

**Law and Policy Reform
at the
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FOREWORD

The Asian Development Bank (ADB) has long recognized that a comprehensive and effective legal and regulatory framework is a fundamental prerequisite for sustainable economic development. In furtherance with its policy on Governance: Sound Development Management adopted in 1995, ADB in 1999 continued its legal and policy reform in its developing member countries. Development of human resources in the legal and judicial sectors continues to be a priority area, in addition to systemic issues, such as the need to publicize and widely disseminate laws.

In the aftermath of the 1997-1999 Asian financial crisis, ADB has supported reforms to create more predictable, transparent and accountable legal and regulatory frameworks. In particular, for Asia to be able to face future financing challenges, it is critical that these recent reforms are sustained and improved. Governments in the Asian region must be able to provide a sound macroeconomic environment and continue to develop and maintain stable, transparent and effective legal frameworks conducive to sustainable economic development. Financial sector reforms have thus been the focus of many ADB operations in recent years.

Two important initiatives are legal frameworks for insolvency and secured transactions law. As noted by the G-22 Working Group's Report on International Financial Crises (October 1998), the Asian financial crisis highlighted "the critical importance of strong insolvency and debtor-creditor regimes to crisis prevention, crisis mitigation and crisis resolution. Effective national insolvency regimes contribute to crisis prevention by providing the predictable legal framework needed to address the financial difficulties of troubled firms before the accumulated financial difficulties of the corporate sector spill over into an economy-wide payments crisis." Thus, in 1998 the Office of the General Counsel initiated two regional technical assistance projects to study legal and regulatory regimes for insolvency and secured lending, and to provide forums on issues and good practices in these areas for regional policymakers, lawyers, bankers, and experts. The insolvency law regional technical assistance project includes two seminars and two reports. The first report was published in the 1999 edition of this publication. The final report on *Insolvency Law Reforms in the Asia and Pacific Region* is presented in this edition. This report presents an assessment of the insolvency law regimes of ten Asian economies. As the Asian region continues to strengthen its insolvency laws, the findings of this technical assistance and the good practices presented therein will hopefully provide useful benchmarks and recommendations for reform. The good practices indicated in the study must, of course, be adapted to each country's unique circumstances, institutional set up and capacity. Underlying each good practice is a set of practical issues, and there may be more than one way to address each issue.

This publication also includes the report on *The Need for an Integrated Approach to Secured Transaction and Insolvency Law Reforms*. This report derives from a unique seminar session that explored the interrelationships between the legal regimes for secured transactions and insolvency law. The outcome was a delineation of the potentially supporting but also conflicting issues underlying both legal regimes, and the importance of an integrated approach to reforming both of these areas of law. This report will be particularly useful for policymakers in developing member countries seeking to create greater harmony between these potentially conflicting areas of law.

A companion volume of the 2000 Edition of *Law and Policy Reform at the ADB* will provide a report on secured transactions law reform. It discusses how such reform can significantly improve widespread access to credit for borrowers through use of movables like equipment, livestock and inventories as well as receivables. In addition to the intrinsic value of such law reform for the credit markets, it also complements effective insolvency regimes by providing a debt collection framework for enterprises prior to insolvency, thereby reducing the magnitude of insolvency debt. Finally, an effective secured transactions law regime also promotes good corporate governance that may prevent insolvency.

We are pleased with the progress achieved to date with these projects and their continuing contribution to improving and enhancing the legal systems of ADB's developing member countries. We are committed to pursuing such law and policy reform initiatives that are welcomed by such developing member countries and to working with them in this critically important work.

Gerald A. Sumida
General Counsel

An Overview of ADB's Law and Policy Reform Activities in 1999

AN OVERVIEW OF ADB'S LAW AND POLICY REFORM ACTIVITIES IN 1999

1. ADB continued to pursue its law and policy reform program in 1999, with the overarching goal of poverty reduction in its DMCs, by promoting sustainable economic growth and good governance through the establishment and capacity building of their legal and regulatory systems. Over the years, ADB has provided substantial assistance through loan and technical assistance projects with significant law and policy reform (LPR) components. Consistent with ADB's policy to mainstream governance, LPR is an important crosscutting issue addressed in most ADB operations. The LPR component may vary, depending on the nature of the project, from simple legislative drafting to addressing major institutional issues such as lack of capacity to enforce laws. Stand-alone legal technical assistance is becoming a significant part of ADB's LPR activities. In 1999, ADB focused on LPR for private sector development, particularly for finance, banking, and governance; judicial reform; legal training; dissemination of legal information; and environmental protection. With adoption of ADB's LPR on Poverty Reduction in 1999, technical assistance projects designed to explore linkages between poverty, empowerment and the legal system have also been initiated.

Supporting ADB's Overarching Goal of Poverty Reduction

2. To support ADB's overarching goal of poverty reduction, work began in 1999 on preparation of the project Poverty and the Law: Strengthening Access to Justice. The primary objective of the project is to compile a knowledge base on laws and institutions and practices affecting access of poor people in six DMCs to administrative, economic and judicial decision-making affecting their rights; assess the legal and judicial institutional constraints to participation by the poor in economic and social activities; identify the need for reform in the law and policy-making institutions in these DMCs; and identify strategic points for reforms to promote social inclusion, including access to justice. The ultimate goal of this project is to promote poverty reduction by developing policy-oriented strategies and actions to protect and promote the welfare of the poor in the DMCs concerned.

3. Pursuant to the regional technical assistance, Sociolegal Status of Women in Selected Developing Member Countries, country reports have been prepared for Indonesia, Malaysia, Philippines, and Thailand. The studies recommend promoting women's legal equality through legal reforms that may be supported through ADB projects on education, labor, health, financial reform, and infrastructure, and providing regional and national support for legal awareness and training programs to sensitize policymakers, lawyers, members of the judiciary, law enforcement personnel, and members of the community at large on the legal status of women.

4. To further study the linkages between legal literacy, governance and poverty, ADB approved a regional technical assistance on Legal Literacy for Governance.¹ Under this regional technical assistance, legal literacy techniques used in Bangladesh, Indonesia, Mongolia, Pakistan, Philippines, Thailand and Vietnam will be surveyed to seek insights into those techniques which have proved particularly useful for promoting governance and reducing poverty through empowerment of the poor and women. Successful practices will be identified for delivering legal literacy at grassroots level and to administrators of law. Such practices will be pilot-tested under ongoing ADB loan projects, where beneficiary participation based on a sound understanding of legal rights and related enforcement mechanisms, is critical to the success of such projects. The regional technical assistance will, therefore, promote access to justice which in turn should enhance participatory processes, accountability and good governance.

Promoting Good Governance

5. Governance issues have also been addressed in government agencies and the social sectors. In Indonesia alone, three program loans were provided in 1999 with substantial law and policy reform components aimed at promoting good governance through decentralization. The community and local

¹ RETA 5856: Legal Literacy for Supporting Governance.

government support sector development program² involved drafting and enacting laws for devolving of administrative authority and fiscal authority to, and rationalizing revenue sharing between different government levels. The health and nutrition sector development program³ will prepare an integrated proposal to update and rationalize the legal and regulatory frameworks for decentralized health care financing, delivery, and management. The power sector restructuring program⁴ provides for the promulgation of a new electricity law, allowing for the establishment of an independent regulatory body for market oversight. Under the Financial Sector Governance Program⁵ in 1998, ADB assisted Indonesia in drafting a new anticorruption law. To further assist Indonesia to establish an independent anticorruption commission, a further technical assistance was also approved in 1999.⁶ An important component of this technical assistance will be vigorous public dissemination and consultations on the purposes of the commission and related anticorruption legislation. The technical assistance will provide contextualized good international and regional practices in establishment and successful operation of an independent anticorruption commission. In Mongolia, the governance reform program loan focuses on strengthening public administration and public expenditure management.⁷

Tackling Systemic Issues in Legal and Judicial Reform

6. In 1999, work under the previously approved technical assistance to Pakistan on legal and judicial reform⁸ was completed for preparing ADB's first stand-alone loan to a DMC for judicial and legal reform (see *Box 1*). The study is the first comprehensive survey of the systemic issues confronting the legal and judicial sector in Pakistan. Under the project, budgetary allocations for the judicial system were studied and an initial survey of litigants and would-be litigants was carried out to determine who uses/or does not use the courts, and why. Extensive stakeholder consultations were also carried out.

Box 1: Legal and Judicial Reform in Supporting Governance in Pakistan

Technical assistance for legal and judicial reform supported a diagnostic study of the legal system in Pakistan, to identify the systemic causes for inefficient legal and judicial institutions, infrastructure, and procedures that are inimical to enterprise and economic development. The broad-based, process-oriented study reflects two interrelated objectives of identifying the most pressing needs for reform in Pakistan's legal and judicial sector and generating momentum for a reform effort. Different legal and judicial stakeholders were involved, including a survey of litigants and would-be litigants to determine who uses the courts, their reception of the courts, and why people use or don't use the courts.

The study identified the most important reforms necessary to return the legal and judicial system to its fundamental purpose: the fair and predictable resolution of disputes. The study made recommendations to address the need for good governance measures, such as a freedom of information act and an administrative grievance mechanism; the internal governance of legal institutions, including establishing a national policy-making body and appointing provincial judicial ombudspersons; changes in incentives and reporting structures that will improve judicial performance and accountability; delay and human resource constraints; and the financing of the judiciary to improve salary structures and judicial facilities. The recommendations represent a deliberate effort to make strategic choices about reform activities and to structure credible institutions. The study will provide the basis for a legal and judicial reform loan to Pakistan, which is slated for consideration in 2001.

7. A major issue confronting many developing countries is delay in adjudication of cases. Chronic delays undermine not only the legitimacy of the legal system but can lead to a crisis of legitimacy of other state institutions. To analyze the causes of these delays, ADB approved a technical assistance on court

² Loan 1677-INO: Community and Local Government Support Program.

³ Loan 1675-INO: Health and Nutrition Sector Development Program.

⁴ Loan 1673-INO: Power Sector Restructuring Program.

⁵ Loan No. 1618-INO: Financial Governance Reforms: Sector Development Program.

⁶ TA 3381-INO: Establishment of an Anticorruption Commission.

⁷ Loan 1713-MON(SF): Governance Reform Program.

⁸ TA 3015-PAK: Legal and Judicial Reform Project.

congestion.⁹ A number of countries where court congestion is a serious issue will be studied together with countries that have introduced vigorous reform programs to tackle this menace, e.g., Singapore.

Legal Information System

8. Access to legal information and justice is a fundamental prerequisite for good governance. In 1999, work continued on development of a legal information system in PRC¹⁰ for electronic laws and their authenticated English translations and regular updating on a sustainable basis. In Tajikistan, ADB is assisting the Law Reform Commission, which has been established in agreement between the Government and ADB.¹¹ A major problem confronting the country is unavailability of timely legal information. Moreover, laws and other legal acts are frequently inconsistent. For that reason, with the assistance of the TA, inconsistencies, repetitions and lacunae in the legislation currently in force will be reviewed and appropriate amendments made. Moreover, a database of laws and legal acts will be established, and all necessary measures will be taken to facilitate publication of a collection of laws in Tajik and Russian languages. Appropriate measures will be taken to ensure that the database and collection of laws will be updated on a regular basis.

9. In 1999, work continued on developing Project DIAL – Development of the Internet for Asian Law – which promotes the use of the Internet to assist those involved in developing and drafting legislation in DMCs. Project DIAL will make available the full texts of legislation, regulations, and related law reform reports to legislative drafters and law reform personnel in DMCs through establishment of DIAL “research stations” in selected DMCs and training of DMC officials and law reform personnel. “DIALogue” will be a feature of the system through which users from DMCs may access expert panelists from different countries to discuss particular law-related topics. Further information about DIAL can be obtained from the DIAL home page at <http://www.austlii.edu.au/dial/>.

Promoting Private Sector Development

10. In the aftermath of the Asian financial crisis, attention was focused on issues of governance in the financial sector. ADB provided assistance for financial sector reform through loans and technical assistance to its DMCs, including PRC,¹² Indonesia,¹³ Lao People's Democratic Republic (Lao PDR),¹⁴ Thailand,¹⁵ and Viet Nam.¹⁶ These have included assistance for preparing securities laws; creating collateral security registration systems, including assistance for preparing secured transaction legislation; and amending insolvency laws, accounting laws, and capital market supervision regulations. An adjunct theme of ADB's assistance in financial sector reform has been the efficient mobilization and use of resources.

11. In response to a request from the PRC, ADB approved a major technical assistance for providing assistance in drafting several key economic laws for adoption in 1999-2001 (see Box 2).

⁹ RETA 5855: Surveys on Court Congestion and Access to Justice.

¹⁰ TA 3000-PRC: Strengthening of the Legal Information System.

¹¹ TA 3238-TAJ: Dissemination of Laws and the Strengthening of the Legal Information System.

¹² TA 3253-PRC: Strengthening Public Infrastructure Investment Policy and TA 3304-PRC: Capacity Building of the Capital Markets Regulatory System.

¹³ TA 3178-INO: Capacity Building for Setting Up District-Level Financial & Budgetary Systems.

¹⁴ TA 3154-LAO: Development and Application of the Secured Transactions Law and Bankruptcy Law.

¹⁵ Loan 1600-THA: Financial Market Reform Program Loan; TA 3355-THA: Restructuring of Specialized Financial Institutions.

¹⁶ Loans 1733(SF)/1734-VIE: State-Owned Enterprise Reform and Corporate Governance Program; TA 3353-VIE: Corporatization and Corporate Governance; and TA 3354-VIE: Reform SOE Audit.

Box 2: Developing a Market Economy: Economic Law Reform in the People's Republic of China

The transformation of the People's Republic of China (PRC) from a centrally planned to a market economy involves a fundamental change in the system of governance. In March 1999, the PRC Constitution was amended to incorporate the rule of law as a guiding principle for governance of the country. In support of the Government's economic reform policy, one of the objectives of the PRC's legislative program is to provide assistance for establishment of a legal and regulatory framework appropriate for a market economy. To support this, ADB approved a technical assistance to the PRC for preparing seven key economic laws and regulations that have been given priority for adoption in 1999–2001. ADB will assist the PRC in (i) amending the Company Law, (ii) enacting a new bankruptcy law, (iii) completing a trust law, (iv) providing for laws on closure and restructuring of financial institutions, (v) developing a social security law, (vi) drafting a new law on registration of commercial and industrial organizations, and (vii) developing an administrative licensing law.

This law reform program will result in a legal and regulatory framework conducive to economic reform, effective administration of corporations, improvement of corporate governance, and creation of conditions of fair competition for different types of enterprises. The new bankruptcy law and law on closure and restructuring of financial institutions will be essential to ensure the efficient and productive use of resources. The trust law will enable the emergence of new vehicles for financial investment and asset management in the form of pension funds, mutual funds, housing assistance funds, and financial asset management companies. The new social security law – covering unemployment benefits, accidental injury and death, and pensions – is an essential part of the PRC's transformation from a centrally planned to a market economy. Implementation of technical assistance will put in place a legal and regulatory framework that will reduce the risk of a financial crisis.

12. In 1999, ADB approved a financial intermediation and resource mobilization program loan to the Kyrgyz Republic, to assist in the transition of its financial sector from a command economy to an increasingly market-driven one. ADB's program loan addresses the inherent structural weaknesses of the financial sector and its overwhelming dependence on the state banking sector. Legal and regulatory reforms will be put in place to ensure transparency and disclosure norms for listed companies and the securities market, thereby instituting sound governance practices in the corporate sector. The regulatory framework for the insurance sector will also be strengthened and a new public debt law prepared. Resource mobilization is being supported through assistance to Bhutan,¹⁷ PRC,¹⁸ and Uzbekistan¹⁹ for reviewing legal frameworks relating to pension fund schemes and insurance; to PRC,²⁰ Indonesia,²¹ and Viet Nam²² for secured lending; and to Uzbekistan²³ and Vanuatu²⁴ for establishing the regulatory frameworks for rural savings mobilization and for establishing savings and credit unions.

13. Pursuant to another ADB technical assistance, Viet Nam has enacted the Decree on Secured Transactions, which enables the granting of security interests on both present and future assets to secure

¹⁷ TA 3111-BHU: Upgrading the Royal Insurance Corporation of Bhutan, Restructuring of Government Employee Provident Fund and Introducing a Pension Scheme and TA 3212-BHU: Strengthening of the Banking Supervision Function of the Royal Monetary Authority of Bhutan.

¹⁸ TA 3148-PRC: Pension Reform; and TA 3302-PRC: Capacity Building of the Insurance Sector Regulatory System.

¹⁹ Loan 1504-UZB: Rural Enterprise Development; TA 3045-UZB: Developing Commercial Banking Skills; and TA 3134-UZB: Pension Reform.

²⁰ TA 3303-PRC: Institutional Strengthening of the Cinda Asset Management Company.

²¹ TA 3228-INO: Development of a Deposit Insurance Scheme.

²² TA 3227-VIE: Strengthening Corporate Governance at Viet Nam Bank for Agriculture and Rural Development.

²³ TA 3254-UZB: Rural Savings and Credit Union Development; and TA 3352-UZB: Institutional Strengthening of the Banking Sector.

²⁴ TA 3206-VAN: Rural Financial Services.

the performance of any civil, economic, or commercial obligation.²⁵ A decree on the registration of security will soon accompany this decree, providing a measure of certainty in secured transactions.

14. Broader issues in the legal and regulatory frameworks – relating to capital market institutions in the context of financial sector reform, financial market development, and financial management strategies – are being addressed in Papua New Guinea²⁶ and Viet Nam.²⁷

15. ADB has facilitated a regional discussion on issues of insolvency and secured transactions in Asia and the Pacific through two regional technical assistance projects (see Box 3).²⁸ The report on insolvency is presented in this publication, together with the report on the intersection between insolvency and secured transactions law.

Box 3: Secured Transactions and Insolvency: A Framework for Efficient Resource Use

In 1999, ADB held a two-part symposium on Secured Transactions Law Reform and Insolvency Law Reform under two technical assistance grants approved in 1998. More than 150 senior judicial officers; government policymakers; central bank and private sector representatives; participants from World Bank, International Monetary Fund, and United Nations Commission on International Trade Law; and others attended the symposium.

During the Secured Transactions Law Reform Symposium, participants discussed the key role of movables as collateral in a market economy. Secured lending based on such movable collateral was identified as a vital component of debt financing. Debt financing was recognized as a crucial engine for economic growth and recovery in Asia after the financial crisis. The rights of small and medium-sized borrowers were especially adversely affected by the lack of a comprehensive legal framework creating secured interest in all movables. Inadequate priority and publicity of the interest of secured lenders and inefficient enforcement security interest in movable collateral resulted in less access to credit and reduced channels of credit.

The Asian financial crisis has illuminated the lack of frameworks in many DMCs for the systematic restructuring of debt and the efficient liquidation of businesses incapable of being restructured. As a first step to facilitate developing sound legal frameworks to address these problems, ADB carried out studies of the insolvency regimes in 11 Asian economies. The studies have been published on www.insolvencyasia.com. At the Insolvency Law Reform Symposium, participants discussed the studies, reviewed common problems in insolvency law reform, and explored regional and international best practice, especially the impact on credit market.

The participants also evaluated the points of intersection between integrating the legal regimes for bankruptcy and the economic issues of secured transactions.

Developing Human Resources for the Legal System

16. ADB recognizes that human resource development is fundamental to the successful implementation of law and policy reform. Therefore, a major focus of ADB's legal technical assistance is on strengthening legal capacity in its DMCs. In 1999, ADB paid particular attention to the training needs of its smaller DMCs. A major technical assistance was approved for strengthening legal education and judicial training in the Maldives. Under this project, establishment of a college of law will be supported and twinning arrangements with overseas institutions will be explored. Curricula and textbooks on law of Maldives will also be developed under this project. Another component of this project will focus on judicial

²⁵ TA 2823-VIE: Registration System for Secured Transactions.

²⁶ TA 3240-PNG: Financial Management Strategic Framework and TA 3280-PNG: The Governance and Public Sector Reform Program.

²⁷ TA 3353-VIE: Corporatization and Corporate Governance.

²⁸ RETA 5773: Secured Transactions Law Reform and RETA 5795: Insolvency Law Reform.

training, particularly for island magistrates who have no formal legal education. To assist the Maldives judiciary to cope with increasingly complex commercial issues, a few of the judges from Malé will receive long-term overseas training. In response to a request from the South Pacific Judicial Conference, ADB has also joined hands in the past years with four other donors to provide technical assistance for establishing an ongoing comprehensive process of education, training and professional development for judicial services personnel in developing island nations, including all 12 Pacific DMCs.²⁹ The project will be based at the Institute of Justice and Applied Legal Studies attached to the University of South Pacific's Suva campus. Its focus will be on magistrates, including lay magistrates, together with judges, registrars, and other court staff.

17. To respond to the rapid developments in Bangladesh energy sector, a technical assistance was approved for training lawyers of energy sector executing agencies in Bangladesh to enhance their understanding of applying new regulations.³⁰ A technical assistance was also approved for strengthening the institutional and professional capacity within the State Law Office of Vanuatu.³¹ Under an ongoing technical assistance in Viet Nam,³² 1999 saw 500 lawyers upgrading their knowledge of recent commercial legislation and market economy law principles, and their practical legal skills. The reaction to the participatory training techniques and case study method has been so enthusiastic that these teaching methods are being adopted at the Hanoi Law University. Similarly under the ongoing technical assistance for legal training in Mongolia, the eight Mongolians, who were selected to teach at the Legal Retraining Center financed by ADB, returned to Mongolia at the end of 1999 after completing their seven-month intensive training-of-trainers' program at the Law Faculty of the University of Melbourne. The Legal Retraining Center opened for classes in February 2000, and it is expected that about 200 Mongolian legal professionals from the government, judiciary, prosecutors' office, academia, and private practice will receive training in commercial law and lawyering skills (e.g., legal drafting, negotiation and research) at the Center each year.

18. Delivery of efficient and timely legal services to governments is a major issue in many DMCs. Organization and resourcing of government legal services is often a low priority. Yet the costs associated with inefficient government legal services can be significant. To survey the present set up for the management and delivery of government legal services, analyze the underlying issues and identify the direction of future reform, ADB in 1999 approved a regional technical assistance covering six DMCs.³³ The project will undertake an analysis of incentive systems and alternative organizational set ups, including increased competition in delivery of such services through outsourcing to the private sector.

19. Private sector infrastructure development continues to be a regional priority. Earlier, ADB provided training in legal aspects of private sector infrastructure development to government officials in India, Indonesia and PRC. To respond to the demand for such needs, ADB also approved in 1999 a regional technical assistance for training government officials in legal issues arising in private sector infrastructure development in Bangladesh, PRC, and Viet Nam. Under this project, training workshops will be held in these countries with participation of local institutions that can continue this training on a sustainable basis. A seminar to consider legal issues in private sector infrastructure development, particularly in the context of the recent financial crisis, will also be held in Manila. The seminar will bring together policymakers, private sector investors and legal practitioners.

Supporting Legal Frameworks for Environment

20. ADB's law and policy reform program has played a significant role in enhancing the goal of projects for improving the environment; two ongoing projects are in the PRC³⁴ and India.³⁵ Moreover,

²⁹ RETA 5895: Pacific Judicial Training (Phase 1).

³⁰ TA 3343-BAN: Corporatization of the Ashuganj Power Station.

