' financial problems, lowering the cost to the public budget.

An effective insolvency system can also enable financial institutions in a country whose financial sector is in distress to curtail the deterioration of their assets by providing them with a means of enforcing their claims. It can also bring about the deepening and broadening of capital markets—for example, by stimulating the development of a secondary market in debt instruments that allows financial institutions to transfer their loans to entities specialized in the workout process.

Finally, in circumstances where the corporate sector is in distress because of an international financial crisis—as was the case in the recent Asian crisis—an effective insolvency law can ensure that private creditors contribute to the resolution of the crisis. For example, rehabilitation procedures may allow the courts to impose restructuring agreements over the objections of creditors, not only reducing the public cost of the crisis and relieving external financing needs but also buttressing the stability of the international financial system by forcing creditors to bear the costs of the risks they have incurred.

IMF report on insolvency procedures

This article is based on a report published in 1999 by the IMF's Legal Department, *Orderly & Effective Insolvency Procedures: Key Issues* (Washington: International Monetary Fund). Drawing on the experience the IMF has gained in providing technical assistance on insolvency procedures to a broad group of countries, the report identifies the key issues that arise in the design and application of orderly and effective insolvency procedures, discusses issues that are relevant to all countries, and attempts to identify the advantages and disadvantages of different approaches.

Aims of an insolvency system

Although the insolvency laws of countries differ in important respects, most systems share two objectives. The first is to allocate risk in a predictable, equitable, and transparent way, thereby bolstering confidence in the credit system; the second is to maximize the value of the insolvent entity.

The first objective needs to be seen from a number of different perspectives. In terms of the creditor-debtor relationship, a creditor's right to initiate insolvency proceedings against a debtor as a means of enforcing its claims reduces lending risks and therefore results in an increase in available credit. The allocation of risk among creditors is also important—for example, by affording secured creditors special treatment vis-à-vis unsecured creditors, the law can protect the value of security, which, in turn, benefits those borrowers that cannot afford or obtain unsecured credit.

However, the allocation-of-risk rules set forth in insolvency laws will create confidence in a country's credit system only if they are applied with *predictability* or, more specifically, if they are applied in a consistent manner by the individuals and institutions charged with implementing them. Although countries make different policy choices as to how risk should be allocated, experience demonstrates that participants are able to manage this risk if the rules are applied predictably. A pro-debtor law that is applied consistently will engender greater confidence than a pro-creditor law that is applied in an arbitrary way.

The allocation of risk must also be perceived as being *equitable*. Unlike secured-transactions law, an insolvency law is designed to address a debtor's inability to pay its creditors as a group, not individually. Because the application of the law sets in motion a collective proceeding, creditors must have confidence that they will be treated equitably vis-à-vis other similarly situated creditors. The law should therefore address the problems of fraud and creditor favoritism that often arise.

The second objective, the protection and maximization of value, is most obviously pursued in rehabilitation proceedings, where value is maximized through the continuation of a viable enterprise. But it is also a primary objective of procedures that liquidate enterprises that cannot be rehabilitated. Liquidation proceedings can maximize value by imposing a stay on creditor actions so as to prevent premature dismemberment and appointing a liquidator whose primary duty is to maximize the value of the estate for the benefit of all creditors.

The pursuit of either objective often increases the likelihood that the other will also be achieved. For example, the authority given to a liquidator to nullify fraudulent or preferential transactions and transfers that occurred before the commencement of the proceedings both ensures that creditors are treated equitably and enhances the value of the estate. However, there are times when the objectives may be in conflict. For example, during insolvency proceedings, some countries interfere with the termination provisions of a contract previously entered into by the debtor so as to give the trustee the option of continuing the contract. While this interference maximizes the value of the estate, it may undermine the predictability of contractual relations.

Rehabilitation procedures

While the maximization of value is a central objective of rehabilitation, a critical issue that arises in connection with the design of rehabilitation procedures is how to balance the interests of the various beneficiaries—creditors, owners, and employees. An even more fundamental question is whether rehabilitation can be achieved most effectively through the application of a formal procedure. It is a question that needs to be answered if only because so many countries rely on liquidation proceedings as the principal mechanism for rehabilitating enterprises. They do so in a number of respects. First, the very existence of liquidation proceedings creates incentives for an out-of-court restructuring. Even in economies with sophisticated rehabilitation procedures, most rehabilitations take place in the "shadow of the law." Second, because an enterprise can be sold as a going concern, liquidation can provide an effective vehicle for rehabilitation. Although the owners lose control of the business, creditors' claims can be maximized. To the extent that the law requires the continuation of employment contracts upon the sale, the interests of employees can be safeguarded. Finally, those who favor rehabilitating enterprises through liquidation proceedings point out that rehabilitation procedures can be subject to significant abuse. Particularly in circumstances where the capacity of the judiciary is limited, there is a concern that nonviable enterprises will merely use rehabilitation procedures as a means of forestalling liquidation, during which time the value of creditors' claims may be dissipated.