³¹ TA 3197-VAN: Strengthening the State Law Office.

³² TA 3388-VIE: Preparation of Action and Investment Plans for the Central Region Development Strategy of Viet Nam.

³³ RETA 5876: Organization and Management of Government Legal Services.

³⁴ Loan 1715-PRC: Shanxi Environment Improvement.

³⁵ Loans 1719/1720/1721-IND: Urban and Environmental Infrastructure Facility.

many of ADB's natural resource – and infrastructure – related projects have environmental protection components supported through reforming environment-related laws and establishing appropriate regulatory frameworks. Many technical assistance projects were approved in 1999 that directly addressed environment and natural resource conservation and management issues. In the PRC's Shanxi Province, for example, ADB is supporting a legal framework for introducing market-based instruments for controlling air pollution.³⁶ A series of technical assistance projects is addressing issues relating to the legal and regulatory frameworks and procedures for enforcing river basin management, managing wastewater and controlling pollution, recovering costs in the water resources sector, and reviewing the environmental protection legislation at national and local levels in Bangladesh, PRC, Fiji Islands, India, Indonesia, and several other DMCs. The Office of the General Counsel also supported a study of environmental principles and concepts reflecting international law and public policy (see Boxes 4 and 5).

Box 4: Provincial Legislation for Environment and Natural Resources

One of the most pressing areas for policy reform in the People's Republic of China (PRC) is land and administration. The improper pricing of landed natural resources in particular has contributed to extensive soil erosion, deforestation (accompanied by silting of rivers) and most importantly, high rates of conversion of farmland to industrial and residential uses. The destruction of PRC's farmland has already resulted in the loss of farm income for many poor farmers living in periurban areas. In the long term, this land use conversion could threaten the entire country's food security. As a result, the PRC has adopted a policy of no net loss of farmland for the foreseeable future.

In a previous technical assistance project, a team of environmental law specialists from the University of Peking Law School and New York University School of Law worked with the Environmental and Natural Resources Protection Conservation Committee (EPNRCC) of the National People's Congress to draft a national land administration law that contains important and innovative mechanisms to price more appropriately farmland upon conversion and to compensate farmers whose land is taken for development purposes. Provinces, however, have considerable autonomy in the PRC and national laws usually need to be supplemented by provincial implementing legislation.

In this technical assistance project, a team of law specialists from the two universities worked with the EPNRCC of the Sichuan People's Provincial Congress to draft and implement a provincial land administration law to implement the National Land Administration Law. In December 1999, the Sichuan People's Congress adopted the Implementation Measures of Sichuan Province on the Land Administration Law of the PRC, which adopts the most important farmland protection mechanisms of the national Land Administration Law. Representatives of all of the provinces of the PRC will receive training based on the achievements of the Sichuan People's Congress.

³⁶ TA 3290-PRC: Capacity Building in Ministerial Status Responsibilities in the State Environmental Protection Administration.

Box 5: Examining International Environmental Law and Its Relation to Poverty Reduction

A forthcoming ADB publication spells out comprehensively, and in operationally useful terms, practices and criteria that reflect new prescriptive expectations about sustainable development and relevant general international standards that multilateral development banks are committed to uphold. This publication, entitled *Multilateral Development Banking: Environmental Principles and Concepts Reflecting General International Law and Public Policy*, written by ADB staff consultant Professor Gunther Handl, sets forth in clearly operational terms how an agent for change such as a multilateral development bank should act in conformity with prescriptive expectations about sustainable development. Current legal theories, practices and policies concerning the role of multilateral development banks are analyzed.

Under the heading of "Alleviation of Poverty", for example, the contents, purpose and operational implications are described as follows:

Poverty is generally recognized as one of the leading contributing causes of environmental degradation. For example, the Brundtland Commission speaks of the "vicious cycle of poverty leading to environmental degradation, which leads in turn to even greater poverty". In Agenda 21 the international community agrees that [a] specific anti-poverty strategy is therefore one of the basic conditions for ensuring sustainable development. An effective strategy for tackling the problems of poverty, development and environment simultaneously should begin by focusing on resources, production and people and should cover demographic issues, enhanced health care and education, the rights of women, the role of youth and of indigenous people and local communities and a democratic participation process in association with improved governance.

The "established public policy requirement" for the alleviation of poverty is summarized as follows:

Ever since the Stockholm Conference on the Human Environment and, more specifically, publication of the Brundtland Commission report, alleviation of poverty has been endorsed by the international community as a basic condition of sustainable development in developing countries. Virtually all preparatory meetings for the United Nations Conference on Environment and Development (UNCED), the international legal instruments adopted at the Rio Conference themselves, and most post-UNCED multilateral conventions and conference declarations reflect the fact that poverty reduction in developing countries has become a core objective of international public policy. By the same token, the various references to poverty reduction (or, indeed, eradication) suggest more of a programmatic concern with the issue rather than an assumption by states of a specific international legal commitment to tackle poverty in developing countries as an essential step in breaking the vicious circle involving poverty, underdevelopment and environmental degradation. At the same time, however, there is no denying that alleviation of poverty is intrinsically connected to the enjoyment of basic human rights, thereby reinforcing the importance of poverty reduction as a fundamental tenet of international public policy.

This summary of the status of the considerations surrounding "Alleviation of Poverty" is followed by references to recent legal sources, including Article 4 of the Desertification Convention, Article 20 of the Biodiversity Convention, Article 4 of the Climate Change Convention, plus policy statements such as paragraph 22 of the Hanoi Declaration of 1998, paragraph 27 of the UN General Assembly's Programme for the Further Implementation of Agenda 21, and paragraph 14 of the Vienna Declaration and Programme of Action.

Law and Policy Reform in 2000

21. Consistent with its overarching goal of poverty reduction, ADB's LPR activities in 2000 will focus on linkages between good governance (including efficient legal systems) and poverty reduction. A regional technical assistance on Poverty and the Law will be approved and consultants fielded. In addition, ADB will explore partnerships with other organizations that are active in sectors that directly impact reduction to strengthen legal and regulatory frameworks for supporting pro-poor interventions.

Insolvency Law Reforms in the Asian and Pacific Region

INSOLVENCY LAW REFORMS IN THE ASIAN AND PACIFIC REGION

REPORT OF THE OFFICE OF THE GENERAL COUNSEL ON TA 5795-REG: INSOLVENCY LAW REFORMS*

I. INTRODUCTION

1. Since October 1998 the Asian Development Bank (ADB) has been extensively involved in insolvency and related law and policy reform in the Asian region. In the 1999 edition of this publication, the Office of the General Counsel presented interim findings of the Regional Technical Assistance for Insolvency Law Reform (TA No. 5795-REG) (hereinafter "RETA") subsequent to a Symposium held at the Bank's headquarters from 25-26 January 1999 (hereinafter "January Symposium"). The following is the final report on the RETA in relation to the corporate insolvency laws and practices of eleven Asian economies¹ subsequent to a second Symposium held at the ADB's headquarters from 25-26 October 1999 (hereinafter "October Symposium").

2. Also, and very importantly, work carried out under this RETA and a complementary regional technical assistance (TA No. 5773-REG: Secured Transactions Law Reforms), and featured elsewhere in this publication² highlights the important relationship between secured transactions and insolvency laws. In particular, it presents the work of the ADB to foster an understanding of the need for an integrated approach to law reform in these areas. It also includes a report on the discussions of a joint session at the October Symposium between participants under this RETA and participants of a Symposium on Secured Transactions Law Reforms.³

A. The Global and Regional Economic Backdrop

3. Insolvency law rarely attracts much more than a fleeting interest and ranks low on any government's reform agenda. The commercial community, though sometimes aroused, is also largely disinterested in the subject. Legal and other scholars rarely concern themselves with insolvency law issues. It is thus quite remarkable that, during the last decade of the last century, corporate insolvency laws and related practices should have assumed an unparalleled national, regional and global importance.

4. Three, largely unrelated, economic causes or factors contributed to this unique prominence. The first in time was the economic recession that affected many of the more developed economies early in that last decade. Following the economic boom of the mid 1980's, stock and property values declined sharply. As many corporations had borrowed extensively during the boom years, the crash resulted in widespread corporate collapse. This produced in many of the economies affected by the recession intensive endeavors at a national level to develop or further develop corporate rescue and associated informal insolvency techniques. It also led to the most concerted endeavors yet undertaken to provide regional and global foundations to take account of cases of cross-border corporate insolvency.

* Prepared by Mr. Ronald Winston Harmer for the Office of the General Counsel.

¹ The economies covered by the RETA include Korea, Japan, Taipei, China, Hong Kong, China, Singapore, Malaysia, Thailand, India, Pakistan, and the Philippines (collectively, the "RETA economies").

² See *The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms*, *infra*, at 87.

³ Carried out under TA No. 5773-REG: Secured Transactions Law Reforms.

5. The second cause was the collapse of command economy practices and associated political ideologies in a large part of the world and the consequent process of economic transformation throughout the decade toward market based economic practices. In the economies affected by that economic change the need was for the establishment of insolvency law regimes to take account of insolvent state-owned enterprises. Previously there had been no such regimes because there was no need.

6. The third was the regional economic crisis that affected many economies in the Asian region in the last years of the decade. This exposed, amongst many other things, the inadequacy of corporate insolvency law regimes or their application in many of those economies. It resulted in widespread endeavors to improve the quality of the insolvency laws and their application. These economic and historical events have made an indelible and revolutionary mark on national, regional and global insolvency law development.

7. The insolvency law developments were driven, in part, by an appreciation that insolvency and related laws were vital to economic development and stability. At a local or national level, this appreciation resulted in many countries developing or substantially reforming their respective insolvency law regimes. That, in turn, has impressed upon governments the importance and need to maintain insolvency law regimes under constant review, in contrast to long gaps in time between sporadic, haphazard and, at times, impulsive reform. In addition, the banking and financial sector commenced the development of informal corporate insolvency techniques to overcome defects in, supplement, or provide an alternative to formal insolvency law regimes.

8. At a regional level, countries in trading blocks (such as the economies of the European Union and the economies of the North American Free Trade Area) have advanced the need for regional co-operation and assistance in the development and application of insolvency laws. At a global level, the convergence of these events and the realization that trade and commercial development is at the heart of economic development has led to endeavors by the major multi-lateral agencies to develop universal principles of insolvency law regimes. In addition, considerations of multinational trade and commerce have afforded a real prospect of international co-operation and assistance in cases of cross-border insolvency. For example, the United Nations Center for International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency [published in UNCITRAL Yearbook, vol. XXVIII, 1997] may soon be adopted and applied by a number of countries.

B. Recent Insolvency Law Developments in the Asian Region

9. Before the onset of the Asian financial crisis insolvency laws of many Asian economies were, generally speaking, out of date and irrelevant to modern commercial needs. In many cases the insolvency laws had been imported from overseas jurisdictions at the turn of the last century, and had never been reviewed. Available statistics indicate that in many of the economies there had been no cases of corporate bankruptcy at all. In some of the economies there were no experienced judges, administrators or professionals to administer the insolvency laws. Related laws and practices, such as those relating to debt recovery and security enforcement, were similarly defective. The area of secured transactions was quite undeveloped in many of the economies.

10. Despite that most of this was (or should have been) reasonably apparent, the buoyant economic conditions that many of the economies enjoyed during the first half of the last decade placed the prospect of insolvency and related law reform out of consideration. In the economic circumstances that then prevailed there was little opportunity of engaging many of the economies in discussions concerning the need to review, reform and modernize those laws and the institutional capacity to apply them.

11. The onset of the financial crisis changed all that, and produced an environment in which insolvency and related law reform became an important part of governments' reform agendas. The lack of frameworks for the systematic restructuring of insolvent or financially distressed corporations or the liquidation of businesses incapable of being restructured posed impediments throughout the region to

economic recovery, complicated the rehabilitation of financial sector institutions, inhibited the growth of domestic markets and stifled foreign investment. 'Framework' in this context extended to outmoded insolvency laws, inadequate court systems and weak enforcement and administration of both laws and procedures. These problems, although presciently evident, were largely ignored or circumvented in the 'boom' economy that preceded the advent of the crisis. A study on insolvency law reform in the region was, therefore, timely, particularly if investor confidence in the RETA economies was to be restored.

12. Law and practices relating to debt funding, debt recovery, secured transactions and formal insolvency processes were subjected to critical scrutiny and review. For example, new corporate reorganization chapters of the insolvency laws of Indonesia and Thailand were enacted, and proposals for corporate insolvency law reform in Hong Kong, China were advanced. Six of the RETA economies commenced the promotion of informal corporate work-out processes. Thus, when this technical assistance commenced in October 1998, a process of law and commercial reform was under way in many of the economies that were most effected by the crisis.

13. Since the commencement of the technical assistance further progress has been made. In Thailand some adjustments have been made to the already reformed insolvency law and a new court with exclusive jurisdiction in bankruptcy was established. In Indonesia a new commercial court with bankruptcy jurisdiction has been established. A further major reform of the insolvency law has been proposed. In the Philippines a detailed set of new rules to guide formal corporate insolvency reorganization procedures has recently been announced.

14. Korea has commenced a total review and reform of its insolvency law system. Japan is actively pursuing reforms to its corporate insolvency laws, and India has established a committee to redraft its corporate insolvency laws. In Pakistan a set of rules to enable the 'sick' company provisions of the corporate insolvency law to operate has recently been proclaimed. In Hong Kong, China the corporate insolvency reform proposals are nearing legislative action. In Thailand a new secured transactions law has been drafted. In Indonesia, Thailand, Malaysia, and Korea, the informal work-out processes have commenced to operate, in some cases with considerable success.

15. In some of the RETA economies attention has been given to corporate governance and related issues. Endeavors are being made to improve corporate accounting and reporting standards. And, in RETA economies that were hardest hit by the financial crisis, the banking and financial sectors have been the subject of extensive investigation, rearrangement and reform.

16. However, there still remains much to be done. A number of the insolvency laws are still out of date and irrelevant to economic and commercial needs. Some of the recent reforms require further review. In some of the RETA economies the institutional capacity, particularly of the courts and government agencies, to apply the insolvency laws requires considerable expansion and improvement.

17. In a number of the RETA economies the inefficiency of related processes, such as debt recovery and security enforcement laws and processes, creates a commercial imbalance in debtor-creditor law. It often has the unintended result of a 'debtor friendly' system and places unwanted and unnecessary pressure on insolvency laws to somehow create a balance. It can also have adverse economic effects by, for example, affecting the availability and the cost of corporate finance.

18. There is also a significant need to encourage the development of and compliance with proper standards of corporate governance and corporate management. Serious deficiencies in these areas undermine the effect of even the most advanced forms of corporate insolvency law regimes.

19. The region as a whole also requires endeavors to promote regional and country specific co-operation in cases of cross-border insolvency. Finally, knowledge and experience to deal with corporate reorganization, in both formal and informal processes, is required at a number of levels. This requires continued and long-term education and training programs.

C. The RETA Design

(i) Purposes and Goals

20. The aim of the RETA was to focus on structures and processes available for the rehabilitation and restructuring of insolvent corporations and the liquidation (or bankruptcy) of corporations that are incapable of rehabilitation. It was to bring together government officials responsible for insolvency law reform and insolvency administration, judges, bankers, insolvency practitioners from both the legal and accounting professions and academic experts to consider the state of insolvency law regimes in the region and the responses of governments.

21. However, the purpose of the RETA was not solely to address the immediate effects and consequences of the economic crisis or to propose immediate and rushed solutions to the many problems presented by it. The RETA was designed with the much broader and longer term aim of encouraging the greater development of legal and commercial systems, practices and institutions relative to insolvency law, for application in all circumstances. The broad aims of the RETA were to:

- i. Study the relationship between corporate debt and the insolvency or financial difficulty of corporate debtors in the region;
- ii. Make recommendations that are suitable for the region to effectively deal with a problem of corporate insolvency and recovery of debt; and
- iii. Make available through the Internet (www.insolvencyasia.com), the insolvency and other related legislation of the RETA economies and the studies and reports produced as a result of the project.

(ii) Areas of Inquiry

22. An insolvency law is but part of an overall system of law and the economic, commercial and social environment in which that system functions. It relies for its effectiveness on the institutional infrastructure that is necessary to support the system of law. Further, the study of insolvency law cannot be addressed in isolation as an insolvency law will normally both influence and be influenced by a large number of economic, legal, commercial, social and cultural considerations (see **Appendix 1** for insolvency law influences). The RETA was thus designed accordingly.

23. The discovery process commenced by inquiring into and addressing background areas. These areas included the following:

- **Corporate Sector:** An examination of the private corporate sector, including issues such as the incorporation of companies, accounts and accounting standards, directors and corporate governance, family control of corporations, equity holdings and other influences of banks in corporations, conglomerates of corporations, and political and government association with corporations.
- **Banking and Financial Sector:** An examination of the banking sector, including controls on banks, association with borrower corporations, lending and loan administration practices and control of systemic banking sector financial difficulties.
- **Social, Cultural and Other Influences:** An examination of the influences relevant to commercial culture and attitudes, in particular attitudes toward formal legal processes, the utilization of court and other systems for dispute and other resolution, the use of informal processes and the availability of skilled professionals for advisory and other work.

- **Corruption, Bribery and Fraud:** An examination of corruption, bribery and fraud, and the influences it may have generally on commercial practices and, in particular, on the operation of the legal system, including the operation of the courts and the insolvency laws.
- **Legal System and Institutions:** An examination of the legal system generally, its origins and the influence of foreign based laws and institutions, attitudes toward and the extent of 'globalization' of legal processes and commercial practices.
- **Secured Transactions and Enforcement:** An examination of property laws, including ownership and registration systems, the creation of security interests in property, issues of registration and priority of secured interests and enforcement of secured property rights.
- **Debt Recovery:** An examination of the extent of credit trading and the recovery and enforcement of unsecured debt.

(iii) Methodology

24. A work guide was prepared by the ADB's international experts for the guidance of the local experts. The sections of inquiry included forms and structures of business organizations; the banking system; forms of financing for business enterprises; secured financing and enforcement; unsecured financing and recovery of debt; commercial and cultural attitudes toward financial difficulty, debt recovery and insolvency; the insolvency law regime and its operation; the use of informal insolvency processes; the court system and institutions; and foreign and cross-border aspects of insolvency law.

25. Individual studies for each of the RETA economies were prepared by the local experts (the 'local studies') based on the work guide. The local experts also made available copies of insolvency and other relevant legislation together with copies of guidelines for the operation of informal insolvency techniques. A Comparative Report (hereinafter the "First Comparative Report") was prepared by the international experts. It, together with the local studies, were reviewed and discussed at the January Symposium. A summary of the results of the January Symposium and the work of the RETA to that point in time was prepared and published by the ADB in the 1999 edition of this publication (hereinafter the "1999 Report").

26. The second phase of the RETA concentrated on a more detailed examination of particular issues in five of the RETA economies. These economies comprised Indonesia, Thailand, Malaysia, Philippines and Korea. The second phase was designed to take account of significant insolvency law and related developments in those economies during the relatively short period of nine months since the date of the January Symposium.

27. The methodology for this phase of the RETA was similar to the first phase. The local experts in the five selected RETA economies prepared further local studies. These addressed areas of recent development including numbers and studies of formal and informal corporate insolvency case techniques; corporate management; lending and credit control practices of banks and other financial institutions; secured lending transactions; problems in the application of both formal and informal insolvency processes; the operation of the judicial system in relation to insolvency regimes; the efficiency of informal insolvency practices; public and private case management administration of liquidations and reorganizations; the availability and quality of information and statistics relating to corporate insolvency; and actual or proposed reforms to the insolvency law.

28. Based on the supplementary local studies and field visits to the five selected RETA economies, a second comparative report was prepared which critically analyzed the above areas and proposed recommendations for reform and further development. This comparative report along with the supplementary local studies were reviewed and discussed at the October Symposium. The October Symposium was combined, in part, with the Symposium on Secured Transactions Law Reforms. This presented a unique opportunity for a significant discussion of issues arising from the intersection of corporate debt financing, secured transaction financing and corporate insolvency.

29. The two symposiums were attended by government, quasi-government officials and the judiciary from the selected RETA economies, India, Pakistan, People's Republic of China, and Singapore. The Symposiums were also attended by representatives from academia, the legal and accounting professions, and by representatives from other multilateral and international financial institutions, including the International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), UNCITRAL, World Bank, and the International Law Institute.

30. All of the local studies, comparative reports, the final report, and this publication will be made available on the internet. The URL is www.insolvencyasia.com.

II. THE CORPORATE INSOLVENCY LAW IN THE RETA ECONOMIES

31. This section sets out the main features of a typical corporate insolvency law regime followed by survey of the corporate insolvency law regimes of the RETA economies.

A. Basic Elements of a Formal Corporate Insolvency Law Regime

32. One of the most important aspects of an insolvency process, whether a formal or informal process, is that it is a **collective procedure**. That alone distinguishes it from practically any other procedure known under any system of law or legal tradition (the procedure known as the "class action" might come closest to its collective nature). A collective process of this nature has to endeavor to accommodate all of those who are affected by or have an interest in the insolvent debtor. That, as will be seen, presents particular problems and issues. These are not easy problems to address in any environment.

33. The range of interests that need to be accommodated by an insolvency law include the insolvent debtor; its directors and shareholders; creditors who are secured to various degrees; employees; fiscal creditors; guarantors of the debtor; unsecured creditors. It also includes government, commercial and social institutions and practices of which some account must be taken in prescribing an insolvency law regime and in the practical operation of such a regime. No one person nor group of persons or institutions may assert a claim to be unaffected or uncontrolled by an insolvency law.

34. A corporate insolvency law regime may be expected to provide for two types of process. One is **liquidation** (or "winding-up" or "bankruptcy", as it is sometimes called). The other is **rescue**, a generic term which embraces a number of processes variously titled as "composition", "arrangement", "reconstruction", "rehabilitation" and so forth. Other processes of various descriptions that provide for particular circumstances might also form part of the regime.

(i) Liquidation

35. The remedy of liquidation is a long historical and traditional method of dealing with the insolvency of a corporation. It is used, in effect, to terminate the commercial activities of an insolvent corporation. Liquidation tends to be close to "universal" in its concept, acceptance and application. It normally follows a pattern that includes:

- an application to a court or tribunal either by the corporation itself or by creditor(s);
- an order or judgment that the corporation be liquidated;
- the appointment of an independent person to conduct and administer the liquidation;
- the immediate closure of the business activities of the corporation;

- the termination of the powers of directors and employment of employees;
- the sale of the assets of the corporation;
- the adjudication of claims of creditors;
- distribution of available funds to creditors (under some form of priority); and
- the ultimate dissolution of the corporation.

36. The liquidation process is justified by the application of economic and legal theories. The economic theory maintains that in a competitive market economy an enterprise that is unable to compete has no place in and should be removed from the market place. A principal identifying mark of an uncompetitive enterprise is one that becomes insolvent. The legal theory supplements this by maintaining that such a process can only function effectively if it is regarded as a collective process, from the time of its inception. It follows that an ordered, civilized administration is necessary under which all creditors (of varying ranks and classes) should be bound and treated equally. The combination of these theories has cemented the liquidation process as the necessary basic component of a corporate insolvency law regime.

(ii) Rescue

37. In the context of this report "rescue" means any form of process, by whatever name called, which provides for the continuation (and not the liquidation) of an insolvent corporate debtor. This may take the form of a composition, by which the debtor and the creditors agree to a simple compounding of debts. For example, the creditors agree to receive a percentage of the debts they are owed in full, complete and final satisfaction of those debts. The debts of the corporation are thus reduced or satisfied, it becomes solvent and may continue on.

38. A rescue might also take the form of a complex reorganization under which, for example, the debts of the debtor are restructured (extended length of loan, extended period in which to make payment, deferral of payment of interest, possible change in the identity of lenders and so forth); the possible conversion of some debt to equity together with a reduction (or, even, extinguishment) of existing equity; the sale of some of its non-core assets; and the closure of non-profitable business activities.

39. However, rescue does not imply that the corporation, its creditors and its shareholders are or will be completely restored. Nor does rescue necessarily mean that ownership and management of an insolvent corporation will maintain and preserve their respective positions. In general, however, rescue does imply that under whatever form of plan, scheme or arrangement is agreed, the creditors will eventually receive more than if the corporation was immediately or soon liquidated.

40. Although something approaching a "rescue" process has been part of the insolvency law regimes of many countries for some time, they were generally very conservative in their nature and, as a result, little used. Most have recently been replaced or supplemented by more contemporary and efficient processes.

41. The "rescue" process is not so universal as that of liquidation and thus does not follow such a common pattern or process. However, to the extent that similarities may be detected among the widely differing processes that might be termed "rescue", it may be said that the key or essential elements include:

- the voluntary submission by a corporation to the process (which may or may not involve judicial proceedings and thereafter judicial control or supervision);

- an automatic and mandatory stay or suspension of actions and proceedings against the property of the corporation affecting all creditors for a limited period of time;
- the continuation of the business of the corporation either by the existing management, an independent manager or a combination of both;
- the formulation of a plan which proposes the manner in which creditors, equity holders and the corporation itself (including its business and assets) will be treated;
- the consideration of and voting on acceptance of the plan by creditors;
- possibly, the judicial sanction of an accepted plan; and
- the implementation of the plan.

42. However, within that similarity of framework there are many variations and divergences. The rescue concept, like winding up, also rests upon a fusion of economic and legal theories for its justification. The economic theory (which is a more contemporary theory than the one that is used to justify the liquidation process) maintains that not all enterprises which fail in a competitive market place should necessarily be liquidated. A corporation with a reasonable prospect of survival (for example, one which has a profitable or potentially profitable business) should be given that opportunity. It can be demonstrated that there is greater value (and, by deduction, greater benefit for creditors in the long term) in keeping the essential business and other component parts of such a corporation together.

43. The legal theory maintains that rescue requires a law which:

- permits quick and easy access to the process;
- provides sufficient protection for all of those involved in the process (which primarily includes the corporation and its property and the various ranks and classes of creditors);
- provides a structure which permits the negotiation of a commercial plan;
- enables 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; and
- provides for judicial or other supervision to ensure that the process is not subject to unfair manipulation or abuse.

44. This legal theory also places considerable emphasis on the concept of the collective nature of the procedure. It is of critical importance to this modern process that the opportunity, whether prompted by possible sanction or encouraged by possible benefit, should be available to a corporation in financial difficulty to commence the process before it is too late. It is also critical to the modern rescue process that attempts by creditors, whether secured or otherwise, to intervene upon the process and pursue their independent individual rights should be restrained, by automatic operation of the legislation, as far as possible.

45. Another essential requirement is that the process must be transparent and be capable of relatively quick resolution. It is not appropriate, in the modern context, for the rescue process to be subject to delay or extensive time periods for the performance of various parts of the process. The creditors of the corporate debtor must be fully informed and involved in the decision process.

(iii) Special Insolvency Laws

46. In a market economy the liquidation and the rescue process should not be the subject of political or government influence or intervention. However, the presence of some exceptional economic, social or other such circumstance might sometimes justify a special process and the involvement or intervention of government. Typical of such a process is one that might sometimes be applied when the banking sector of a country is itself in financial difficulty.

B. Evaluation and Comparison of the Corporate Insolvency Laws of the RETA Economies

47. The insolvency laws of the RETA economies can be conveniently grouped into three main categories. The groupings are largely dictated by historical reasons because, as may be seen, many of the insolvency laws of the economies have been derived from common sources. The three categories are:

- **Category A.** Those economies whose insolvency law regimes have been largely derived from English and common law influences. This group comprises Pakistan, India, Singapore, Malaysia and Hong Kong, China.
- **Category B.** The second group comprises Japan, Taipei, China and Korea. The core bankruptcy laws of these three economies are all similar. They were derived from the same continental European civil law source, as initially adopted in Japan and later applied in the other two economies. A later adoption of a United States reorganization law in Japan appears to have been also used as a model for Korea and, to a lesser extent, Taipei, China.
- **Category C.** The third group completes the remainder of the economies, namely Thailand, Indonesia and the Philippines, where the influences have been from different sources. The Thai bankruptcy law appears to have been influenced by English law models. The Indonesian insolvency law was based on Dutch law. United States models influenced the principal parts of the Philippines insolvency laws.

48. The laws of the economies in each of these three categories are now briefly examined.

(i) Category A: English Law Based RETA Economies

49. In these economies the essential corporate insolvency law is contained in companies or corporate legislation. In most cases it remains in the same basic framework and with the same content as English type companies legislation of some decades ago. Thus, in each of the five economies in this category, there is a liquidation (or winding up process) and a 'scheme of arrangement' process that, very broadly, corresponds to a 'rescue' process. Only one economy, that of Singapore, has enacted a more modern corporate rescue law. In both India and Pakistan a government inspired and controlled rescue process has also been developed.

(a) Pakistan

50. The essential corporate insolvency law is part of the Companies Ordinance, 1984. This is supplemented, in part, by a provincial insolvency law that provides for claims of creditors and for priorities between creditors. The provisions relating to corporate insolvency have never been reformed nor revised since their adoption many decades ago.

51. **Liquidation Process.** The Companies Ordinance provides for the liquidation of an insolvent company (through both debtor and creditor driven mechanisms). This part of the law is reasonably sound, though it could be modernized and improved.

52. **Reorganization Process.** The reorganization part of the Companies Ordinance provides for a form of reorganization known as a 'scheme of arrangement'. This part of the law is outdated, and meets only a few of the good practices standards. Such statistics as are available in Pakistan reveal no recent use whatsoever of the reorganization provisions. Similar scheme of arrangement provisions as can or were once to be found in English, Australian, New Zealand, Hong Kong, China and Singapore legislation have long been regarded as unsuitable for modern commercial needs and either have been discarded and replaced by more contemporary legislation or are in the process of being discarded and replaced.

53. **Special 'Sick' Companies Process.** A section of the Companies Ordinance relates to companies that own 'sick industrial units'. This legislation was inserted as a result of amendments to the Ordinance in 1984. It appears to have been modeled on a new law that was then proposed for enactment in India. The Pakistan legislation enables a company that is declared to be financially 'sick' to submit a plan of rehabilitation for ultimate approval by the government.

54. Despite the fact that this process was legislated for in 1984, it has not been applied because it was not until 1999 that the government framed rules or regulations for its operation (Companies [Rehabilitation of Sick Industrial Units] Rules 1999). These rules provide for the establishment and constitution of a government 'Task Force' and a 'Bankers Committee'. The Bankers Committee may refer a company that is facing financial or operational problems to the Task Force. If, following some inquiry, the Task Force is of the opinion that the company is a sick unit, the Task force is required to refer the company to the Federal Government. The government may then declare the company to be 'sick' and require the Task Force to prepare a plan for the rehabilitation of the company. A plan is then submitted to the government for approval. The Task Force may prescribe its own procedures and may employ experts and advisors from a wide range of disciplines to assist the Task Force in its work and functions.

(b) India

55. **Core Provisions.** The relevant 'core' corporate insolvency law is contained in the Companies Act, 1956. It provides for liquidation and scheme of arrangement processes. The same observations that are made in relation to these processes in Pakistan apply to them.

56. **Special 'Sick' Companies Process.** In 1985 the Indian government enacted legislation regarding the rehabilitation of 'sick' companies. This is contained in the Sick Industrial (Companies Special Provisions) Act, 1985. It provides a model for dealing with systemic problems of corporate financial disability, particularly in relation to state owned or state controlled industries or industries that might be considered of national economic importance. Under this special purpose legislation an administrative Board for Industrial and Financial Reconstruction was established. A sick industrial company (defined as one that has incurred losses in consecutive years and whose asset to liability ratio had fallen below 1.1) is required to report its condition to the board. Alternatively, banks and other financial institutions to which the company is indebted may report such a company to the board. A stay or suspension of actions against the property of the company takes immediate effect. The board may then conduct an inquiry into the financial position of the company to determine whether the company might, in time, recover or benefit from a rehabilitation plan or be liquidated. The board has wide powers to implement any such course of action without requiring the consent or agreement of any creditors of the company. It may also determine that a company should be liquidated and refer the case to the relevant court for adjudication.

(c) Singapore

57. **Liquidation and Scheme of Arrangement.** The relevant Singapore legislation on corporate insolvency is contained in the Companies Act. In its original form it was and, in part, remains similar to that of India and Pakistan. It provides for liquidation and schemes of arrangement processes on which the same observations as have been made in relation to India and Pakistan are also relevant.

58. **Judicial Management.** Singapore has largely abandoned the scheme of arrangement process as its principal corporate reorganization process. This was the result of some substantial reform to the Companies Act in 1987 when a new corporate rescue process, known as 'judicial management', was introduced. This has had some considerable success and is widely regarded as a possible reform model for countries in the region.

59. The judicial management process was introduced to overcome, in part, the failings of the scheme of arrangement process. That process was considered slow, cumbersome, expensive and generally inefficient. It also did not provide for sufficient protection for a company during the time that it might take to determine if it might be restructured. The judicial management process allows a company that is unable to pay its debts to apply for the appointment of a judicial manager. The creditors of such a company may also apply. The court may appoint a judicial manager who then manages and controls the company to the exclusion of the directors. An automatic stay of actions and proceedings against the company operates. The judicial manager is then required to propose a plan for the reorganization of the company. The plan must be approved by a majority of the creditors.

(d) Hong Kong, China

60. **Liquidation and Schemes of Arrangement.** Corporate insolvency law in Hong Kong, China is part of the Companies Ordinance, 1984. Again, the basic processes of liquidation and scheme of arrangement are provided for in that legislation. The same observations as above therefore apply. It is instructive that the number of schemes of arrangement in Hong Kong, China are less than 2 per year, a statistic that clearly shows the scheme of arrangement process to be outdated and not suited to modern commercial needs.

61. **Proposed 'Rescue' Reform.** Recent proposals for corporate insolvency law reform in Hong Kong, China may result in a form of 'provisional supervision' reorganization process. The detail of this is contained in the local study for Hong Kong, China. It has some similarities to the judicial management process in Singapore and to some other contemporary formal rescue processes as found in such other countries such as Australia, England and Canada. If this process is adopted it will provide Hong Kong, China with a very advanced corporate insolvency rescue regime.

(e) Malaysia

62. Malaysia completes the survey of the economies that took their basic corporate insolvency law from that of England. The Malaysian version is contained in the Companies Act, 1965.

63. **Liquidation and Schemes of Arrangement.** Like Pakistan, India, Hong Kong, China, and Singapore, the Malaysian legislation provides for liquidation and scheme of arrangement processes. Like Pakistan, India and Hong Kong, China, Malaysia also still struggles with the outdated 'scheme of arrangement' process. Despite some endeavor of in Malaysia to encourage the development of a new form of 'rescue' process (similar to that introduced in Singapore and that proposed in Hong Kong, China), insolvency law reform in Malaysia has not advanced. The effect of the economic crisis on the local corporate sector has resulted in a number of companies seeking protection under the scheme of arrangement process. Although, in all the circumstances, it has operated tolerably well, some judicial decisions have clearly compensated for shortcomings in the law and procedure.

(ii) Category B: Civil (Japanese) Law Based RETA Economies

64. This next section considers three economies that share similar civil and other law based insolvency law regimes. These have evolved in the following circumstances. The corporate insolvency law regime of Japan evidences two influences. The first, in the form of the Bankruptcy Act 1922, which was derived from German law at the time of the Meiji restoration in Japan in the latter part of the 19th century. The second, in the form of the Reorganization Act 1952, was taken from United States law.

65. These laws were subsequently applied in both Taipei,China and Korea. The Japanese bankruptcy law of 1922 was used, in part, as a model for the Bankruptcy Law 1935 of China and, although subsequently repealed by the government of the People's Republic of China in 1949, it remains the law in Taipei,China. The same law was also applied to Korea. It remains as the Bankruptcy law of 1962.

66. The Japanese reorganization law was used as a model for the Reorganization Law, 1962 of Korea and to a lesser extent in Taipei,China where it now forms part of the Company Law.

(a) Japan

67. **Liquidation.** This process is provided for in the Bankruptcy Law, 1922. Although somewhat outdated, the law is, basically, sound

68. **Reorganization.** Japan has three potential rescue processes. The most commonly used are the corporate reorganization process under the Corporate Reorganization Law and the composition under the Composition Law. The third is the company arrangement process.

69. The company arrangement process involves an application to a court to commence the process. This is generally accompanied by an application for suspension of actions against both secured and unsecured creditors. The directors continue to manage the company under the supervision of the court. A plan of arrangement is prepared and submitted to creditors for approval. It is a requirement of this process that approval must be unanimous. If the plan is not approved the corporation will be liquidated or the process may be converted into the composition process.

70. The composition process requires that an application be made to a court accompanied by a plan of composition. An investigator is appointed to report to the court on the plan and the condition of the corporation. Management continues as before. An application may be made to stay or suspend actions, but only actions of unsecured creditors. Unsecured creditors then consider the plan. Secured creditors are not restrained nor affected by the process in any way. Approval of a plan of composition requires a three quarter majority vote in favor by all creditors and fifty per cent of creditors present and voting at the meeting of creditors. It then becomes binding on all unsecured creditors. Performance of the plan is not, however, supervised. If the plan is not approved the corporation is liquidated.

71. The main rescue process is corporate reorganization. It is extremely involved and is said to be suitable for large public companies only. The procedure requires the filing of an application with a court. There is no automatic stay or suspension of actions against the corporation. It is usual, therefore, that an application for an interim stay has to be made to protect the property of the company. An interim trustee is normally appointed at the same time. It takes control of management of the corporation. The court then undertakes a process of inquiry of the corporation; of major creditors; of main shareholders, management and representatives of employees of the corporation.

72. If the court is satisfied that the conditions necessary for the commencement of the case are fulfilled, it issues an order to that effect. It is only at this point that there is an automatic permanent suspension of actions. The appointment of the trustee is confirmed and the trustee continues to control the corporation. An interim meeting of creditors occurs at which the trustee and management give information concerning the corporation. The trustee is required to prepare a plan of reorganization. This can take up to two years. The plan is then submitted for consideration by the creditors. There is a complicated voting requirement for approval of the plan. In effect, this requires a majority vote of two thirds of the unsecured creditors (in value), three quarter's majority of secured creditors and a majority of shareholders. The court must also sanction the plan. If the plan is not approved the corporation will normally be liquidated.

73. Each of these procedures is independent of the other and, although each is reasonably effective in its own right, it is difficult to appreciate the need for such a variety of alternative processes under

separate forms of procedure.

(b) Korea

74. **Liquidation.** The Bankruptcy Act, 1962 provides for the liquidation or bankruptcy of a corporation. It is basically the same as the Japanese bankruptcy law.

75. **Reorganization.** The Composition Act, 1962 provides for the possibility of a compromise of the debts of a corporation and the Company Reorganization Act, 1962 provides for the possible rehabilitation of a corporation. Only a debtor corporation can file for a composition. The composition procedure is designed for temporary relief. At the time of filing the debtor must propose the terms of the composition and a plan to perform the composition. A liquidation commissioner is appointed to review the corporation and the proposal. The management of the corporation continues in power. A meeting of creditors considers and votes for the approval or otherwise of the composition. It appears that an agreement must be reached for the debtor to perform its debt obligations in full. If the composition is not approved, the corporation cannot be transferred to a liquidation process.

76. The corporate reorganization process differs from the composition procedure because it is aimed toward reorganizing or rebuilding a debtor corporation. Under the reorganization process the company makes an application to a court which then determines if the reorganization should commence. During this process of consideration the court can make interim orders and appointments to protect the property of the company and place the management of the company in the control of a receiver. If the court accepts the application a permanent stay of actions takes effect and the court appoints a permanent receiver, who effectively displaces management. A timetable is set for the submission of a reorganization plan.

77. A reorganization plan is then submitted to the creditors and must be approved by a complicated voting majority of creditors of various classes. The court must then authorize the reorganization plan to be implemented. The implementation of the plan is under the control of the receiver.

78. **Reforms.** The insolvency law regime system is presently under extensive review through the Ministry of Justice and the International Bank for Reconstruction and Development. Major reforms to the system are likely to result from this review.

(c) Taipei, China

79. **Liquidation.** The Bankruptcy Law, 1935 provides for both liquidation (or bankruptcy) and for a composition.

80. **Reorganization.** The position is similar to that in Korea and Japan. The reorganization process is only available to a public company. The company must show that without reorganization it would have to cease its business activities. The corporation, shareholders or creditors may commence the process. The court must decide to commence the reorganization process. If it does the court appoints reorganizers who take control of the company. A reorganization plan is submitted to a meeting of interested parties which comprises secured creditors, unsecured creditors, preferred creditors and shareholders. Approval of the plan is required by both creditors and shareholders. If the reorganization process breaks down or if a plan for reorganization is not approved the court may order that the corporation be liquidated.

81. Only a debtor corporation may initiate a composition. A composition plan is prepared which the creditors then consider. The corporation continues under its own management, subject to supervision by court appointed supervisors. A suspension applies to unsecured creditors but not to secured or preferred creditors. Adoption of the composition plan requires a majority vote of creditors present who represent more than two thirds of the total unsecured debts of the corporation. The composition must then be approved by the court and is then implemented.

82. The reorganization regime, although it provides for basic elements, is far from modern and has not been revised for some considerable time. Like the reorganization regimes of both Japan and Korea, it suffers from the fact that a large part of the procedure is court controlled and driven.

(iii) Category C: Mixed Legal Heritage RETA Economies

The next section considers the insolvency regimes of the remaining three economies, whose respective laws have been influenced from different sources.

(a) Philippines

83. **Liquidation.** The Philippines has possibly the most remarkable corporate insolvency law regime in the region. The Insolvency Law, provides a liquidation (or 'insolvency') process. However, this is rarely used.

84. **Reorganization.** The Insolvency Law also provides for a form of 'rescue' process known as 'suspension of payments'. It is only available to a corporation that has assets sufficient to meet its debts (i.e. a company that is suffering from a temporary liquidity problem). It requires an agreement to be made between the corporation and its creditors for the eventual payment of the debts in full. The suspension of payments process was regarded as too restrictive and inflexible to enable more liberal forms of corporate reorganization to occur. This led to demands for a more liberal form of reorganization.

85. In 1976, a Presidential decree known as PD902A was declared. Under its terms, jurisdiction regarding corporations that sought the suspension of payments process was taken away from the regular courts and given to the Securities and Exchange Commission (the SEC). In addition, an alternative to suspension of payments was introduced. This is known as 'rehabilitation'. It enables a corporation whose assets do not exceed its liabilities to apply to the SEC for the appointment of a rehabilitation receiver and/or management committee and then to develop a rehabilitation plan.

86. This 'rehabilitation' process has become increasingly used in the Philippines. There are few cases of suspension of payments and practically no cases of insolvent liquidation under the basic Insolvency Law. The rehabilitation process has functioned with very few rules or guidelines, except as developed from time to time by the SEC. A number of basic standards have been absent. For example, the provisions of the decree relating to a stay or suspension of actions against the corporation or its property admit of no exceptions and may even operate so as to require all creditors (secured and unsecured) to be treated the same. Further, there has been no requirement that creditors should be consulted regarding the approval or endorsement of a rehabilitation plan nor that they should have any powers whatsoever in relation to a rehabilitation plan. That part of the process has been solely the province of the SEC, from which there is no appeal to a court.

87. Although the rehabilitation process has operated with some apparent success, there has been a clear need to provide greater transparency, predictability and fairness in the procedure. On January 15, 2000, the SEC's newly enacted Rules of Procedure on Corporate Recovery took effect. These provide for the following important details:

- A set of rules governing the qualifications of persons who may be appointed as a receiver or liquidator;
- The creation of classes of secured and unsecured creditors;
- Detailed time periods for various parts of the procedure;
- A clear statement of the functions and duties of a receiver under the rehabilitation process;
- The creation, functions and duties of a management committee comprised of secured and unsecured creditors and representatives of the debtor; and

- Rules to govern the liquidation of a corporation in the event that rehabilitation is not possible.

88. The SEC will continue to administer the rehabilitation process, thus cementing the shift from what was once a judicial function into a quasi-judicial or administrative process. This is unique in the region.

(b) Indonesia

89. **Liquidation.** The corporate insolvency regime of Indonesia is contained in the Bankruptcy Ordinance 1905. This law was taken from Dutch law of the late 19th century. It provided for a liquidation or bankruptcy process and a form of 'composition' or suspension of payments process. It was outdated and rarely used. Following the effect of the financial crisis some substantial reform was made, in the form of a Government Regulation in lieu of Law, April 1998. This regulation is known as the Bankruptcy Regulations. It came into force in August 1998. The regulations supplement and amend the Bankruptcy Ordinance and substantially expand and reform the suspension of payments process.

90. **Reorganization.** There are two "rescue" processes available under the Insolvency Law of Indonesia. The first is commenced by the debtor (or creditors) filing a petition for bankruptcy. A stay or suspension of all actions takes effect for 90 days. If, within that time, the debtor corporation presents a plan of composition and creditors approve it, the plan takes effect. If a plan is not proposed the debtor is liquidated.

91. The second process is commenced by a corporation filing a request for suspension of payment of debts. This is then followed by a temporary suspension of payments for a maximum period of forty-five days during which time the proposal for the permanent suspension of payments must be prepared for negotiation between the debtor and the creditors. The affairs of the debtor corporation are jointly managed by court appointed administrators and by the debtor. If the proposal is presented within that time the court may order a "permanent" stay which is effective for a period of 270 days. The plan must then be negotiated during that time. The creditors vote on the proposal. If it is refused the court may proceed with the liquidation of the debtor corporation.

(c) Thailand

92. **Liquidation.** The provisions for corporate insolvency are contained in the Bankruptcy Act, 1940. This appears to have been influenced by English bankruptcy law models. It contains, for example, a series of 'presumptions of insolvency' that may be likened to the English law concept of 'acts of bankruptcy'. Prior to 1998, the Thai law contained a liquidation (or bankruptcy) process and a composition process. There was no rescue or reorganization process.

93. **Reorganization.** As a result of the economic crisis, Thailand, like Indonesia, reformed the law by introducing a new chapter on 'business reorganization'. This reform was made in April 1998 and came into operation from August 1998. It applies only to corporations, banks, security and insurance corporations. A debtor corporation, a creditor of a debtor corporation or the respective regulatory authorities of the banking, insurance and securities sectors may make an application for business reorganization.