Nonetheless, formal rehabilitation procedures are a necessary component of an effective insolvency system for a number of reasons. First, an out-of-court restructuring requires the unanimous support of creditors. With the growth of capital markets and increasing diversity of creditors, both the debtor and its creditors may need to rely on the "cram-down" provisions that are typically included in rehabilitation procedures and that allow the debtor and a qualified majority of its creditors to impose a rehabilitation plan on dissenting creditors. Indeed, this feature of a rehabilitation procedure further facilitates an out-of-court restructuring insofar as it reduces the leverage of the potential "hold out" creditor during negotiations.

Second, while the sale of an enterprise as a going concern through liquidation may satisfy the interests of creditors and employees, it does not address the owners' interests. This outcome is problematic for a number of countries that are trying to encourage the development of an entrepreneurial class and that see insolvency law as a way to give debtors a second chance. Indeed, it is generally recognized that the owners and management of an enterprise in trouble will be willing to resort to bankruptcy proceedings at an earlier stage—increasing the likelihood that the enterprise can be rehabilitated—if they feel that bankruptcy represents an opportunity to start over.

What implications do these considerations have for the design of rehabilitation procedures? Clearly, if the goal is to encourage debtors to activate rehabilitation procedures early enough in the process to increase the chance of success, it is necessary for the law to give them incentives to do so. Some countries impose upon enterprises an obligation to commence proceedings when they can no longer service their debt and make their directors and officers subject to penalties for failure to comply with this obligation. Alternatively, the law can focus on positive inducements. These may include the possibility of management's retaining control during the proceedings and the right of management to propose a rehabilitation plan before the other stakeholders do.

For rehabilitation procedures to succeed, however, they must also address the interests of creditors. First, adequate safeguards must be in place to give creditors the assurance that rehabilitation procedures will not be used merely to delay the inevitable liquidation, during which time the value of the debtor's assets—and therefore the value of creditors' claims—is dissipated. Thus, it is imperative that a rehabilitation procedure enable the proceedings to be converted to a liquidation as soon as it becomes clear that rehabilitation is not possible. Moreover, to guard against irresponsible behavior on the part of the debtor, many countries also require that, even though incumbent management may maintain day-to-day control over the enterprise, a court-appointed administrator supervise management and approve all significant transactions.

In a more positive sense, however, it is important that rehabilitation procedures be designed to enable creditors to participate in the process. After all, a successful rehabilitation can provide the most effective means of enhancing the value of the claims of unsecured creditors. For this reason, it is important that the available options not be limited to either approval of the debtor's plan or liquidation. Unsecured creditors should be allowed to propose their own plan.

The treatment of secured creditors raises particularly difficult issues and deserves special mention. Even though designing an insolvency law is often considered an exercise in balancing the interests of the debtor and its creditors, one of the thorniest issues is, in fact, the resolution of conflicts between creditors, particularly unsecured and secured creditors. Although the claims of unsecured creditors will often be most effectively enhanced through a successful rehabilitation, a secured creditor will be most interested in foreclosing upon its collateral. In circumstances where the collateral in question constitutes an important asset, such a foreclosure can prevent the continued operation of the business and frustrate attempts to rehabilitate it. Therefore, to protect unsecured creditors, the stay on creditor enforcement must also extend to foreclosure actions by secured creditors. At the same time, the law must ensure that due regard is given to the special interests of secured creditors: to the extent that they are treated as unsecured creditors, the value of security will be eroded, to the detriment of those borrowers that cannot obtain or afford unsecured credit.

To achieve the correct balance between these conflicting objectives—maximizing the chances of rehabilitation and protecting the value of security—secured creditors should be provided with adequate protection during the period of the stay. Such protection can consist of the payment of contractual interest and compensation for any depreciation of the collateral that may occur during the proceedings.

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The key is implementation

Although all countries need to address many of the same issues when designing an insolvency law, they may choose to resolve them differently, depending on their specific needs and priorities. What is important, above all, is establishing a system that is internally consistent and a strong institutional infrastructure that ensures effective implementation.

Experience has demonstrated, in fact, that the existence of a strong institutional infrastructure is more important than the design of an insolvency law. In particular, given the complexity and urgency of insolvency proceedings, effective implementation requires judges and administrators who are efficient, ethical, and adequately trained in commercial and financial matters. With respect to administrators, experience demonstrates that this service should be provided by the private sector, subject to a licensing requirement. Regarding the judiciary, in countries where the judicial capacity is limited, consideration should be given to designing a law that is relatively simple and, more specifically, minimizes the need for the exercise of discretion by the judge. In the longer run, however, deficiencies in this regard can be overcome only by strengthening the judiciary. Because this process is a time-consuming one, it must start well before the arrival of the type of crises that make implementation of an effective insolvency system such a priority. F&D