94. A request for reorganization is filed with the bankruptcy court. It must determine whether or not to accept the request. If the request is accepted, an immediate stay or suspension against all actions and proceedings comes into force. A 'planner' is required to be appointed who has the legal authority to manage the affairs of the corporation. The 'planner' prepares a plan of reorganization. The plan must be prepared within three months of the appointment of the planner and forwarded to the official receiver and to all creditors. A meeting of creditors is convened to discuss and approve or disapprove the plan. The court must then approve the plan.

95. The application of both the bankruptcy process and the reorganization process in Thailand has encountered some difficulties because of the manner in which the threshold criterion of 'insolvency' has

been interpreted and applied. The only test of insolvency under the Thai law is that the liabilities of the debtor exceed the value of the assets of the debtor (sometimes loosely referred to as a 'balance sheet' test). This has had the possibly unintended result of severely restricting the availability of both the liquidation and reorganization processes in Thailand.

96. However, as this report is about to go the press, the Bankruptcy Court has just issued a landmark decision in the Thai Petrochemicals Industry (TPI) case (March 15, 2000). The Court took the unprecedented step of calculating the company's future cashflow and earnings from selling assets and then converted these figures into present values. Based on these figures, the Court ruled that TPI was unable to service its debts, and found the company insolvent. This decision marks the first time that the Court has used the 'cashflow' test and it sets a precedent for the many debt restructuring cases to follow.

III. ESTABLISHING GOOD PRACTICE STANDARDS

97. An evaluation of a formal corporate insolvency law regime can be best approached by reference to comparative standards. This part of the report identifies standards of a basic framework for an acceptable corporate insolvency law regime.

98. **Difficulties with Universal Concepts.** Comparative studies of the subject reveal considerable differences. The reason for these differences can be due to a number of influences or factors. They include the operative legal system tradition; the inheritance of insolvency laws from different systems; the influence of cultural attitudes, customs or traditions; differences in political and economic policies; and practical and pragmatic factors (such as the extent of development of the court system, the availability of skilled professionals to conduct insolvency administrations and so forth).

99. **Established and Respected Principles.** Despite these differences, it is still possible to identify common basic policies and principles of approach in the insolvency law regimes of countries with different legal traditions and of different levels of economic and industrial development. By carefully identifying and applying these relatively common and consistent basic policies and principles it is possible to reach well established, widely accepted and respected standards that survive most tests of relevance, suitability and practicality.

100. **Global Corporate Environment.** There is also some commercial validity or justification to that approach. The corporate environment in which most corporate insolvency law regimes are expected to operate are relatively similar. Such regimes are primarily directed at corporations that are involved in private enterprise trade and commerce. There are a number of common, almost universal, elements associated with the creation and operation of corporations which suggest that laws concerning their financial stability and viability should be similar or should contain common identifiable basic elements.

101. **Economic Expectations and Commercial Needs.** It is also useful and relevant to consider what might be best described as economic expectations and commercial needs. These have real significance for corporate insolvency procedures and techniques. These expectations and needs fashion many of the goals and the means to be employed to attain them. The appropriate role of the law is to enable the goals to be reached and to provide mechanisms to enable the means to be employed. This also assists in the identification and development of appropriate standards.

102. These expectations and needs may be described as follows:

- First, an insolvency law may be expected to serve the micro economic process. Thus, an insolvency law should respond to the economic need to possibly remove uncompetitive or loss making enterprises from the market place. This requires a liquidation or bankruptcy process. It should also respond to the economic need to maximize the value of the

enterprise and to lessen the effects of a possible liquidation. This requires a form of rescue or reorganization process.

- Secondly, an insolvency law may be expected to serve the expectations or needs of the commercial community. The more major of these happen to accord with the economic needs, though perhaps for different reasons. Thus, there is a need for a liquidation process not only to clear away uncompetitive businesses from the market place but also to enable creditors, particularly unsecured creditors, to exercise an ultimate creditor enforcement right. Secondly, there is a need for a rescue process to afford corporate debtors and their creditors the opportunity of determining upon a form of administration that may provide greater value for them. Thirdly, there is a need to provide some positive motivation toward initiating the rescue process. This can come from the background presence of a liquidation process.

Related to these are other commercial needs, such as:

- a need for certainty or predictability in commercial affairs. This requires that the law clearly provide for a resolution of the affairs of a corporation that is insolvent or in financial difficulty. It also requires that the law clearly provide for the respective rights of persons having an interest in the resolution of the affairs of the debtor – creditors, shareholders, management, employees, government and so forth.
 - a need for sensible commercial stability and order. This suggests that the law should protect the property of an insolvent corporation; protect creditors between themselves; and otherwise ensure an ordered progression of the administration of the insolvent corporation.
 - a need for commercial efficiency. The law must be capable of responding quickly and definitively to the problems inherent in dealing with the affairs of a corporation that is insolvent or in financial difficulty.
 - a need for fair commercial or equitable treatment. This demands that the law, above all, manifest itself as a collective or communal process.
 - a need for transparency. This largely translates into affording proper information and involvement in decision making to those most affected by the insolvency. This is particularly important in the rescue process.
- Thirdly, there is the possibility of serving other expectations. One such expectation is in the area of labor and social services. Loss of employment is usually a certain consequence of the liquidation of an insolvent corporation. An efficient rescue process can help to lessen the incidence of unemployment. Another expectation may be to relate to the wider 'commercial' morality, which raises issues about the need to enforce appropriate standards of corporate governance and responsibility. Insolvency laws and processes can, in part, respond to that need by providing for investigation and reporting on the management and conduct of an insolvent corporation.

103. **Development of Insolvency Law Standards.** The ADB has been joined in the development of standards by other multi-lateral agencies. Following the publication of the First Comparative Report (in which standards were proposed for discussion at the January Symposium), both the IMF and the World Bank have developed good practice principles.⁴

⁴ Mentioned in this context are: (i) the Group of 22 Report, Report of The Working Group on International Financial Crises', published October 1998; (ii) a report of the International Monetary Fund, 'Orderly and Effective Insolvency Procedures: Key Issues', published May 1999; (iii) a report on Latin American Insolvency Systems, World Bank technical paper No. 433, published April 1999; and a background paper of the World Bank, 'Building Effective Insolvency Systems: Toward Principles and Guidelines', published February 2000.

104. It should also be noted that the standards identified and advanced as part of this RETA, together with those of the IMF, have been used by UNCITRAL in considering the possibility of developing key objectives, core features and legislative guidelines for a strong insolvency, debtor-creditor regime (see UNCITRAL A/CN.9/WG.V/WP.50, 20 September 1999 on UNICTRAL's website www.uncitral.org).

105. The good practice elements are identified in the material that follows as the respective relevant corporate insolvency laws of the RETA economies are examined. This examination and assessment is based on critical analyses contained in the local studies and assessment and evaluation as a result of the comparative reports and a consideration at the symposiums. The aim of this part is to identify areas of the insolvency law regimes that clearly merit attention, and to signal problem areas that may be capable of being addressed by further study, analysis and assistance.

IV. APPLICATION OF THE GOOD PRACTICE STANDARDS

106. This section identifies the areas in which some basic standards should apply and relates these to an assessment of the corporate insolvency regimes of each of the RETA economies. These standards are not intended to be exhaustive. They cover only the more essential areas that may be considered critical to debtor-creditor relationships in a corporate insolvency environment.

A. Distinguishing between Individual and Corporate Insolvency

107. This involves a consideration of to whom the law should apply. The first issue is whether the law should distinguish between individual debtors and corporate debtors. It is highly probable that different policy considerations and different social and other attitudes will be relevant to each of these areas. Policies toward individual or personal debt or insolvency will often evidence cultural attitudes that are not as relevant to corporate or commercial insolvency. Some examples are found in attitudes toward the incurring of personal debt; the effect of bankruptcy upon the status of individuals; attitudes toward providing relief for unmanageable personal debt; and providing for discharge from insolvency or bankruptcy.

108. By comparison, the policies that are likely to be applicable to corporate insolvency will be based on economic and commercial considerations. These should usually reflect the vital part that corporations play in a market economy and that insolvency procedures and techniques affecting corporations should largely reflect economic expectations and commercial needs, as mentioned earlier. These will not normally be relevant to individual insolvency.

109. It is, therefore, advisable to either apply separate insolvency laws to individuals and corporations or, in the case of a single insolvency law, to clearly distinguish between them in that law. Some features might be common to both (for example, dealing with claims of creditors; priorities between creditors and so forth), but it may be necessary to have distinctly different provisions regarding important elements, such as threshold entry requirements.

110. A further consideration is under what branch (personal or corporate) should individual or personal business activities (including unincorporated partnerships of individuals) fall. The precedents from the experience of many countries suggest that, although individual business activities form part of commercial activity, such cases are best dealt with under the regime for individual insolvency because, ultimately, the proprietor/s of an unincorporated business are personally liable without limitation for the liabilities of the business.

Good Practice Standard 1

An insolvency law regime should clearly distinguish between, on the one hand, personal or individual bankruptcy and, on the other, corporate bankruptcy.

Application of Good Practice Standard 1 in the RETA Economies

Economy	A = Applied P = Applied in part N = Not Applied
Hong Kong, China	A
India	A
Indonesia	N
Japan	N
Korea	N
Malaysia	A
Pakistan	A
Philippines	N
Singapore	A
Taipei, China	N
Thailand	N

111. The five RETA economies whose insolvency law regimes have been derived from English law models make a clear distinction between personal and corporate bankruptcy. In the bankruptcy laws of Thailand, Indonesia, Japan, Korea, Taipei, China and Philippines there is no or not sufficient distinction between corporate bankruptcy and personal bankruptcy.

112. Difficulties have already occurred in the application of the law in Thailand in relation to this issue. Conservative and restrictive policies and attitudes toward individual insolvency have affected the interpretation and application of the bankruptcy law. For example, the criterion for the commencement of bankruptcy proceedings has been narrowly interpreted and is difficult to establish. This has affected the application of the law in relation to corporate insolvency. It has become difficult for both creditors and debtors to commence corporate reorganization proceedings. This demonstrates a possible unintended consequence of not providing sufficient distinction between individual and corporate insolvency processes.

113. It is recommended the insolvency laws of the six RETA economies whose insolvency law regimes do not make a clear distinction between personal and corporate insolvency be revised to make a clear distinction between personal and corporate bankruptcy. As mentioned, this does not necessarily require separate laws but it may require separate chapters of an insolvency law.

B. Coverage of All Corporations

114. Principle suggests that the liquidation and rescue processes of an insolvency law regime should apply to all forms of corporation, both private corporations and state-owned. It may be necessary or desirable to separate out corporations that are engaged in some particular enterprises. For example, the insolvency of banking and insurance corporations should normally be governed by special insolvency legislation or be subject to special rules of the insolvency law. Very few, if any, jurisdictions would permit a banking corporation (whether private or state owned) to be subject to a basic corporate insolvency law without some involvement of regulatory bodies.

115. Principle also dictates that state owned corporations (other than banks) which compete in a market economy should be subject to the same commercial and economic processes as privately owned corporations, including the basic insolvency law. While it can be argued that state owned corporations in a transitional economy might be best dealt with by special insolvency processes, under normal market economy conditions they should not be afforded different treatment than that which applies to private corporations.

Good Practice Standard 2

All corporations, both private or state-owned (with the possible exception of banking and insurance corporations), should be subject to the same insolvency law regime.

Application of Good Practice Standard 2 in the RETA Economies	
Economy	A = Applied P = Applied in part N = Not Applied
Hong Kong, China	A
India	A
Indonesia	P
Japan	A
Korea	A
Malaysia	P
Pakistan	A
Philippines	A
Singapore	P
Taipei, China	A
Thailand	A

116. There is a general application of this standard in all of the RETA economies. However, there are some specific exceptions. The corporate insolvency laws of Indonesia, Singapore and Malaysia also provide for the possible liquidation or bankruptcy of a banking corporation. However, this may only be initiated on the application or with the authority of a responsible controlling authority and does not appear to present any real problem.

117. It should be noted that, in relation to India and Pakistan, their respective special laws for ‘sick’ company processes (mentioned earlier) fail several of the good practice standards, particularly those relating to transparency, involvement of creditors and general collective fairness. They are examples of extra-judicial processes designed to assist in micro economic reform of state controlled industrial units or of industries that are considered important to a national economy. They should thus be viewed as special processes, outside of the traditional forms of insolvency process remedies, and should be evaluated according to the respective economic and other policy dictates of those economies. They provide possible models for adoption toward, for example, state owned enterprises in emerging economies and economies in transition.

C. Separate/Dual Process

118. This involves a fundamental policy issue concerning the framework of the law. The law should provide for a liquidation process and a reorganization or rescue process. The issue is whether to create a strict division between the two; create a division but enable conversion from one process to the other; or provide for both processes to be accessed under a single procedure.

119. The first of these options creates an undesirable degree of polarization and also results in delay, increased expense and inefficiency. It means, for example, that if an attempt at reorganization fails, a new and separate procedure for liquidation must be commenced. The second and third options involve a “unitary” system that might be modeled on one of two alternative designs:

120. The first is a ‘pure’ unitary system in which there would be one only point of entry with the ultimate process (either liquidation or rescue) to be determined at a later point in time. The second is a modified unitary system that provides a choice of one of two separate entries, one entry for liquidation and another entry for rescue, with provision for possible conversion from one to the other. Either of these is acceptable. Each presents a ‘one law, two systems’ approach.

121. Employing either approach would mean that (i) the liquidation process is available to both creditors and debtors (but with the prospect of conversion to the rescue process if circumstances merit that); and (ii) the rescue process is available to, in particular, debtors (though it might also be made available to creditors), with the prospect of conversion to the liquidation process if, again, the circumstances so require.

122. **Appendix 2** shows a broad overall plan of how the modified unitary approach might operate. It shows two points in the process at which there should be provision for transmission from rescue to liquidation mode. These are when creditors reject a rescue proposal or if the rescue plan cannot be effected.

123. This unitary (or modified unitary) approach produces a desirable amount of flexibility, choice and freedom. It avoids the need for multiple laws and the possible confusion, inefficiency and expense that can be associated with that. It can accommodate multi-chapter corporate insolvency laws because it enables the administration of an insolvent corporation to be processed with flexibility (to convert from one possible solution to another) with efficiency and without significant expense or disruption. But, above all, it is safe and provides desirable protection to creditors in particular because once the corporation is subject to the law, it cannot exit from the system without some ultimate determination of its fate. That would also seem to make commercial sense.

Good Practice Standard 3

The optimum design of a corporate insolvency law regime should incorporate both liquidation and rescue processes by a ‘one law, two system’ convertible design. This may be either a pure unitary or modified unitary design. In a modified unitary system the law should provide, in particular for conversion from the reorganization process to the liquidation process.

Application of Good Practice Standard 3 in the RETA Economies	
Economy	A = Applied P = Applied in part N = Not Applied
Hong Kong, China	N
India	N
Indonesia	A
Japan	A
Korea	A
Malaysia	N
Pakistan	N
Philippines	A
Singapore	N
Taipei, China	A
Thailand	N

124. Only a limited number of the RETA economies apply this standard. None of the economies that have adopted English based law insolvency laws follow a unitary design and, consequently, do not provide for conversion from reorganization to liquidation. This includes Singapore, which may appear somewhat surprising considering that its judicial management regime is of comparatively recent origin.

125. Thailand has a provision for conversion, but it is of very limited scope. Indonesia, Japan, Korea and Taipei, China follow a modified unitary approach by providing for a conversion from reorganization to liquidation. Only the Philippines has something approaching a pure unitary system. Under the new rules of the SEC regarding reorganization, if a corporation fails to have a plan approved the SEC may order the liquidation of the corporation.

126. It is suggested that the RETA economies with non-unitary systems should consider the adoption of a unitary based insolvency law system.

D. Access to the Process

127. Policy considerations suggest that access to the process (either or both of liquidation and reorganization) should be convenient, inexpensive and quick. If access is too restrictive it can deter both debtors and creditors. Delay can result in insolvent corporations, which should be liquidated, being left uncontrolled with the likely dissipation of assets. Restricted access can be particularly harmful to the possibility of rescue. However, if it is too unrestricted there is a possibility of the process being abused, particularly by creditors.

128. The preferred policy is to make access easy for a debtor corporation by requiring simple threshold proof of the basic criteria of 'insolvency'. The concept of insolvency has been much discussed and debated. However, it should, by now, be widely accepted that the most simple and safe exposition is that a debtor is in a state of insolvency when the debtor is not able to pay a mature (due) debt. This is what is generally known as 'cash flow' or commercial insolvency. The other test, commonly known as the "balance sheet" test, requires that debts or liabilities exceed value of assets.

129. From a procedural aspect, the debtor itself will know when this position has been reached and it should not be necessary to require other than a simple declaration to that effect by the debtor, through its directors or board of management, as evidence that it is insolvent. From the perspective of a creditor, the standard of 'insolvency' needs some pragmatic procedural refinement to establish a threshold test of evidence or proof. A reasonably convenient and objective test is the failure of a debtor to pay a debt within a specified period of time after a written demand for payment has been made.

130. For reorganization cases it is essential that the law give the utmost encouragement to enable a corporation that is in financial difficulty or insolvent to voluntarily submit itself to the process. Although the power to initiate the rescue process may be given to creditors as well, the reality is that in almost all cases the debtor alone will initiate the process. This is where the most attention must be centered.

131. In a voluntary reorganization case, a lesser standard, might also apply – that of 'financial difficulty'. This might be best described as a state of financial affairs which, if not dealt with, will almost certainly result in a state of insolvency.

132. It has sometimes been posited that the application of such a lesser standard could result in the process being abused by a debtor corporation (to prevaricate and deprive creditors of prompt payment of debts in full). That, it is suggested, is highly improbable. In the unlikely case that such an event might occur, the remedy is for the law to provide for the relevant court or tribunal to declare that the debtor is no longer subject to the application of the insolvency law.

133. If the law is a modified unitary design, attention should also be given to the possibility of access by a debtor through conversion from the liquidation process to the rescue process. This is particularly relevant if a creditor has imposed the liquidation process on a debtor.

Good Practice Standard 4
(1) A debtor should have easy access to the law by providing simple threshold proof of the basic criteria (insolvency or financial difficulty). The debtor through its directors or board of management may conveniently provide a declaration to that effect. There should be sanctions for false declarations.
(2) A creditor should be required to establish threshold proof of insolvency by evidencing a ‘presumption’ of insolvency on the part of the corporate debtor. Clear evidence of the failure of a corporate debtor to pay a matured debt is all that should be required to evidence such a presumption.

Application of Standards 4.1 and 4.2 in the RETA Economies		
Economy	A = Applied P = Applied in part N = Not Applied	
	Standard 4.1	Standard 4.2
Hong Kong, China	A	A
India	A	A
Indonesia	A	P
Japan	P	P
Korea	P	P
Malaysia	A	A
Pakistan	A	A
Philippines	A	P
Singapore	A	A
Taipei, China	P	P
Thailand	N	N

134. There is some considerable variation between the RETA economies in relation to application of these very important standards. The ‘English’ insolvency law based economies apply both standards.

135. In relation to bankruptcy or liquidation, Japan, Korea, and Taipei, China appear, in practice, to apply something approaching these standards but their respective insolvency laws contain only a general statement of the criteria for insolvency and do not provide specific procedural rules by which the criteria may be presumed or proved. In Japan, for example, the relevant articles of the law provide that when a debtor is ‘unable to pay’ the debtor may be adjudged bankrupt and that a debtor shall be deemed unable to pay when the debtor has ‘suspended payment’. There are no definitions or meanings of these terms in the law. The criteria are vague and could be extremely difficult for a creditor to establish.

136. Indonesia has a particularly good, low threshold, criteria for its reorganization process. It states that a debtor who is unable or *expects to be unable* to continue to pay matured debts may apply for reorganization. Singapore also has an acceptable low threshold test for judicial management. The law states that a company that is or *will become unable* to pay its debts as they fall due may apply for judicial management. The Philippines applies the threshold criteria standards, but it is necessary that three creditors join in a petition for bankruptcy or liquidation against a corporation.

137. The law in Thailand actually prohibits voluntary bankruptcy and provides a high threshold (asset/liability) test for all other applications. This causes considerable difficulty in practice. Reform on this aspect is urgently required in Thailand. The reform should:

- introduce the 'cash flow' test of insolvency for corporations, both as regards liquidation and reorganization;
- provide for an even lower standard in relation to voluntary reorganization (the Indonesian and Singapore models provide good examples); and
- also enable a corporation to file for voluntary bankruptcy.

138. It is recommended that the RETA economies in which there is either no or only partial application of these standards consider reforms to their respective insolvency laws.

E. Immediate/Interim Effects of Commencement

139. There are three important matters to consider under this heading. One is management of the affairs of the debtor corporation. The second is the stay or suspension of actions or proceedings against or affecting the property of the debtor corporation. The third concerns the ongoing funding of the business operations of the debtor corporation

(i) Management/Control

140. If a debtor corporation is to be **liquidated**, the total powers of management should pass to an independent administrator as soon as possible. In the case of a **rescue**, the options are to:

- retain power in the existing management;
- remove power from the existing management of the debtor corporation and give total power to an independent administrator; or
- provide for a type of fusion by appointing an independent person to exercise supervisory and, if necessary, ultimate power of management but, at the same time, retaining existing management.

141. The third of these options appears to be the most desirable. The removal of all power from existing management, except in particular circumstances, can cause damage and can result in repercussions. For example, if a debtor corporation is seeking a genuine rescue, the removal of or an extreme reduction in the powers of management might sometimes remove the incentive. If, on the other hand, the creditors have little or no confidence in existing management, to maintain existing management with no check on powers can antagonize creditors.

142. Sometimes the solution will depend on whether the process is voluntary (where the debtor corporation has applied) or if it is involuntary (where a creditor or creditors have applied and the debtor corporation is hostile). There will also be cases in which it will be necessary to appoint a provisional or interim independent administrator.

Good Practice Standards 5.1 and 5.2

(1) Liquidation. If it is determined that a debtor corporation should be liquidated, the powers of the existing management should be terminated and an independent administrator appointed to exercise those powers and to conduct the liquidation.

(2) Reorganization. Existing management should, generally continue, subject to the exercise of supervisory power by an independent administrator but with the possibility, if circumstances require it, of the independent administrator assuming complete power.

Application of Good Practice Standards 5.1 and 5.2 in the RETA Economies		
Economy	A = Applied P = Applied in part N = Not Applied	
	Standard 5.1	Standard 5.2
Hong Kong, China	A	A
India	A	A
Indonesia	A	A
Japan	A	P
Korea	A	P
Malaysia	A	A
Pakistan	A	A
Philippines	A	A
Singapore	A	P
Taipei,China	A	P
Thailand	A	P

143. There is a general application of standard 5.1 but some variation in the application of standard 5.2. In Japan and Korea, the reorganization law provides that upon the commencement of a reorganization an independently appointed receiver shall ‘exclusively’ manage the business and assets of the company. Although, in most cases, the practice is that the management continues to work with the receiver, some reform to this aspect should be considered in these jurisdictions.

144. In Taipei,China the law permits the directors of a corporation to be the ‘reorganizers’ without any independent supervision. In Singapore and Thailand the law actually suspends the powers of management. In Thailand that presents a problem because owners of corporations (particularly family owned corporations) have a strong cultural and commercial aversion to surrendering complete control. It may be necessary to review this aspect of the Thailand law.

(ii) Stay and Suspension

145. The policy issue is whether there should be an immediate stay or suspension of actions and proceedings against property of the debtor corporation and, if so, the terms and conditions of such a stay or suspension. This raises the problem of the extent to which an insolvency law should intrude into and interfere with accepted commercial practices and processes. For example, should an insolvency law restrain the rights of secured creditors?

146. This issue is more fully addressed in the following article on *The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms*. It is suggested that for policy and pragmatic reasons there must be some restraint on some creditors if a fair and ordered administration is to result. For this reason, it is highly desirable that some form of stay or suspension comes into immediate effect once an application has been made, particularly by a debtor corporation, for relief under the insolvency

law. This so-called "automatic" stay or suspension is a feature of many modern insolvency regimes. If a creditor or creditors have applied, there should not be an immediate stay or suspension until the application has been heard and determined, but a stay should be capable of being applied, on an interim basis, if circumstances can be shown to warrant it.

147. In the environment of the "rescue" culture, the dictates of policy suggest that where there is a genuine aim of effecting a rescue, the extent of automatic stay or suspension should be very wide and all embracing. The rationale for this is that attempts at rescue will fail unless the essential assets and component parts of the debtor corporation and its businesses are maintained. However, where it is clear that the corporate debtor will be liquidated that rationale is no longer relevant and the stay or suspension should only affect unsecured creditors.

148. The duration of the stay in a reorganization should be limited and should be consistent with the time that it might reasonably take for a reorganization plan to be approved or not. Secured creditors affected by a stay should have a right to apply for the stay to be lifted if it is shown that they will be severely prejudiced. It is not appropriate for a stay to be of an uncertain or unnecessarily lengthy duration.

Good Practice Standards 5.3, 5.4 and 5.5	
(1) Liquidation.	A stay or suspension of actions and proceedings against the property of a debtor corporation should be immediate, but confined to unsecured creditors only. There should be no interference with or stay upon the rights of secured creditors, owners of leased property or the like.
(2) Reorganization.	The automatic stay or suspension of actions should be as wide and all embracing as possible. It should apply to all creditors (secured or otherwise) and to persons having an interest in property used, occupied or in the possession of the debtor (such as lessors of property, retention of title claimants and the like).
(3) The stay should be of limited specific duration and should provide for the possibility of relief from the stay on the application of affected creditors or other persons to the court or tribunal.	

Application of Good Practice Standards 5.3, 5.4 and 5.5 in the RETA Economies			
Economy	A = Applied P = Applied in part N = Not Applied		
	Standard 5.3	Standard 5.4	Standard 5.5
Hong Kong, China	A	P	P
India	N	P	P
Indonesia	N	A	A
Japan	A	A	P
Korea	A	A	P
Malaysia	N	P	P
Pakistan	N	P	P
Philippines	A	A	A
Singapore	A	A	A
Taipei, China	A	A	P
Thailand	N	A	A

149. There is considerable variation between the RETA economies in the application of these standards. The main concerns that emerge are as follows:

- **Standard 5.3:** In Pakistan, India, Malaysia, Thailand and Indonesia it is possible that security enforcement powers can be delayed, even though the corporation is being liquidated.
- **Standard 5.4:** The main concern here is that in the economies of Pakistan, India, Malaysia and Hong Kong, China, there is no automatic stay or suspension under the scheme of arrangement reorganization processes. An application must be made to court for such a stay. It may not even then be possible in some of those jurisdictions to stay the enforcement of secured property rights. In Indonesia the stay covers 'debt repayment' by the debtor corporation. It is not clear whether this covers actions by secured and other like creditors to enforce rights over property. In Japan, Korea and Taipei,China the application of the automatic stay may be delayed by the initial investigation task that the court must undertake. However, the court may make an interim stay order pending the conclusion of that investigation and the formal commencement of the rehabilitation process.
- **Standard 5.5:** In some of the RETA economies the concern is that where there is an automatic or court ordered stay, its duration could be extensive because of inefficiencies in the conduct of the reorganization processes. This is particularly the case in Japan, Korea and Taipei,China.

150. It is recommended that the absence, in some reorganization processes, of an initial automatic stay should be remedied. Some of the other concerns are relevant to the position of secured creditors. Attention should be given by those RETA economies affected by them because of the possible effect on the availability, terms and costs of secured financing. These areas are more fully addressed in the following article on *The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms*.

(iii) Critical/Urgent Funding

151. A third aspect concerns the continued funding of the business activities of the debtor. If the debtor is suited only to liquidation, the problem of on-going funding will not, except in rare cases, be a problem. Usually the business of the debtor will have been closed down or will be in the stages of closing down. However, where a genuine prospect of rescue exists, on going funding may be of critical importance. If a debtor has no available funds to meet its immediate cash flow needs (for example, to pay for supplies, to pay wages to employees) a rescue will fail unless those funds can be provided.

152. An insolvency law should and can help this situation by providing power to obtain funding and by providing assurances or protection for the eventual repayment or recovery of this funding. The law can do this by, firstly, recognizing the need for and sanctioning such funding and, secondly, by creating a form of 'super priority' for its repayment to the provider. It can also assist by recognizing and enforcing, where it is appropriate, rights of subrogation.

Good Practice Standard 5.6

The law should sanction and provide for a commercially sound form of safe ‘priority’ for funding that is necessary for the on-going and urgent business needs of a debtor during the rescue process.

Application of Good Practice Standard 5.6 in the RETA Economies

Economy	A = Applied P = Applied in part N = Not Applied
Hong Kong, China	N
India	N
Indonesia	N
Japan	N
Korea	P
Malaysia	N
Pakistan	N
Philippines	N
Singapore	P
Taipei, China	N
Thailand	P

153. There is a clear problem in the region in this area. The laws of only three economies, those of Singapore, Korea and Thailand, expressly provide for the possibility of sanctioning the provision of ‘new money’. However, of these, only the Singapore judicial management law provides for protection by way of priority repayment of that new money.

154. It is recommended that a regionally based technical assistance should review the issue in more detail and propose legislative models for possible adoption in the RETA economies and the Asian region.

F. Administration: Efficient Initial and Continuing Processes

155. An insolvency law serves principally a ‘communal’ or collective purpose. The operation of such a law will break down and become ineffectual if it is subject to delay or if it otherwise lacks an essential procedural framework to ensure that delay is kept to a minimum and cases are properly and timely processed. Sensible rules for the processing of cases of corporate insolvency or financial difficulty are most necessary.

156. These should be consistent with ensuring that the parties receive fairness and justice. Swift and reasonably rigid time limits are necessary to ensure that the process is conducted without delay. However, not only should the law provide for this, it is equally essential that a court or other tribunal ensure that these requirements are met.

Good Practice Standards 6.1 and 6.2

(1) The insolvency legislation should provide for swift and strict time limits for the initial process regarding an insolvent corporation. The court or other tribunal system must be properly resourced to enable the process to be implemented.

(2) The medium term administration of an insolvent corporation that is being reorganized (for example, from the time of commencement to the time that a plan is approved or not) also requires the application of a sensible time frame. The long-term administration of a company that is being liquidated requires efficient continuous handling.

Application of Standards 6.1 and 6.2 in the RETA Economies

Economy	A = Applied P = Applied in part N = Not Applied	
	Standard 6.1	Standard 6.2
Hong Kong, China	A	A
India	N	N
Indonesia	A	A
Japan	P	A
Korea	P	A
Malaysia	A	A
Pakistan	N	N
Philippines	A	A
Singapore	A	A
Taipei, China	P	A
Thailand	A	A

157. The insolvency laws of most of the RETA economies apply these standards. The reforms to both the Indonesian and Thailand insolvency laws prescribe strict time limits for all stages of both liquidation and reorganization proceedings. They provide very good models.

158. In Singapore the judicial management process is also subject to practical short time limits and operates extremely well. The reorganization process in the Philippines operates swiftly. This is primarily due to the case management skill of the SEC. It drives the process efficiently. The principal reorganization laws of Japan, Korea and Taipei, China provide for lengthy and drawn out procedures. The reorganization processes in those economies are consequently subject to extensive delay.

159. In some of the other jurisdictions there is a problem of timely and efficient processing because of inefficiencies in the court and judicial system. Consequently the commercial need of the standard is not often reached. This is particularly so in Pakistan and India where the liquidation and reorganization processes can be subjected to extreme delay because of general delays in the court systems.

G. Liquidation Processing

160. The main processes of the liquidation of an insolvent corporation involve the following:

- termination of business activities; securing the assets, books and records; dealing with outstanding contracts;

- convening a meeting of creditors with representatives of management (directors) to explain the causes of the insolvency and provide a forum for questions and examination;
- the realization of assets;
- assessing and adjudicating the claims of creditors;
- investigating the conduct of the corporation and reporting on that investigation;
- taking action to recover assets of the corporation; setting aside unlawful asset dealings;
- distribution of proceeds to creditors according to the legislative priorities and reporting to creditors;
- dissolution of the corporation.

161. The performance of these tasks requires special skills and experience. Once the process has been commenced, there must be a steady, certain and ordered progression of each case. For cases of liquidation, the experience in many jurisdictions is that they are usually best administered through a special government agency. Sometimes, if the liquidation is complex, the administration is transferred out to specialist private administrators with suitable qualifications and experience. The administration needs to be conducted professionally and efficiently and with as little delay as possible.

Good Practice Standards 7.1 and 7.2

(1) The administration of a corporation in liquidation is a public responsibility and should be viewed as part of the overall regulation of corporations. It is possibly best handled by a specialist government agency, which must be adequately resourced and financed.

(2) The law should require that creditors are informed of the progress of the administration at relevant stages.

Application of Good Practice Standards 7.1 and 7.2 in the RETA Economies

Economy	A = Applied P = Applied in part N = Not Applied	
	Standard 7.1	Standard 7.2
Hong Kong, China	A	A
India	P	P
Indonesia	P	A
Japan	A	A
Korea	A	A
Malaysia	A	A
Pakistan	P	P
Philippines	A	A
Singapore	A	A
Taipei, China	A	A
Thailand	A	A

162. The law in most of the RETA economies applies both these standards. However, in some of the economies there are problems in the execution. It is often slow, inefficient and lacks a commercial approach. This is due to a lack of knowledge and expertise in the government agencies. That, in part, is the product of inadequate staffing and resources. It should be observed, however, that many of the more developed countries suffer from similar problems. The need for a professionally managed and operated government department or agency has not been sufficiently recognized.

163. In Pakistan, India and Indonesia the public agencies that administer liquidations are not adequately resourced to enable the administrations to be conducted efficiently. Hong Kong, China and Singapore provide the best examples and models of a properly resourced, professional government agency of the kind that is needed to efficiently conduct the large bulk of corporate liquidations.

164. In a number of the RETA economies there is a need for technical assistance to provide more knowledge, training and expertise for the government administration agencies.

H. Rescue: Provision of Information

165. One of the most important issues for a rescue process is the conduct of a thorough independent assessment of the business activities, assets and liabilities and general affairs of the debtor corporation. Transparency of the process is important. It is ultimately for the creditors to determine on a course of rescue or otherwise for a debtor. It follows that the creditors must be provided with all relevant information concerning the debtor, its assets and liabilities, financial position and affairs generally so that they may make an informed decision.

166. The law must, therefore, proscribe, in broad terms, the substance of the information to be provided and how and when that information is to be provided. In some jurisdictions this has been developed to the point of devising standardized information schedules. Sometimes this is left to the debtor to provide (with sanctions for false or misleading information) or for the information to be gathered and presented by an independent person.

167. If it is proposed that the business of a debtor will continue to be conducted, other important information will include matters such as projections of profit/loss, cash flow, marketing, industry trends and so forth. Although it may not be considered necessary for the law to exhaustively detail the provision of this type of information, it can be beneficial in countries that have little experience of formal (or informal) rescue techniques if the law provides some detail of the type of information that is expected.

168. Other important information to be provided to creditors concerns:

- an analysis of the causes or reasons for the financial difficulty or insolvency of the debtor; and
- a disclosure and review of past transactions of the debtor which may be capable of avoidance under the avoidance provisions of the insolvency law.

169. If the provision and critical analysis of information is left to the debtor alone, there will be no objectivity in its presentation and assessment for creditors. It is therefore important to provide for the appointment of an independent person to, at least, review and comment on the information.

Good Practice Standards 8.1 and 8.2

- (1) The law should prescribe, as fully as possible, for the provision of relevant information concerning the debtor.
- (2) It should also provide for independent comment and analysis on the information.

Application of Standards 8.1 and 8.2 in the RETA Economies

Economy	A = Applied P = Applied in part N = Not Applied	
	Standard 8.1	Standard 8.2
Hong Kong, China	P	A
India	P	N
Indonesia	A	P
Japan	A	A
Korea	A	A
Malaysia	P	P
Pakistan	P	N
Philippines	A	P
Singapore	A	A
Taipei, China	A	P
Thailand	A	P

170. The laws in most of the RETA economies endeavor to apply these standards but with varying degrees of effectiveness. The RETA economies that have more recently enacted formal reorganization processes, such as Singapore, Thailand, Indonesia and Philippines, attempt to provide the greatest application. The Singapore judicial management law provides an excellent model.

171. However, the position in Thailand, Indonesia and Philippines is not entirely satisfactory because of problems associated with the appointment of an independent expert or advisor to ensure that the provision of information is handled professionally and objectively.

172. In a number of the RETA economies there appears to be a cultural or commercial aversion to the employment of professional experts and advisors. This is often more an issue of expense and cost than anything else. It may be an extension of a similar reluctance on the part of ‘family’ controlled corporations to employ management and finance expertise or to retain independent executive directors as members of the management board.

173. Ultimately this type of problem places a severe strain on the reorganization process. Unless there is a willingness for the appointment of independent professionals both debtor and creditors become suspicious and skeptical of the process. Invariably that strain carries through to the courts. In some jurisdictions they are expected to be the arbiter between creditors and debtor and to exercise commercial judgement in supervising the process. This is not a role to expect a court to play in the commercial environment of reorganization.

I. The Position and Role of Creditors

174. **General.** Unless creditors are involved in the insolvency process the law will seem irrelevant. Although, in the case of liquidation, the creditors may not have much need for intervention or decision, it

is nonetheless important that they be involved and receive reports on the conduct of the liquidation. In the case of a rescue, the creditors are vitally important.

175. A rescue process is largely the province of creditors working, hopefully, in concert with the debtor. Creditors are vital to the process. They need to be organized, available and involved. A rescue or reorganization process should, in effect, create a market place of its own where the bargaining, dealing and negotiation of people of commerce can be given full and fair effect.

176. The interests of creditors should prevail in decision making as part of the rescue process. That is dictated by the fact that, because the corporation is insolvent or in extreme financial difficulty, the capital or equity of owners will have been severely depleted, if not completely lost and, although they have been affected, it is the creditors whose interests should become paramount. It should be the decision of the creditors that will determine whether a proposal of rescue is accepted or not (and, under some regimes, if it is not accepted, that the company be liquidated).

177. **Meetings.** Meetings of their number as a whole are obviously important. Also important is the selection, appointment and formation of a small committee of their number, which can take a more active and involved role in considering the adequacy or otherwise of information, the formulation of a plan and, possibly, the implementation of a plan. Meetings, to be effective, require organization and control. Rules and procedures are required to deal with such things as the calling of meetings, the eligibility of persons to attend and participate in meetings (including voting rights and establishing quorum) and the chairing and general conduct of meetings.

178. **Classes of Creditors.** The interests of which account should be taken are secured creditors, preferred (or priority) creditors, unsecured (or ordinary) creditors and persons who own property which is used, leased or occupied by the corporation. Sometimes, depending upon policy dictates, account is also taken of employees as a further separate interest group.

179. It is probably safer to provide for classes of creditors, although some jurisdictions appear to function quite well without an immense or any detailed structure or sophistication in this area.

180. The law should be sensitive to the position of secured creditors. If the rescue proposal is such that it might affect secured creditors (in the sense of reducing the value of their security or seriously impairing their rights to enforce the security), they should normally be afforded voting rights as a separate class.

181. **Voting.** As between creditors themselves, a system of voting rights and their exercise is used to distinguish between creditor interest groups; and bind creditors to decisions reached in accordance with the exercise of voting rights. Much may be written on the issue of voting rights and their employment. But essentially this may be reduced to two issues – voting rights and powers; and the effect of a majority vote.

182. For reasons of principle, policy and pragmatism, an insolvency law, despite that it is a collective legal process, cannot accord equality to different, competing interests; nor depend upon the need for unanimity within different interest groups for its application. However, it is most necessary that the process have binding effect.

183. In many jurisdictions the voting rights of creditors are measured by reference to their number and the value of the debts owed to them. Thus, for example, the approval of a proposal of rescue might require a majority vote in both number and value. This can sometimes produce the problem of a deadlock. There may be a majority in number but not a majority in value or vice versa. In some jurisdictions simple majority in number determines voting only. The effect of a majority vote to approve a plan should be to bind all creditors. Likewise, the effect of a majority vote not to approve a plan should result in or lead to a conversion of the administration process to one of liquidation.

184. 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, adjournments should be kept within reasonable limits and strict time limits should apply. The prospect that a debtor will be liquidated unless agreement can be reached produces a powerful incentive for the efficient operation of the reorganization process.

185. **Manipulation.** Under any system of voting it is important to ensure that voting powers are not manipulated and that the interests of genuine creditors are not interfered with nor prejudiced by the voting powers of persons who are connected to the corporation. These are commonly referred to as ‘insiders’ – persons who have some intimate connection or relationship with the debtor, its directors, managers, owners and shareholders. The law must ensure that the rights of commercial creditors are not abused else they will be totally disaffected by the process.

Good Practice Standards 9.1, 9.2, 9.3, 9.4 and 9.5

- (1) An insolvency law should make proper provision for the involvement of creditors as part of the liquidation or rescue process.**
- (2) An insolvency law should clearly define the voting rights of creditors and should prescribe minimum requirements for the approval of a plan of rescue.**
- (3) Provision should be made for voting by classes of creditors, particularly secured creditors, if the rescue proposal is required to bind such classes.**
- (4) The law should provide protection against manipulation of the voting system and, in particular, should ensure that a court or other tribunal is empowered to set aside the results of voting which are obtained by the exercise of votes of insiders or persons who are related to the corporation, its shareholders or directors.**
- (5) The effect of a vote of the requisite majority of a class should be made binding on all creditors of that class.**

Application of Good Practice Standards 9.1, 9.2, 9.3, 9.4 and 9.5 in the RETA Economies

Economy	A = Applied P = Applied in part N = Not Applied				
	Standard 9.1	Standard 9.2	Standard 9.3	Standard 9.4	Standard 9.5
Hong Kong, China	A	A	P	P	A
India	A	A	P	P	A
Indonesia	A	A	P	P	A
Japan	A	A	A	P	A
Korea	A	A	A	P	A
Malaysia	A	A	P	P	A
Pakistan	A	A	P	P	A
Philippines	P	P	N	N	A
Singapore	A	A	P	A	A
Taipei, China	A	A	A	P	A
Thailand	A	A	A	A	A

186. In general there is high creditor involvement in the reorganization process, which is of cardinal importance. The only exception appears to be in the Philippines where there has been an absence of organized creditor involvement in the reorganization process. However, the new procedural rules appear to provide for greater creditor consultation and involvement. Indonesia makes no provision for classes of creditors.

187. There appears to be a weakness in some of the RETA economies regarding the possibility of 'insider' voting manipulation. This is because either the law makes no specific provision and leaves such issues to be determined by the courts or the law is not sufficiently specific.

188. Voting requirements for approval of plans of reorganization vary considerably and demonstrate a remarkable range. This can be as low as a simple majority vote to a majority as high as 75% and in some economies there is a requirement for a dual standard of majority both of number and in aggregate debt of creditors.

J. Formulation of a Reorganization Plan

189. Three main aspects must be considered. First, what should be the nature or form of a plan? Secondly, what opinions or comments should accompany a plan? Thirdly, who should devise a plan?

190. **Nature or Form of Plan.** The purpose of rescue is to maximize the possible eventual return to creditors and provide a better result than if the debtor were, hypothetically, liquidated. It follows that the law should not intrude greatly or at all in proscribing the nature or form of a plan. It should not, for example, permit only of a plan 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 leave it to the market place to determine what is the appropriate commercial solution.

191. Of course, there may be some boundaries that some jurisdictions might want to establish. For example, that the preference or priority accorded to some classes of creditors in, for example, a liquidation must be maintained in a rescue plan. Or that the effect of the plan must not be such that it could result in a debtor remaining insolvent and being returned to the market place in that condition.

192. A non-intrusive approach regarding the nature or form of a plan is desirable. This enables any one of a number of possibilities to result. It could be a simple 'composition'; it could provide for the continued trading of the business and for its eventual sale as a going concern (and for the debtor to then be liquidated); it could provide for a sophisticated form or restructuring of debt and equity and so forth.

193. **Comments on a Plan.** It further follows that if the nature of the rescue process is to provide a better eventual result for the creditors than if the debtor was liquidated, there should be some objective statement from an independent adviser to that effect. Likewise, that if a plan projects an eventual satisfaction (whether by composition or otherwise) of debts or other liabilities, some objective statement of the commercial probability of that should accompany the proposed plan.

194. **Devising a Plan.** The final issue of who should have the responsibility of devising a plan is, in a commercial sense, dictated by the reality that a number of people may be expected to play a part. Certainly it may be expected that the management (and/or 'owners') of a debtor should have a major and, possibly, the principal role. But so would an independent adviser if they are expected to comment on a proposed plan. Major creditors may also expect to be involved – possibly not so much to initiate but certainly to participate in and negotiate the generation of a suitable plan. It may not, therefore, be necessary for the law to become intensely regulatory in this area. In the interests of certainty and efficiency, however, it is desirable that the law make some statement on those aspects and that a specified time limit is provided for the presentation of a plan.

195. This last observation is important because a tight time frame for the presentation and consideration of a plan places desirable pressure on both the debtor and the creditors to endeavor to reach a satisfactory arrangement. Combined with a provision of the law that will effect a conversion to liquidation unless a plan is agreed within a limited period of time, a commercial environment is created that causes both sides to work toward a beneficial result.

Good Practice Standards 10.1, 10.2 and 10.3	
	(1) The law should not proscribe the nature of a plan, except in regard to fundamental requirements and to prevent commercial abuse. In particular, the law should not intrude into the ‘commerciality’ of a plan except to ensure that the result of a plan will provide a greater benefit to creditors than in a liquidation of the debtor.
	(2) The law should provide for objective analysis of a proposed plan by an independent adviser. In particular, it should be demonstrated that the proposed result or effect of a plan is commercially sound.
	(3) The law should provide for a plan to be provided, nominally by the debtor, within a specified period of time.

Application of Good Practice Standards 10.1 10.2 and 10.3 in the RETA Economies			
Economy	A = Applied P = Applied in part N = Not Applied		
	Standard 10.1	Standard 10.2	Standard 10.3
Hong Kong, China	P	P	P
India	P	P	P
Indonesia	P	P	A
Japan	P	A	P
Korea	P	A	P
Malaysia	P	P	P
Pakistan	P	P	P
Philippines	P	P	A
Singapore	A	A	A
Taipei, China	P	A	P
Thailand	A	P	A

196. Most of these standards are applied in most of the RETA economies. However, there are some areas to which attention should be directed. With the exception of Singapore and Thailand, none of the insolvency laws provide that the result (or intended result) of a plan must provide a greater benefit to creditors than if the debtor corporation was liquidated. This is, in part, compounded by the absence, in some of the RETA economies, of a requirement for an objective analysis of a plan.

197. In some instances these omissions place an unnecessary burden on the supervising court or tribunal and may require the court or tribunal to form some judgement of its own on the plan. That may be considered desirable because it at least provides some protection for creditors, but it detracts from the ‘commercial’ forum that a reorganization process should endeavor to establish so that the participants can form their own judgement based on objective evidence and opinion. Without that essence the process becomes an essentially ‘legal’ and constricted process.

198. It is suggested that this area of the law might be greatly improved in some of the RETA economies. Two examples follow.

- The Indonesian reorganization law makes provision for an independent trustee to provide a report on the proposed plan but it does not specify that an objective critical analysis of the plan must be part of the report. This would be a valuable addition to the Indonesian process.
- In Thailand there are problems in securing an independent person as the planner of the plan of reorganization because of both fear of loss of control and an aversion toward paying for the services of an experienced and professional person. Yet it is clearly important in that jurisdiction that the rehabilitation process have every characteristic of a commercial forum. The position in Thailand would be greatly improved by the establishment of a body of independent, qualified planners.

K. Control/Supervision of Process

199. This leads to a consideration of the most appropriate role for a court or tribunal to perform in the rescue process. The obvious areas in which a court or tribunal involvement is desirable are these:

- To ensure that the process is efficiently conducted. This, it should be observed, is not just the province of the court. The law itself should provide the rules of procedure and time. But there should be no objection to a court or tribunal taking on a 'case management' role and driving the process forward.
- To ensure that the process is conducted fairly and in accordance with proper procedures. This requires that those 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 for appropriate redress.
- To resolve problems or disputes that may develop. Even the most detailed of legislative procedures cannot provide for every eventuality or avoid problems in application or interpretation. It is desirable that the law provides the court with a general power to avoid or overcome technical and non-material problems and difficulties.
- To determine whether an approved plan is unfair and not in the best interests of the creditors as a whole. This raises the issue of the part the court might be expected to perform in approving or sanctioning a plan. It is questionable whether any further formality is required after the creditors have made their decision. There seems little point in requiring, other than as a possible necessary legal formality, a court to approve or sanction a plan. Judges should not be required to 'second guess' the decision of people of commerce. However, this is not to suggest that a court, tribunal or other regulatory body should not need to be satisfied that the decision of the creditors has been properly obtained and the necessary pre-conditions were satisfied. That power might be better expressed by giving the court or tribunal a general supervisory power to review, on cause shown by an affected and dissatisfied party. This would provide a minority of creditors with the right to challenge a plan or attack the means by which it was procured (for example, by the influence of 'insider' votes). It is an important balancing power.

Good Practice Standard 11

The law should provide for a court or other tribunal to have a general supervisory role of the rescue process. In particular the court or tribunal should be empowered to set aside the approval of a plan if it is shown that it is not in the best interests of creditors considered as a whole.

Application of Good Practice Standard 11 in the RETA Economies

Economy	A = Applied P = Applied in part N = Not Applied
Hong Kong, China	A
India	A
Indonesia	P
Japan	P
Korea	P
Malaysia	A
Pakistan	A
Philippines	P
Singapore	A
Taipei,China	P
Thailand	A

200. In some of the RETA economies a considerable supervisory burden is placed on the courts because of deficiencies in other parts of the law relating to the provision of information, the preparation of a plan of reorganization and the conduct of meetings of creditors to consider and approve the plan. The comments made in relation to Standard 10 are relevant to this standard. For example, in Japan, Korea, Taipei,China and Indonesia, the control or function of the courts is very involved. This contributes to considerable delay in the process.

201. In the Philippines, the SEC, which acts in an extra-judicial capacity, has a quite extraordinary power to set aside the decision of a majority ‘non-approval’ vote of the creditors in relation to a proposed plan of rehabilitation. The SEC can, in effect, impose a plan upon creditors if it is of the opinion that the ‘non-approval’ of the majority is ‘manifestly unreasonable’. That runs quite contrary to the above standard.

L. Implementation of Plan

202. Most plans will be executed without a great deal of need for further intervention. Sometimes, however, it might be necessary that the implementation be supervised or controlled by an independent person.

203. Of more importance, however, is what occurs if execution of the plan breaks down or is found to be incapable of performance. Many jurisdictions provide for the possibility of a plan being amended if that is in the interests of creditors. But if a plan becomes impossible of performance (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.

Good Practice Standards 12.1, 12.2 and 12.3

- (1) Provision should be made for the possibility that the execution of a plan may require supervision or control by an independent person.
- (2) A plan should be capable of amendment (by vote of the creditors) if it is in the interests of the creditors.
- (3) The law should provide for the debtor to be liquidated upon the termination of a plan as a result of non-performance of the plan.

Application of Good Practice Standard 12.1, 12.2 and 12.3 in the RETA Economies			
Economy	A = Applied P = Applied in part N = Not Applied		
	Standard 12.1	Standard 12.2	Standard 12.3
Hong Kong, China	P	P	N
India	P	P	N
Indonesia	P	P	P
Japan	A	A	N
Korea	A	A	N
Malaysia	P	P	N
Pakistan	P	P	N
Philippines	A	P	P
Singapore	A	P	N
Taipei,China	A	A	N
Thailand	A	P	A

204. The laws of some of the RETA economies are not sufficiently explicit regarding supervision or control of the implementation of a plan. In practice this may not present a problem if the plan is implemented. But it can present a serious problem in the event that the plan may require amendment or cancellation.

205. Likewise, many of the laws are silent regarding the possibility of and the procedure for amending a plan. In Indonesia, for example, the provisions for supervision or execution of a plan are weak. In particular, there are no adequate provisions for possible amendment of a plan or for the termination of a plan if there is a failure to perform. The most notable failing, however, is that only a very few of the insolvency laws in the RETA economies make it clear that the failure of a plan should lead to the immediate liquidation of the debtor corporation.

M. Creditor Priorities

206. A major difference in insolvency law regimes is in the ranking of preferred or priority creditors. Many insolvency law regimes, for example, provide that debts such as tax debts and debts due to employees are to be paid in full, ahead of all other creditors. To give greater effect to one of the underlying principles of an insolvency law - equal treatment for creditors - the modern approach is to limit priority claims as much as possible. Clearly, secured creditors are entitled to be paid their claims from the proceeds of secured property. It must also be the case that the costs of the insolvency administration (whether under a liquidation or rescue process) should be paid in priority to any other claim. However, with those exceptions, it should be the aim of a modern insolvency law regime to limit the number of priority claims to as few as possible.

Good Practice Standard 13

An insolvency law regime should, as far as possible, preserve the principle of equal treatment for all creditors. Accordingly, the insolvency law should limit the number of priority claims to as few as possible.

Application of Good Practice Standard 13

Economy	A = Applied P = Applied in part N = No Applied
	Standard 13
Hong Kong, China	P
India	P
Indonesia	P
Japan	P
Korea	P
Malaysia	P
Pakistan	P
Philippines	P
Singapore	P
Taipei, China	P
Thailand	P

207. Very few of the RETA economies have sought to limit priority claims. In Indonesia, for example, there is a long list of priority claims and taxation claims are given priority over all other priority claims.

208. It is recommended that all of the RETA economies should review the priority provisions of their respective laws and consider whether policy, economic and commercial considerations support their retention. In cases where some creditor claims are given priority ahead of secured creditors from the proceeds of the sale of secured property, carefully consideration should be given whether such a policy is justified.

N. Avoidance of Transactions

209. One of the more extraordinary policies of established insolvency law regimes is to include provisions, which have retrospective effect. These are designed to upset and overturn past transactions to which an insolvent corporation was a party that have had the effect of either reducing the net worth of a corporation (for example, by gifting its property or transferring or selling property for less than its fair commercial value) or of upsetting the principle of equal sharing between creditors of the same class (for example, by payment of a debt to an unsecured creditor or granting a security to a creditor who is otherwise unsecured when other unsecured creditors remain unpaid).

210. This aspect of an insolvency law regime is much debated. The debate centers not so much on the policy behind such provisions but on how effective in practice such provisions are and the somewhat arbitrary rules that are necessary to define, for example, relevant time periods and the nature of the transactions themselves. There is some validity in the criticism that the actual operation and enforcement of such provisions is not, in many cases, effective.

211. Nonetheless, it may be submitted that avoidance provisions are important because, first, they are sound in policy; secondly, they may result in recovery for the benefit of creditors; and thirdly, provisions of

this nature help to create a code of fair commercial conduct and are part of appropriate standards for corporate governance.

Good Practice Standard 14

An insolvency law regime should contain adequate provisions relating to avoidance of transactions, which result in damage to creditors or conflict with the principle of equal treatment of creditors of the same class.

Application of Good Practice Standard 14 in the RETA Economies	
Economy	A = Applied P = Applied in part N = Not Applied
	Standard 14
Pakistan	A
India	A
Singapore	A
Malaysia	A
Hong Kong, China	A
Japan	A
Korea	A
Taipei, China	A
Thailand	A
Indonesia	A
Philippines	A

212. Considerable care must be taken with this assessment because, although all of the insolvency laws in the RETA economies contain avoidance provisions, in some laws the provisions are expressed vaguely (for example, in the Indonesian law) and there is some considerable doubt about their effectiveness and application. It is difficult to be precise about the degree of application in practice. Some of the local studies suggest that there is a considerable failure to apply this part of the law. In part, this appears to be due to the absence of professional experienced insolvency administrators who have the ability and skill to properly investigate suspect transactions and to then prosecute their avoidance. In some of the RETA economies the judges may not have the necessary experience and knowledge to conduct avoidance cases.

213. This is an area in which training and education is especially required as part of a general training and education technical assistance on the operation and administration of an insolvency law regime.

O. Civil Sanctions

214. The conduct and behavior of owners and directors of a corporation is primarily a matter of corporate law policy and regulation. It should not, for example, fall to an insolvency law to remedy defects in that area of legal regulation or to police corporate governance policies. However, if the consequence of the past conduct and behavior of persons connected with an insolvent corporation is that damage and loss is caused to the creditors of the corporation (for example, by fraud or irresponsible behavior), it is the appropriate province of an insolvency law to provide for the possible recovery of the damage or loss. This should extend to powers of inquiry and examination.

Good Practice Standard 15

An insolvency law regime should contain provisions for the civil sanction of fraudulent and other like conduct in the operation and management of a corporation, which causes damage or loss to creditors of an insolvent corporation.

Application of Good Practice Standard 14 in the RETA Economies

Economy	A = Applied P = Applied in part N = Not Applied
	Standard 15
Hong Kong, China	A
India	P
Indonesia	P
Japan	P
Korea	P
Malaysia	P
Pakistan	P
Philippines	P
Singapore	A
Taipei, China	P
Thailand	P

215. Although most of the laws in the RETA economies contain some provisions relating to this standard, it is highly questionable whether they are applied or enforced. The comments made in relation to Standard 14 are apposite here. It is another area that would benefit from special training and education.

P. Cross-Border Insolvency Recognition and Assistance

216. The growth of both regional and international trade and commerce has focused attention of the many problems associated with cross-border insolvency. The trading and business activities of a corporation (particularly the “multinational” form of corporation) may result in the corporation having businesses, assets and trading activities in more than one country. If such a corporation becomes insolvent and is subject to an insolvency administration in one jurisdiction it becomes important that the other jurisdictions in which its business activities are situated can respond to and, hopefully, cooperate in the overall administration of the corporation. This is a particularly important factor in relation to a corporation that is proposing a rescue.

217. A number of initiatives have been taken in an attempt to provide for the effects of cross-border insolvency cases. A number of countries have enacted unilateral recognition legislation as part of their domestic insolvency law. Examples of this are found in the insolvency law regimes of USA, England, Australia and Canada. Although provisions such as these are reasonably effective, they suffer from the fact that they are unilateral (and, therefore, one sided), they are usually restrictive and confined in their application and sometimes they may be discriminatory and unpredictable in their application.

218. There are two examples of a multilateral treaty approach. The most effective is between the countries of Scandinavia (Sweden, Norway, Denmark and Finland). The effect of the treaty is that there is automatic recognition in all treaty states of a case of insolvency adjudicated in one of the treaty

countries. The treaty provides for mutual co-operation and assistance in such cases. The other example of the multilateral treaty approach is found in South America through the Montevideo treaty on bankruptcy. Some of the countries of South America are signatories to this treaty, which has been used on some occasions for mutual recognition of cases of insolvency.

219. The countries of the European Economic Union have attempted, but so far without success, to promote a “convention” on bankruptcy recognition and co-operation. The form of this approach is similar to conventions on recognition and enforcement of judgements.

220. Although not the subject of a treaty or convention, two of the RETA economies, Singapore and Malaysia, have provisions in their respective bankruptcy laws, which provide for mutual recognition of and assistance in cases of bankruptcy originating in their respective jurisdictions. These provisions, however, are confined to cases of individual bankruptcy and do not extend to cases of corporate insolvency.

221. The most recent development has been to propose uniform cross-border insolvency legislation, which would equip every country with similar legislative provisions regarding recognition, relief and co-operation between and with the courts, regulators and administrators of other countries. This has been the thrust of the model cross-border insolvency law proposed by UNCITRAL (May 1987).

222. The UNCITRAL model law has the following important features:

- It enables the institution or person in charge of the administration of a case of insolvency to have access to the courts or tribunal of another country for the purpose of seeking recognition in that other country. Provided some basic conditions or criteria are met, recognition should follow as a matter of course.
- If recognition is granted, basic mandatory relief provisions take immediate effect in the recognizing country (such as a restraint on enforcement or individual creditor rights and on collective insolvency proceedings against the corporate debtor). Other relief may be sought on application to the relevant courts or tribunals of that country.
- For the purpose of the overall administration of the insolvency, the model law places considerable emphasis upon co-operation between the relevant administrative organs, courts and tribunals in each country. This is designed to ensure, for example, that proposals for the possible rescue of a multinational corporate debtor will be enhanced by a co-operative approach toward a plan of rescue and reorganization.

223. The UNCITRAL model law requires adoption by individual countries. Thus far, countries such as USA, Australia, Canada, New Zealand and England have indicated support for the adoption of the model law. It is highly probable that the model law will be substantially adopted in both the USA and in Australia within the next 6 months.

Good Practice Standard 16

An insolvency law regime should include provisions relating to recognition, relief and co-operation in cases of cross-border insolvency, preferably by the adoption of the UNCITRAL model law on cross-border insolvency.

Application of Good Practice Standard 16 in the RETA Economies

Economy	A = Applied P = Applied in part N = Not Applied
	Standard 16
Pakistan	P
India	P
Singapore	P
Malaysia	P
Hong Kong, China	P
Japan	N
Korea	N
Taipei,China	N
Thailand	N
Indonesia	N
Philippines	P

224. The region is extremely weak in this area. In five of the RETA economies, Japan, Korea, Taipei,China, Thailand and Indonesia, the insolvency laws are specifically territorial. Those laws each provide that an insolvency administration originating in their respective jurisdictions shall have no *'territorial'* effect. They further provide that an insolvency administration originating in another country shall have no effect in their respective jurisdictions.

225. In the remainder of the economies co-operation and assistance regarding insolvency cross-border insolvency administrations may be possible but only by the application of discretionary and uncertain basic law principles. As previously mentioned, only Singapore and Malaysia have specific legislative cross-border insolvency provisions between them. However, these provisions only apply to cases of individual bankruptcy.

226. It is recommended that a regional technical assistance review this area in the region to assist in the development of legislative provisions for cross-border co-operation and assistance in insolvency cases. This legislation should be largely based on the UNCITRAL cross-border insolvency model law provisions.

V. INFORMAL PROCESSES

A. Origins and Development

227. **Origins:** The concept of the informal work-out emerged some ten years or so ago in the USA and England, as an alternative to the application of formal insolvency law processes. Some commendable pioneering work to encourage the development of this approach was done, in a non-official capacity, by the Bank of England. It has since been further developed by some of the leading English

commercial banks. This development has become known as "the London approach". In America, the concept of the informal work-out has become possibly more developed. It is now sometimes used as the preliminary to that which has become known as a "pre-packaged" chapter 11. In recent years the practice and development of the informal process has spread to many countries. It has recently been enhanced by an endeavor, through the initiative of major bank and other financial groups, to determine acceptable work-out standards. These are being refined and proposed in the form of a *Protocol on Global Approach to Workouts*, by the Lenders Group of INSOL International. The standards have been formed in consultation with the banking and financial sector, representatives from treasury departments of large corporations and representatives of central banks. Although it may seem to be a somewhat institutional development, the approach to work-outs in the protocol remains a purely voluntary process.

228. **Reasons for Development:** The reasons for the development of the informal process are important because they suggest that even the more developed and "modern" formal rescue regimes are not always entirely suitable to the task of rescue. It is claimed that, first, there is a need for something more flexible and less rigid than the process which is available under formal insolvency rescue regimes and that, secondly, many cases of corporate financial difficulty require much earlier pro-active response from creditors which is not normally possible under the formal rescue regimes. It is also suggested that, because of the essentially private nature of the process, there is less publicity and less commercial damage for the debtor.

B. Conditions and Processes

229. **Necessary Conditions:** The informal work-out depends for its effectiveness on a number of well-defined initial premises. These may be summarized as follows:

- the fact that a corporation owes significant debt to a number of bank or other financial institution creditors and the present inability of the corporate debtor to service that debt;
- the attitude that it may be preferable to negotiate an arrangement for the financial difficulties of the corporate debtor, as between the corporate debtor and the financiers and also between the financiers themselves;
- the use of relatively sophisticated refinancing and other commercial techniques that might be employed to alter, rearrange or restructure the debts of the corporate debtor or the corporate debtor itself;
- the prospect that there may be a greater benefit through the negotiation process than by direct and immediate confrontational resort to the insolvency law; and
- the sanction that if the negotiation process cannot be started or breaks down there can be relatively swift and effective resort to the application of an insolvency law.

230. Of these, it is possibly the last factor that provides the main impetus to bring the creditors and the debtor together. That is yet another reason why an efficient insolvency law is important.

231. **Main Processes:** To be effective a work-out also requires the employment of a number of skills and processes. **Appendix 3** presents a diagram of a typical informal process. The most important of these processes are the following:

- The creation of a "**forum**" in which debtor and creditors can initially come together for the purpose of exploring and negotiating an arrangement to deal with the financial difficulty or insolvency of the debtor. This "forum" is not only for the benefit of the debtor and its creditors, but also for the creditors, between themselves.

- The appointment of a "**lead**" **creditor** to provide leadership, organization, management and administration.
- The selection of a committee which is representative of creditors (commonly called a "**steering**" **committee**) to assist the lead creditor and to act as a provisional sounding board toward proposals for the corporate debtor.
- A "**standstill**" (an agreement to suspend adverse actions by both creditors and the debtor) during a defined, preferably short, time period. The standstill may be compared to the "moratorium" or stay of actions and proceedings, which has become an important feature of formal rescue insolvency law regimes. In essence, the 'participants' in the proposed work-out (the creditors) agree not to improve their position relative to each other. The debtor agrees not to change its position other than in the normal conduct of its business.
- The gathering and provision of complete and accurate **information** regarding the corporate debtor, including its business activities, current trading position, general financial position and assets and liabilities. This may be compared to the statutory requirement for the provision of similar material, which is found in most of the formal rescue regimes.

(i) Commencing the Process

232. A work-out essentially involves bringing debtor and creditors (at least, the main creditors) together. Someone has to initiate the prospect of intercourse. This is really up to the debtor and/or one or more of the main bank creditors. The informal work-out process does not rely upon a facilitator to impose, initiate or help the process along.

233. Sometimes commencement poses difficulties. A corporate debtor may, for example, be willing to have negotiations with its main bank creditor (who might be expected to be in a position of considerable control) but may be unwilling or not appreciate the desirability of discussions with a number of creditors. As between the creditors themselves, some of them will be concerned for their own position and may not wish to participate in or contemplate a "collective" approach.

234. These types of problems can sometimes be overcome. An approach has been to use the sanction of quick and convenient access to both individual debt enforcement processes and formal insolvency law procedures as "bargaining" factors in the commencement and progression of an informal work-out. The availability of this type of "shadow" sanction can influence both a corporate debtor and its creditors. If a corporate debtor refuses or is reluctant to participate in an informal process, it will almost certainly lead either to individual debt or security enforcement action or the application of the formal insolvency procedures which the debtor will not be able to delay nor defeat. Unwilling creditors face much the same sanction. They may find that they are subject to a formal insolvency process which effectively prevents them from enforcing their individual rights and may not represent the most optimal process for creating the most value.

(ii) Engaging Advisors

235. Few, if any, attempts are made at a work-out without the involvement of independent experts and advisors from various disciplines (for example, legal, accounting, finance and business reorganization, marketing). It is often the corporate debtor, sometimes creditors, who will refuse to engage or suffer the appointment of such persons because of cost, intrusion, and a reluctance to surrender control and other reasons. But it is normally a necessity. Information, independently verified, is the prime pursuit of the creditors together with professionally developed plans of refinancing, restructuring, management and operation.

236. The contention of the creditors, which would seem somewhat indefensible, is that this would normally occur under a formal insolvency rescue regime and it should also occur in the informal situation.

(iii) Classes of Creditors

237. Creditors will rarely be in the same position as one another. Some will have security and others will have better security than others. There may be issues between creditors of competing priority rights (or rights generally) in respect of the same security property. Unsecured creditors may also have different rights. Some may have guarantees from third parties. Lease finance creditors may have rights to recover leased equipment. Some creditors may be subrogated to others.

238. This complexity often presents critical problems, particularly if the aim of the process is to maintain the assets and business undertakings of the corporate debtor together. If some creditors have commenced recovery or enforcement action it may be difficult to dissuade them from continuing with that enforcement.

239. The prospect of a work-out breaking down because of the differences between creditors can only be dealt with by a combination of two things. First, the persuasion that there is a prospect of a better result through the work-out process and, secondly, the threat of the sanction of imposing a formal insolvency process that will have the effect of restraining all creditors from pursuing individual rights.

(iv) Dissenting Creditors

240. Unanimity amongst creditors cannot be anticipated nor expected. In part, the problem of dissenting creditors can only be dealt with as mentioned above or by the application of some "peer" group pressure on the dissenting creditor. This is not uncommon in established banking sectors. But, because it is an informal process there are no rules of enforcement by which a dissenting creditor may be compelled or bound to the view of the majority.

241. This sometimes results in the trading of "distressed" debt. A bank creditor may not, for example, be willing to participate in the work-out process or may not be prepared to wait or renegotiate the eventual repayment of the debt. There are debt traders who might be prepared to acquire the debt. If this occurs the debt trader becomes the creditor and engages in the work-out. This can produce a culture clash because bank creditors and distressed debt traders come from different backgrounds and exhibit different approaches toward debt recovery.

(v) Outside Creditors

242. In most cases of informal work-outs it is impossible to involve every creditor in the work-out process. One problem is often the sheer number of creditors. Another is the inefficiency of involving creditors who are owed small amounts. Yet another problem is that many creditors do not have the commercial expertise and knowledge to participate in the process. But, even though they may be left out from the "forum", they cannot be forgotten nor ignored. Some of them may be important. They might be suppliers of essential goods or services or they may participate in essential parts of the production process of the debtor corporation.

243. It is often the case in an informal work-out that smaller creditors are paid in full and encouraged to continue their supplies of goods or services. From the perspective of the major creditors, this type of "favoritism" does not normally cause much harm. An alternative approach is to secure agreement of the main (bank) creditors to a reorganization plan and then use the plan as the basis of a formal court-controlled reorganization process in which other creditors participate. This can then bind all the other creditors. It is sometimes referred to as a "pre-packaged" plan.

(vi) Cash Flow/Liquidity Problem

244. If a corporation becomes a candidate for a possible work-out it will often require continued access to established lines of credit or the provision of fresh credit. There can be a problem with both. The

normal reaction of a lender will be to terminate or close off access to any further credit. Evaluation and negotiation can only deal with this problem. If a lender is already secured there may not be a problem for that creditor to extend further credit.

245. But the real problem arises when all lines of credit have been exhausted (or terminated) and there is a pressing need for cash flow and liquidity. This can only be provided by what is often referred to as "new money". The problem is whether a creditor or creditors who might be willing to provide this new money can be reasonably guaranteed that, if the worst happens, they will be repaid in full.

246. The creditors who participate in an attempted work-out may agree amongst themselves that if one or more of their number provide "new money", the other creditors will subrogate their claims to enable the "new money" to be repaid ahead of those claims. Thus, as between that group of creditors, there is a contractual agreement for the eventual repayment of the new money to the creditor who provides it if the work-out is successful.

247. However, if the attempt at the work-out does not succeed and the debtor corporation is liquidated, there is a problem concerning the treatment of a claim for the repayment of that new money. Unless there is security for the new money it will be an unsecured claim. Because the liquidation law will normally apply the principle that treatment of creditors in the same class must be equal, the claim for payment of the new money will be the same as any other claim of an unsecured creditor. As a result the creditor who has provided the new money may receive only partial repayment or none at all.

248. The insolvency laws of some countries have provisions which provide for a type of "super priority" to accommodate this type of problem. However, those legislative provisions, have been formed to operate only in the context of a formal reorganization process. It is doubtful that they would extend to cover informal work-out arrangements. This is an area upon which further review and technical assistance may be beneficial.

C. Development and Operation of Informal Work-Outs in the RETA Economies

249. The commercial culture of many of the RETA economies appears to be more conditioned toward non-confrontational dispute resolution by negotiation and mediation and not the employment of strict legal processes. This suggests that there is a relatively firm basis upon which to promote and build the elements that are necessary to structure an informal negotiated approach to the problem of an insolvent or financially troubled corporate debtor.

250. Initiatives at government level to promote the concept of the informal work-out were taken in Indonesia, Korea, Malaysia, and Thailand in response to the financial crisis. As will be seen, these are more formally structured because they are operated through an agency that operates in a semi-official capacity to promote and sometimes supervise work-out cases. The initiatives of Indonesia, Korea, Malaysia, and Thailand are of more comparative interest, but it should be observed that all of these initiatives have been adopted primarily to deal with the financially distressed banking and finance sector. Thus, in each of the economies the informal work-out process as applied to the corporate sector is usually a by-product of endeavoring to deal with non-performing loans in the banking and finance sector. This may help to explain why the processes are more structured and more formal than might otherwise be the case. This factor is also relevant in considering the long term future of the processes.

251. From the statistical evidence that is available, the informal rescue process is clearly the area of the greatest development and success in corporate insolvency in the four RETA economies that have established it. In only a short time since they commenced to operate, the statistics, comments and observations indicate that all the informal initiatives are working reasonably well.

252. Singapore and Hong Kong, China have also commenced to use informal processes. These processes are all largely modeled on the informal work-out technique developed in the USA and in

England. The guidelines are largely based on the “London approach” and do not need any detailed analysis. They have been developed by the commercial banking sector in co-operation with central bank or financial regulatory authority. They are essentially private and non-structural work-out processes, and are non-intrusive, voluntary and non-prescriptive. The basic framework was outlined earlier. Although they are of recent origin, the level of confirmed positive results demonstrates that they are capable of working extremely well.

253. These initiatives are important and deserve appropriate recognition, response and support. In the context of the cultural, social and commercial environment of many of the economies in the region, the development of this technique may prove to be of greater utility, though not necessarily of greater importance, than the development of formal rescue processes. However, it is useful to consider some of the areas in which difficulty has been experienced.

D. Consideration of Work-Out Models in the RETA Economies and Their Recent Operations

(i) Indonesia

254. The Indonesian, Korean, Malaysian, and Thai approaches each provide for a facilitating agency to assist the process. In Indonesia the facilitator is the Jakarta Initiative Task Force, appointed by the President. Its principal functions are to facilitate negotiations; refer cases of “public interest” to the courts under the insolvency law; and to provide a central reference point for obtaining necessary government and other approvals to implement plans of restructure. Working with this agency is an Advisory Committee whose functions include review of the workings of the informal process and making proposals for improvement and new approaches and actions. However, neither the Task Force nor the Advisory Committee may dictate the terms of a restructuring plan. Otherwise the Jakarta Initiative largely follows the “London approach” in process and methodology.

255. Comment: The experience of the Jakarta Initiative is somewhat difficult to discover. The local expert for Indonesia suggested that progress under this initiative has been a lot slower than anticipated and only a few restructurings have been put in place. The process has been also hampered by a lack of co-ordination between the relevant authorities.

256. The report of the World Bank, Corporate Restructuring & Governance Group, of April 1999, stated that the progress in finalizing cases of informal restructuring has been slow. Reasons attributed for this include that both creditors and debtors have been reluctant to recognize losses, the new bankruptcy law has been ineffectively applied, and the complexity of the financial and operational restructuring that is required appears sometimes to be beyond local capacity.

257. The reasons why the operation of the Indonesian informal process initiative does not appear as successful as those of Thailand, Korea or Malaysia appear to be that, firstly, the bank restructuring authority, IBRA, does not appear to exert the same leverage on corporate debtors as its Malaysian counterpart, Danaharta. Secondly, recourse by a creditor to the formal insolvency processes (in particular, liquidation) in respect of a reluctant or hostile corporate debtor does not pose any great threat in Indonesia. Thus there is less motivation for a corporate debtor to engage in a voluntary informal work-out.

(ii) Korea

258. **Korea** established an “Administrative Committee” under its informal process. In turn it has appointed a “Company Restructuring Committee” to act as facilitator. The Korean informal scheme operates on the basis of an agreement between “Creditor Financial Institutions” who have chosen to be bound by the agreement. In effect, a case of possible corporate restructure would involve a corporate debtor of one of these institutions. That institution may invoke the informal process amongst the other institutions in respect of that corporate debtor. Once that occurs a stay or suspension of actions against

the corporate debtor by any of the other institutions that are party to the agreement takes effect, by force of the agreement. The Korean approach is thus more in the nature of a formal agreement between certain banks to work toward the possibility of a restructure. It differs quite considerably from the voluntary informal approach in other jurisdictions.

259. **Comment:** There has been a significant concentration on informal techniques for cases of corporations that are in financial difficulties. In particular, the structured informal process that was created under the direction of the Korean Financial Supervisory Commission has been well utilized. The Korean supplementary local study evidenced a number of successful work-outs through the employment of this process in which a variety of restructuring and refinancing techniques have been employed. These have included reduction of share holding of owners; debt/equity swaps among bank creditors; sale of non-core assets.

260. However, despite the apparent success of the process, there are some concerns that it is not operating as efficiently as it might. Problems are seen in a number of areas, such as:

- The inter-bank agreement only binds those financial institutions that have signed it. Thus, other creditors may still pursue their individual rights and frustrate or impede the process;
- There is a fundamental difference of approach between financially troubled companies and the financial institutions. The former seek the input of new capital, the latter emphasize short term retrieval of loans; and
- Often there is a considerable dispute regarding the continued management of the corporation.

261. It is considered that training and education, especially at management level, in work-out techniques, assessment of long term risk and negotiation would be of assistance.

(iii) Malaysia

262. In **Malaysia** there is a two-tiered system. First, the CDRC informal corporate debtor process. This process is operated through a Steering Committee, which convenes meetings between debtors and creditors to assist in each case of informal rescue. A permanent administrative Secretariat has been established by the central bank, Bank Negara Malaysia. Its function is to provide administrative and other support to the Steering Committee. It receives applications for the implementation of the informal process. An outside professional adviser has also been appointed to assist in formulating guidelines in the operations of CDRC and also to conduct a series of workshops and seminars to increase the level of public awareness.

263. Secondly, as regards the banking and financial sector, a statutory corporation known as 'Danaharta' was established with very wide powers to deal with distressed banks and other financial institutions. It has focused on the acquisition and management of non-performing loans in the banking sector. These loans are owed from the corporate sector. Once Danaharta acquires a non-performing loan from a bank it has an extraordinary wide range of powers with which to deal with the corporate debtor.

- Endeavor to broker an informal work-out with other creditors;
- Participate in an informal work-out through the CDRC. It can be the catalyst in encouraging or persuading a debtor corporation to submit itself to this informal process.
- Participate in a formal scheme of arrangement;

- Appoint receivers and managers to a debtor corporation (assuming there is power to do so in the security documentation);
- Enforce security rights through power of sale unaffected by the usual restraints on sale that might affect other secured creditors; and
- Appoint special managers to a debtor corporation and then assume an extra-judicial role of approving a proposed plan of reconstruction.

These are very strong extra-judicial powers.

264. **Comment:** In respect of the CDRC informal work-out process, the Malaysian local expert observed that although it is not very efficient or fast, it has been a major step in the right direction for Malaysia. The main problems seem to be that:

- The CDRC process does not cover small/medium sized corporate debtors;
- There is a problem for corporations that have 'new money' requirements for urgent working capital needs;
- There is difficulty in ensuring that secured bank creditors fully participate in the informal process;
- There is a problem in obtaining agreement on the appointment of professional expert consultants to ensure that the financial and other affairs of the corporate debtor are fully analyzed to provide a constructive commercial basis for a plan.

265. The views of some foreign bank officials in Malaysia indicated that their experience of CDRC is fairly favorable. They comment, however, that sometimes the rescue proposals that are made are not in the best interests of creditors as they might be or are too optimistic and non-commercial. There is not sufficient attention to detail, analysis, and verification of future income, cash flow projections and the like. Local banks tend to favor acceptance without proper analysis. Other comments include that local banks are not yet experienced enough; they send junior staff to meetings and do not respond to proposals and other deadlines on time. This can be particularly frustrating for lead bank and steering committees.

266. The CDRC itself has proposed administrative and other changes to improve the process. These proposals include that CDRC will itself take over the negotiation of appointment of consultants if there is prolonged disagreement and that three more members (from the banking sector) will be added to the steering committee. It is the steering committee that analyses proposals before creditors consider them. At present too many of these proposals come through the process without adequate analysis, causing inefficiency and delay.

(iv) Thailand

267. The approach in Thailand is, again, different. The structured informal process has been significantly assisted by the production of standard form 'Inter-Creditor' and 'Debtor-Creditor' agreements. These were settled in March 1999 as part of the operation of the structured informal work-out process through the CDRAC. The agreements are quite elaborate.

268. The first provides the basic conditions under which the creditors to a work-out will conduct themselves in endeavoring to reach consensus on proposed plans for corporate restructuring. It deals with such things as voting on plans, time limits for decisions, mediation of inter-creditor disputes, and the appointment of an 'executive decision panel' to review and approve or reject a proposed plan. The decision of the executive panel is final and binding on the creditors who have executed the inter-creditor agreement.

269. The 'debtor-creditor' agreement is required to be made by a debtor corporation that seeks to invoke the CDRAC informal work-out process. The debtor must be first 'approved' by the CDRAC. In essence, this agreement is made with the banks and other financial institutions that are parties to the inter-creditor agreement. The 'debtor-creditor' agreement, in turn, is binding on the parties to the inter-creditor agreement. The 'debtor-creditor' agreement provides for such things as convening of meetings, lead creditor, steering committee, provision of information, undertakings by the debtor while the negotiation process is under way, mediation of disputes, debt trading, voting and approval of plan, implementation of plan. The agreement contains reasonably detailed schedules and time-tables for the commencement and advancement of the work-out process and of information that the debtor is required to provide.

270. Comment: The CDRAC process has been reasonably successful. However, it should be observed that CDRAC normally only involves financial sector creditors and the process is really designed for reasonably complex restructurings. It is relevant that some 46% of corporate debtors under the guidance of CDRAC have not signed the debtor-creditor agreements and have sought to negotiate simpler debt restructuring arrangements.

271. A useful innovation in the CDRAC process is that it has been used in some cases to develop 'pre-packaged' plans. This technique is necessary if all creditors are to be bound by a plan (like all the informal processes, the CDRAC process only binds creditors who agree to the plan – it does not bind those who dissent nor other creditors who have not been involved in the process). The plan is 'agreed' by a dominant number of creditors through the CDRAC process and the corporation then applies for reorganization under the insolvency law. The pre-packaged plan becomes the reorganization plan. All creditors are then involved and required to vote on the plan. If approval from the requisite majority is obtained the plan binds all creditors.

E. Possible Barriers to Informal Work-Outs

272. A summary of the main areas that present problems and difficulties are as follows:

- concern about the **availability of experienced work-out personnel and advisors**;
- concern about the **willingness** of both debtor corporations and banks to **engage advisors**;
- concern (in some jurisdictions) that the **insolvency law** provides an **insufficient sanction** to encourage the informal approach;
- concern that informal work-out initiatives have been launched at a time when, because of the **effects of the economic crisis**, the **conditions** for their successful promotion are **difficult**;
- concern regarding the provision of on going funding (or "**new money**").

273. From those observations there appear to be three main barriers. The first concerns, among other things, "know how", experience and commercial knowledge. The second concerns the practical problem of providing for the immediate cash flow needs of an insolvent corporation (the problem of "new money"). The third barrier concerns the level of sanction that might both promote and encourage an informal work-out.

(i) Experience and commercial knowledge

274. It took a considerable period of time for the concept of the informal work-out to be accepted in more fully developed countries. In part, this was because a change in attitude was required, in particular

a change from relying only on the employment of strict legal processes. But it only became successful after a considerable period of knowledge and expertise had developed.

275. In the RETA economies there should not be so much difficulty in inducing a change in attitude since, as has been mentioned, in many of the RETA economies there exists already a preference to avoid the employment of strict legal processes. But in some of the RETA economies there is a need for considerable training and education in the manner in which the informal process may be properly conducted.

276. A successful work-out also involves a considerable degree of commercial experience and knowledge in a number of complex areas. These include the restructuring of the financial obligations of a corporate debtor; the possible sale of some of the non-core business activities of the debtor corporation; the possible conversion of debt into equity; and other complexities. It is possibly the case that the degree of domestic experience, knowledge and expertise in some of the RETA economies is not presently sufficient to enable those complexities to be fully understood and dealt with. There is, therefore, a need for training and education in this area.

(ii) The Problem of “New Money”

277. As mentioned previously, none of the insolvency law regimes of the RETA economies provide sufficient protection for the provision of urgent money for working capital requirements. It has been suggested that this is an area that requires further technical assistance in the region. Although there are not, as yet, any precedents for the protection of new money under an informal process, it would be useful, as part of a technical assistance, to pursue the possibility of extending statutory protection to the informal process.

(iii) The Level of Sanction

278. Despite the overall appeal and commercial sense of informal work-out processes, the prospect of engaging a corporate debtor and its variety of creditors in such a process will not work unless there is an available sanction in the form of quick and efficient access to the employment of a formal insolvency process. As observed in earlier sections of this report, that sanction does not exist in some of the RETA economies because of problems of access to and the application of the insolvency laws. If an insolvent corporation is unwilling to engage in an informal work-out, it is necessary that creditors are able to take formal individual or collective enforcement proceedings and that those proceedings will be effective. It is only through the existence of such enforcement procedures that the necessary sanction may be applied to an insolvent corporation to participate in the informal process.

F. Recommendations and Proposals

279. Education and Training. Further education and training among banks and financial institutions and owners and managers of corporations about the methodology and processes involved in informal work-out processes would be desirable. The process is also dependant on the availability of professional and other advisors with experience and knowledge of the processes. There should be education and training courses to encourage the development of these professionals.

280. Retention of Structured Processes. The development of the informal process has been extremely important for the region. The momentum must be maintained. Once the systemic debt problem of the banking sectors in many of the economies is arrested, the informal processes should be retained and should not be dismembered. They might be reviewed to ensure that they are capable of dealing with corporate debt problems generally and, in particular, that they take proper account of the important collective characteristics of insolvency practices. It is also suggested that the presence of a facilitating agency to bring debtors and creditors together has clearly been very useful and should be continued.

281. Regional Development and Co-Operation. Given the differences in approach to structured informal work-out processes in the region and the greater success of some above others, it appears desirable to encourage consultation and exchanges of information and experience between the authorities that are involved in the processes. This might be done by facilitating a symposium to bring representatives of the government authorities, of banks, of professional advisers and others together.

VI. OTHER INFLUENCES AND CONSIDERATIONS IN THE OPERATION OF INSOLVENCY LAW REGIMES

282. This section presents the RETA findings in areas that, although somewhat removed from corporate insolvency law and related practices, affect its application and image. The first is concerned with corporate management and the second with corruption.

A. Corporate Management

283. The corporation is widely utilized throughout the region for trade, commerce and the conduct of business, particularly for the conduct of medium to large business activities. Whilst the corporation has been long recognized as the most convenient and appropriate form of business organization for the conduct of that size of business, it has been also long acknowledged and accepted that the corporation is a form of enterprise that is open to management and other abuse. Adequate external and internal controls are necessary.

284. Most of the RETA economies apply a broadly similar regulatory system in prescribing the formalities to establish and thereafter conduct and operate the business of corporations. For example, all corporations:

- must have and are managed by directors;
- must maintain statutory records and books of account; and
- must file annual financial and other information.

285. However, there is considerable divergence in the application of such regulatory standards.

(i) Accounts and Accounting Standards

286. In the context of insolvency, the proper construction and maintenance of accounts and accounting information in relation to a corporation serves three important purposes. First, it provides a warning of the onset of financial difficulty and thus serves an important internal purpose. Second, it can be important externally as an information system to financiers and suppliers. Third, it can be crucial to the prospect of rescue or work-out because it should provide information to existing investors and lenders to enable them to determine a plan of rescue and to answer the inquiries of potential investors, purchasers or financiers.

287. A review of the requirements relating to accounts and accounting information of large and medium sized corporations in some of the RETA economies suggests that although there is considerable importance attached to the concept and form, the reality and practice is otherwise. These following extracts from some of the local studies are informative.

Pakistan: *"...the quality and accuracy of information [contained in the financial statements of a corporate borrower] varies". It would probably not be complete nor accurate".*

India: *"Depending upon the extent of the industrial sickness and the accumulated arrears or losses, it is likely that the records of the company would be in disarray...."*

Thailand: *"Auditing standards have come into question recently with the economic crisis....." It is unlikely that the financial and other information regarding the corporate borrower is complete and accurate (particularly regarding the valuation of assets and the assessment of liabilities)".*

Philippines: *".... Unless such financial statements come from a reputable accounting firm... they may not be giving the true state of affairs of the corporate"*

Japan: *"Some recent bankruptcy cases have revealed that management had made false accounting to conceal bad financial conditions of the company"*

Indonesia: *"In general... [there is] .. a lack of sufficient financial information. ...The completeness and accuracy of the information ...depends on the integrity of the management of the company"*

Hong Kong,China: *"...the frequency and standard of [financial reporting] is often less than in many Western countries"*

288. It seems clear that the imposition of proper accounting standards is required in many of those economies, together with an adequate regulatory authority that is able to police the application of those standards.

(ii) Directors and Corporate Governance

289. Directors of a corporation are ultimately responsible for proper management. In some jurisdictions this responsibility has been taken to such lengths as imposing a duty on directors not to permit a corporation to engage in insolvent trading and, even, to take affirmative action once it is apparent that the corporation is insolvent or will soon become insolvent. Duties such as these become part of a "code" of corporate governance standards and can be a considerable aid toward encouraging a corporation in financial difficulty to take early affirmative action by voluntarily submitting to a formal or informal rescue process.

290. Attitudes toward the proper role of and standards under which directors should operate vary among the RETA economies. In many cases it seems that many "directors" are either bare nominees or are controlled by others. This alone suggests that standards of corporate governance responsibility are either far from developed or considered to be of not much consequence in some of the RETA economies. The **Hong Kong,China** local study, for example, observes that: *"....it is not uncommon for listed companies in Hong Kong to be under (extended) family control and for there to be a lack of genuine independence even amongst non-executive members of the board of directors.Many local companies do not have independent managers - or if they do, have brought in the managers to raise money rather than to impose financial controls - so the controlling family often does not hear contrary views being voiced by senior managers within the company"*.

291. In **Korea** something similar is evident. There is a requirement that a corporation has a minimum of 3 directors. However, private ownership or proprietorship or control of a corporation is culturally and commercially important in Korea, and it seems that, in many cases, two of the three directors will be mere employees of the corporation. The third will be the owner or proprietor. The two employed directors will rarely, if ever, play any real part in management of the corporation.

292. It appeared to be the case that standards of corporate management in many of the RETA economies were defective for one or more of a number of reasons. Examples included:

- The effect on the management of a corporation as a result of political and government patronage or cronyism. This form of 'protection' often takes on a form of 'license' to disregard

proper or any standards of corporate conduct because it can operate to shield and protect those responsible for abuse of the standards. In many of the RETA economies there is either a direct political involvement in or strong relationship between political forces and corporations. These associations may be expected to be of some considerable influence in the event that financial difficulty affects a corporation. Some of the local studies place considerable emphasis on this factor as, for example:

Thailand: *"The union between big business and government for mutual benefit is well established in Thailand. Politicians and bureaucrats are frequently board members and shareholders, and may have multiple business interests that in other jurisdictions would be perceived to represent a conflict of interest"*

Philippines: *"Politicians are perceived to be the most powerful sector as they can influence, to a significant extent, the granting of loans by government controlled financial institutions and even, at times, the bailing out of a soon-to-be bankrupt enterprise"*.

- The existence of close family held corporations in which the influence or power of one or more family members can prevent objective assessment and management of the financial position of a corporation. In many of the RETA economies it is apparent that powerful family ownership or control of both large and medium sized corporations is quite common.
- In some of the RETA economies large corporate conglomerates dominate a significant part of the corporate. These are often a group of companies that are industrially linked, even though some of them might be independently owned. This is a relatively common feature of the private corporate sector of, for example, Japan, Korea and Thailand. This can present some complexity if some one or more of the members of a conglomerate become insolvent or suffer financial difficulty. It poses a problem, not only for the creditors but also for the group that constitutes the conglomerate. It could mean, for example, that additional factors have to be taken into account before a possible solution for rescue or otherwise will emerge. As mentioned in the local study of Thailand: *"The inter-relationship between companies in a conglomerate is often very complex and a purely legal analysis will not reveal their true nature"*.
- The association resulting from corporations holding substantial interests in banks or financial institutions that provide funding to the corporation (or its subsidiaries) which can cause considerable commercial conflict in credit assessment, loan management and recovery;
- The absence or disregard of internal financial controls; and
- The failure to impose and enforce proper standards of corporate governance which effectively causes the corporation to disregard the interests of a number of its constituents, including creditors.

293. This is not an area that can or should be regulated by an insolvency law. However, it cannot be ignored because, most importantly, an insolvency law system cannot be expected to operate and produce positive results in an environment of inadequate corporate governance and financial irresponsibility. Weaknesses in this area result in considerable havoc to any form of insolvency law endeavor. It cannot be emphasized sufficiently strongly that continued reform in this area is absolutely vital.

294. An analysis of these difficulties has been provided by some of the local studies, as follows:

(a) Indonesia

295. Some attempt has been made to ensure greater transparency in the contents of annual financial accounts that some particular classes of companies are required to prepare and file. Regulations made

earlier this year require disclosure of financial and cash flow reports. This should provide for greater corporate disclosure and more opportunity to access financial information. However, two matters, identified by the Indonesian local expert, might tend to limit the effectiveness of these regulatory requirements. First, only 6% of companies have submitted annual accounts. Secondly, many classes of companies are exempt from the obligation.

296. New anti-corruption laws have been enacted. Although not specifically directed to the corporate sector, they each assume a likely patronage or corrupt commercial link between corporations and government officials and others.

297. The problems of corporate management in Indonesia appear to be mainly centered upon corruption, non-enforcement of regulatory requirements regarding accounts, and inadequate laws concerning director duties and responsibilities.

298. The Indonesian local expert considered that two things in particular would greatly assist in raising standards of corporate governance in Indonesia. First, the enactment of legal guidelines on the duties and responsibilities of company directors together with sanctions for abuse or breach. Second, the establishment of an independent supervisory board with powers to control corporate practice in Indonesia would do much to help develop the application of corporate governance. The vision is of a regulatory board that would act as an alternative means of law enforcement on business practices. It would act as an investigator body with power to report breaches to the courts and recommend enforcement.

(b) Korea

- There is a significant difference between the accounting standards applied in Korea and those that are generally accepted as conforming to an international standard;
- The management of directors cannot be supervised or controlled because there are few instances of the presence of outside, independent directors;
- There is evidence of poor quality auditing;
- The power of minority shareholders is very weak; and
- There is evidence of corporate fraud.

299. The Korean local expert suggested that concentration on the following areas would be helpful to lessen or eradicate these problems:

- The introduction of a legal requirement that companies with a significant capital base must have a high percentage of outside, independent directors on the board of management;
- The establishment of a supervisory management committee from the board of directors which must include two thirds of independent directors;
- Enabling class and representative actions to be instituted on behalf of shareholders, particularly minority shareholders; and
- Legislation to enable recovery of the proceeds of corporate fraud.

(c) Malaysia

300. In Malaysia, the important issue of corporate governance has in fact been addressed, in part. A recently published 'Code on Corporate Governance' is the result of the work of a committee under the initiative of the Minister of Finance to establish industry standards of best practice. It covers such things

as appointment of directors, compositional balance of a board of directors, supply of information, communication between company and shareholders, financial reporting, internal controls and the relationship between the board and the external auditors.

301. As regards the presence of independent directors on the board of a large corporation, the Corporate Governance Code requires that a board of directors be composed of at least one third outside independent directors.

302. There has also been much greater attention given to the prosecution of corporate governance offences in Malaysia. However, despite these welcome and important advances, problems still exist in Malaysia. The chief concerns are with:

- Valuation of assets. It is said that unrealistic non-objective valuations of corporate assets are common. That presents a misleading, if not false, balance sheet;
- Internal financial control. A number of cases have revealed contravention of internal financial and other controls and failure to detect such breaches.
- Links between corporate groups, political parties and state agencies that are clearly capable of resulting in conflicts of interest.

(d) Philippines

303. In this RETA economy the areas of concern are:

- There are significant differences between what might be regarded as 'international' accounting standards and those that appear acceptable in the Philippines. This results, for example, in valuing assets otherwise than on an objectively and properly assessed basis;
- Many corporations maintain a number of different sets of accounts;
- There is evidence that audited financial statements are routinely produced without an actual audit of the corporation. It is suggested that this area can only be addressed by the imposition of a stringent code of professional responsibility for accountants and a legislative insistence that proper standards are applied;
- Although there are legislative standards of duties and conduct for directors, their abuse is rarely, if at all, prosecuted or enforced; and
- There is some evidence that 'cronyism' is now more rampant.

304. The view of the Philippines local expert is that legal guidelines on director duties and responsibilities are essential and the law should provide sanctions for breach and enforce the application of those sanctions.

(e) Thailand

305. The Thai local expert commented that the application of what are termed 'traditional Thai methods and values of governance' is still more influential than the law. These 'methods' and 'values' pay little or no regard to the more sterner and exacting methods and values prescribed by law and regulation. The local expert pointed out that in Thailand the relevant laws or regulatory requirements exist. However, those laws are not applied nor enforced. The main areas of concern are these:

- The requirement to keep proper accounting records is often ignored or neglected;

- Financial reports do not comply with accounting standards;
- Enforcement of standards and duties of directors is weak; and
- There are still many undisguised links between large corporate conglomerates, political parties and government that result in awards of government contracts, concessions, approvals and other preferential treatment.

306. Despite this, the consultant for Thailand pointed out that there are signs that a combination of the new Constitution of 1997 and the need for austerity following the economic crisis is creating a more transparent, fairer and less abused corporate governance environment.

307. **Recommendations.** It seems apparent that, with one or two exceptions, there are fundamental weaknesses in corporate management in many of the RETA economies. The areas of weakness are:

- Adequate accounting standards either do not exist or are not applied;
- Auditing standards are poor, particularly regarding valuation of assets;
- The need for proper internal financial management and financial control is disregarded; and
- There is either an absence of and/or a failure to enforce an appropriate legal regime of director duties and responsibilities.

308. It is not appropriate in the context of this report to suggest proposals for detailed corporate governance and management. However, for the reasons stated earlier, it is appropriate and necessary to urge the need for reform generally and to identify particular areas that are vital for the operation of an insolvency law system. This leads to a consideration of the following proposals:

- Standards of corporate governance and accountability of managers and owners need to be considerably improved.
- It seems necessary that a legal regime of basic director duties and responsibilities (or 'guidelines' that will help to establish a 'standard' that the law may recognize) is required in many of the economies. From the perspective of the subject matter of this project, it would seem important that any such regime should include a positive duty that a director must have regard to the interests of creditors in the management of a corporation.
- It is fundamentally important that the law (but not the insolvency law) provides adequate sanctions to penalize managers and owners of corporations for fraudulent behavior and also for behavior that falls short of proper standards.
- It also seems necessary that accounting standards, auditing practices and internal financial control mechanisms must be considerably improved. Objectively assessed financial information in relation to a corporation is vital because it provides an early warning of possible financial difficulty, it is important externally as an information system for financiers and suppliers, and it can be crucial to the prospect of rescue or work-out.
- Long term programs of education and training for directors appear desirable and necessary. Such programs should be directed at corporate management generally and particularly at director duties and responsibilities; financial control; and the operation of formal and informal insolvency processes.

309. With respect to training, the following observations by the local experts should be noted. The Thai local expert considered that training would benefit only directors who might be ignorant of their

responsibilities. It was considered that the real problem lay with directors whose conduct is deliberate or willfully neglectful.

310. The Malaysian local expert considered that many directors are ignorant of proper corporate governance in the areas of financial management and responsibility for which education and training is required. Further, it is considered that directors should be educated on the recognition of creditors rights, the mechanics of a work-out, the initiation of work-out processes and the need for correct, up to date information concerning the company.

311. Finally, the Indonesian local expert considered that while training would be useful, another issue lay with the lack of governing provisions in the Company Law. The Company Law provides no or no sufficient standard of performance for officers of a company.

B. Corruption and Fraud

312. Corruption may be described as the misuse of public or private office or personal gain. It includes bribery. Fraud covers both that which may be best described as "hard" fraud and "soft" fraud. Hard fraud is the act of obtaining property or a benefit of whatever description that should rightfully belong or remain with a corporation. Soft fraud is the act of manipulating the accounts, financial statements or other documents of or related to a corporation, which has the effect of altering the factual (and legal) position of a company. Soft fraud may, of course, be a necessary initial step toward the commission of hard fraud.

313. Corruption is seriously harmful, to commercial processes generally. As between those who are party to the corruption, the harm may not seem great. However, in the application of an insolvency law or insolvency related law it can have significant undesirable effects. If, for example, the proper commercial enforcement of a security over property of an insolvent corporate debtor or an application for the winding-up or other form of insolvency administration in respect of an insolvent corporate debtor may be hampered or, worse, prevented by corruption within the judiciary, proper and normal legal and commercial practices and processes are undermined.

314. Likewise, if a corporation obtains a loan from a bank as a result of corrupt political or government influence or direction, there will not be any commercial assessment of the financial position of the corporate borrower. If the corporation becomes insolvent, the same or similar corrupt political or government influence will endeavor to ensure that the insolvent corporation is protected by, for example, requiring that the bank do nothing.

315. That type of intervention and manipulation is, again, damaging because it creates an unreal commercial position. The bank, in the above example, may be a major creditor. Its influence may be dominant in determining what should happen to the insolvent corporation. As a result other creditors are prejudiced.

316. Corruption and bribery are not acceptable. The probability that corruption might intervene in or influence the outcome of the administration of an insolvent corporation defies any attempt to provide anything approaching a commercially workable formal insolvency administration regime or, for that matter, an informal work-out regime. The necessary conditions to bring debtor and creditors together in a normal commercial environment are absent.

317. Evidence of the existence of corruption is not always easy to establish. But it undoubtedly exists in many of the RETA economies at the levels described above. Unless it is controlled and eliminated, the application of insolvency law and related regimes in those economies is doomed to complete failure. That will seriously impact on investor and financier confidence.

318. Fraud committed by one person on another may, again, present itself as simply a problem between those persons. However, it becomes a much expanded problem when assets or property of an

insolvent corporation are put out of reach of the creditors as a result of fraud. In some cases it is the commission of the fraud that makes the corporation insolvent.

319. Corporate fraud is a problem throughout the world. The origins of some of the biggest (and most notorious) cases of corporate insolvency can be traced to fraud committed on the corporation. Relatively speaking, the corporation, because it is a passive, inanimate legal person, is an easy prey for fraudulent managers and owners. The fraud goes undetected and is often only discovered as a result of inquiry and examination when the insolvent corporation is liquidated. In that respect the formal insolvency administration process is a valuable aid to discovering fraud. Unfortunately it is also another reason why those in control of an insolvent corporation may resist as far as possible any application of a formal insolvency process.

320. Like corruption, prosecution of fraud is not the appropriate province of an insolvency law. It is the task of other regulatory authorities. But the administration of an insolvent corporation can provide substantial evidence to enable prosecution. The real problem for insolvency law lies in recovery of the proceeds of the fraud. If fraud, though detected, is not or cannot be recovered, the corporate debtor and persons associated with it have little to fear.

321. Resources of considerable magnitude are usually required to detect, trace and recover the proceeds of fraud because quite often the effect of the fraud is to leave the corporation with no or very few assets. Government intervention to provide resources or otherwise prosecute those involved in the fraud is necessary. Fraud also raises cross-border insolvency issues. The proceeds of fraud are rarely found in the domestic jurisdiction of the corporate debtor.

322. Unless steps are taken to seriously combat corruption and fraud, its impact on the RETA economies, generally, and insolvency regimes, in particular, will continue to plague and hamper economic recovery well into this millennium.

VII. ASSESSMENT OF THE APPLICATION AND ADMINISTRATIVE OPERATION OF THE INSOLVENCY LAW REGIMES

323. The statistical and other information gathered during conduct of the RETA about the actual operation of the formal insolvency law regimes in the RETA economies suggests that in some of the economies there is a considerable problem regarding the application of the insolvency laws. This part of the report first presents the statistical and associated evidence that identifies the apparent problem of application. It then considers the possible reasons, among which are: problems associated with commencement and processing of formal insolvency cases under the insolvency laws; the absence of or problems associated with other legal processes (which includes issues relating to general legal institutional development); and, finally, attitudes to legal processes generally.

A. Statistics and Level of Insolvency Activity

324. **Statistics and other Information.** One method to determine the extent of application of the insolvency laws is to review the statistics of the number and types of cases. Normally that type of information should be readily available, since it is an important and relevant economic statistic and can be a valuable indicator of trends in the economic system. It is also relevant to ascertaining the impact of commercial practices on different sections of the commercial community. It can also be a helpful guide to the possible need for reform to the law.

325. Unfortunately, statistics on insolvency cases in many of the RETA economies are either barely sufficient or almost non-existent. However, with the assistance of the local experts, it was possible,

during the initial work under this RETA, to obtain broad details of levels of insolvency cases. The following information was provided to January 1999:

- **Hong Kong, China:** In 1997/98 there were 459 cases of insolvent liquidation and in 1998/99 there were 491 cases. The number of formal reorganization cases was minimal.
- **India:** National statistics are difficult to obtain, but, as a guide, in Delhi there were no cases of reorganization in the last 2 years and 125 cases of insolvent liquidation.
- **Indonesia:** Prior to the 1998 amendments to the insolvency law there were no cases of liquidation or suspension of payments in Indonesia. Since the amendments some 17 cases were filed.
- **Japan:** By comparison with previous years the number of liquidation and reorganization cases had been high.
- **Korea:** The incidence of liquidation cases was 'low' and of reorganization cases 'high'.
- **Malaysia:** Numbers of liquidation and reorganization cases had been relatively high.
- **Pakistan:** The only available information showed that there were 110 cases of liquidation pending from the last two years and no cases of formal reorganization.
- **Philippines:** There have been no liquidation cases for a number of years. Over a period of 16 years the number of cases filed for suspension of payments was 89.
- **Singapore:** Cases of liquidation and reorganization were average.
- **Taipei, China:** In the 3 years between 1995-1997 there were 2 cases of composition, 8 cases of reorganization and 47 cases of liquidation.
- **Thailand:** The number of liquidation cases was low and of reorganizations was very low.

326. The compelling observation from that survey is that in some of the RETA economies there were no cases of corporate insolvency and only a very few in some others. This is a quite an extraordinary position because even in times of economic boom and growth, a number of cases of corporate insolvency may be expected. When considered in the light of the economic conditions that affected most of the RETA economies during 1998, the figures are baffling.

327. In the latter part of the conduct of the RETA, further statistical information was provided from five of the RETA economies (Indonesia, Thailand, Korea, Malaysia and the Philippines - the RETA economies most affected by the financial crisis). This information, in summary, was as follows (the information is largely for the period January - October 1999):

- **Liquidations:** There were no cases of liquidation in the Philippines. In Thailand there were 24 cases of liquidation (or bankruptcy). In Indonesia there were 13 liquidation cases. In Malaysia and in Korea the figures for insolvent liquidations were around the same as for 1998.
- **Formal rescue:** In the Philippines there were 11 filings for reorganization. In Thailand, 8 companies filed for business reorganization. In Korea the figure for cases of formal rehabilitation was expected to be around 160 (to that should be added some 400 cases for composition). In Malaysia there were 20 filings for schemes of arrangement. In Indonesia there were 6 cases for suspension of payments.

328. By comparison, in those RETA economies in which a form of 'structured' informal process is available, the level of activity was as follows:

- In **Indonesia** 350 cases had come under the Jakarta Initiative debt restructuring program. These included some 250 medium to large-scale companies. However, there was not much other public information available concerning these cases. The percentage of that number that resulted in the adoption of rescue or reorganization plans was quite small.
- In **Korea** about 80 companies had entered the structured work-out process. A high percentage of these had reached agreement on work-out plans. A lot of attention had, however, been directed at restructuring the top 5 chaebol and the next largest group of chaebol (known as the '6-64'). This, plus the fact that many of the subsidiaries or affiliates of these big chaebol are dependant on their restructuring plans, had tended to distract needed informal work-out attention to smaller, medium sized insolvent companies. This may, in part, explain the relatively small numbers.
- In **Malaysia** some 63 companies had been involved in the CDRC debt restructuring process. These included quite high profile listed public companies. The more enforcement driven Danaharta process had resulted in the review of some 1780 corporate cases in the debt settlement/recovery process. Some of these had sought restructuring arrangements through the CDRC. There are others to which special managers had been appointed through the extra judicial powers exercised by Danaharta.
- In **Thailand** more than 700 corporations had sought the assistance of the CDRAC debt restructuring process. Approximately one-half had progressed to the point of putting a standard form of debtor/creditor agreement in place and some 52 of that number had reached agreed restructuring plans with their creditors.

329. In addition, other informal processes operate in some of the RETA economies in the form of 'private' versions of the work-out concept. It is difficult to quantify this level of activity, except by anecdotal evidence. However, the local experts from a number of the RETA economies considered that there had been relatively high activity at this level.

330. Although the level of formal insolvency cases appears to have risen as a result of the effects of the financial crisis, the figures continue to evidence a very low incidence of formal insolvency cases in the courts. It seems clear that, apart from in Malaysia and in Korea, there has been little resort to the liquidation process. The numbers in Thailand, Indonesia and the Philippines are extraordinarily low. They do not even approach the type of figures that might be expected of corporate businesses in a time of healthy and progressive economic development and stability, which is certainly not the case in any of these RETA economies. The numbers in Malaysia and Korea are not consistent with the economic problems in each of their economies. On any reckoning there must be a substantial number of insolvent corporations for which no account can be given. The figures are baffling and difficult to explain.

331. There has also been surprisingly little use of the new forms of formal reorganization processes in Thailand and in Indonesia. This may be due to the relatively recent introduction of these processes into societies in which they were previously not known. It may also indicate that legal and court controlled processes are not suitable for the commercial culture of those economies, an issue that is taken up in a later part of this section.

332. Another possible reason for the low statistical numbers is that the insolvency laws themselves pose impediments to their application. Some of the RETA economies make access difficult for both debtor and creditors, particularly the latter, by providing for high, vague or unclear entry criteria. That can both prevent and deter recourse to the insolvency processes.

333. A similar problem can arise in relation to reorganization if the law places too many restrictions on or in relation to a debtor corporation as a consequence of it volunteering for possible reorganization. For example, in some of the RETA economies there appears to be a strong commercial cultural attitude about 'loss of control' or anything that might result in outsiders dictating the immediate and long-term future of a corporation in financial difficulty. If an insolvency law removes the powers of management from the corporation or excludes a debtor corporation from the initiation of a plan of reorganization, such provisions may militate against the process being used by corporations.

334. By comparison, the level of informal work-out activity under the structured and private processes has been greater, although even that level is surprisingly low. It appears to be a more acceptable form of process and more suited to the commercial culture of some of the economies.

335. It is also important to observe that the initiation and operation of the structured informal processes appears to have fuelled and provided the basic guidelines for the development of 'private' style work-outs within the banking and commercial sectors. That is encouraging, particularly in economies such as Thailand, Indonesia, Malaysia and Korea, where there had been practically no experience and very little knowledge of informal work-out practices.

336. However, as mentioned in the earlier section of this report, it is important to appreciate that the operation of these informal processes is, in some cases, an extension of the repair of the banking and finance sector. It is hoped that the structured informal process will continue to flourish once that repair has been completed.

337. **Improvement of Statistical Information:** Statistical information about formal insolvency processes is rudimentary in many of the RETA economies. All the local experts agreed that insolvency statistical and other related information systems must be improved. A summary of some of the views is as follows:

- **Indonesia:** The level of available information is very small. An 'on-line' system to provide access to bankruptcy decisions, together with information on the financial position of the debtor, causes of insolvency or financial difficulty and areas of business, is required.
- **Malaysia:** It is suggested that statistics might be best maintained by the Central Bank, since this would cover statistics of formal and informal cases and also banks are in a position to maintain their own statistics.
- **Philippines:** The Investment and Research Department of the SEC should continue its compilation of petitions filed with the SEC. If there is a reversion to court jurisdiction in insolvency cases, the relevant courts should compile and forward information and statistics to the Supreme Court.
- **Thailand:** A system has been established through the Legal Execution Department of the Ministry of Justice to gather information concerning statistics of incidence and results of formal insolvency cases. Searches can be quickly made. However, the system does not extend to gathering information concerning values of assets and liabilities, areas of business, causes of financial failure and so forth. This information would be of considerable benefit.

338. A final observation concerns some statistics from **Indonesia**. The supplementary local study mentioned that '12 bankruptcy petitions' were 'withdrawn' or 'settled'. There is reason for some concern about this because it may suggest that the bankruptcy process is being used as some type of individual debt recovery process. That is not a desirable trend. It may indicate that other commercial processes are ineffective, such as debt recovery and secured property enforcement legal processes. That area is dealt with in the following article *The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms*.

339. **Recommendations.** The following proposal is advanced for consideration and adoption in all of the RETA economies:

Statistical information on corporate insolvency should be published by the responsible authority on a quarterly basis with a yearly summary. It should provide details of:

- the number of companies which in that quarter have become subject to a formal insolvency administration;
- a breakdown of those numbers into the categories of liquidation and rescue and, within each category, details of dates of incorporation, reasons for failure and the principal business in which each corporation was engaged at or immediately prior to the commencement of the insolvency administration; and
- estimates of the assets and liabilities of such companies.

Upon the completion of each corporate insolvency administration, the responsible authority should record the following information for public access:

- the name of the corporation and date of incorporation;
- the name of the directors;
- the nature of the administration, the date of its commencement and completion;
- the principle business of the company prior to the administration;
- the cause/s of the insolvency;
- the assets (estimated and realized) and liabilities (estimated and realized); and
- a breakdown of payments made from the administration into general categories such as the cost of administration, employee payments, tax payments and dividend to unsecured creditors.

340. The process of gathering and recording statistical insolvency information should be also extended to informal processes, particularly those that are under the guidance of central bank or other government agencies. The need for 'anonymity' in informal processes can and should be respected, but general information on aggregate numbers, assets and liabilities, industries and causes of financial difficulty might be easily provided in the form of an annual report.

341. Banks and other financial institutions might also be encouraged to provide relevant broad and anonymous data to the same effect, since they will be involved in many more 'private' informal work-outs. There is also a need for reports, writings, opinions and critical analyses of insolvency cases and on the operation of the insolvency law system.

B. Legal Systems and Institutions

342. As mentioned in various sections of this report, a corporate insolvency law is but part of an overall commercial legal system and is heavily reliant for its proper application on, first, a developed and rounded commercial legal system and, secondly, a developed institutional court or tribunal system.

343. The legal systems of the RETA economies differ, in the sense that a number follow a common law system tradition and others a civil law based system. It is sometimes suggested that such a division

can result in a considerable difference in the manner in which laws and legal processes are employed. Some attention was given to this aspect by considering, for example, whether there were any real differences between the application of insolvency laws in common and civil law jurisdictions generally. The evidence suggests that there is none or, at least, none of any substance. The issue of the application of the insolvency laws in the RETA countries has, therefore, not had to take account of such a possibility.

344. However, and more importantly, there is some considerable difference in legal infrastructure in the RETA economies. The extent of development of a legal system and the institutions that normally support that development (principally courts, judges and officials) varies considerably between the economies. In the case of some of those economies, economic and commercial development has not always been accompanied by the development of necessary infrastructure foundations.

345. One factor that may contribute to this is that some of the RETA economies have not had a long history of or strong dependence on a legal and judicial system, particularly in the commercial area. In a number of the RETA economies, with the exception of areas of law such as criminal and government administrative law, there has been little reliance upon a legal system and its institutions. This could be due, in part, to cultural and other factors, as mentioned later, notably the preference for non-confrontational negotiation to remedy disputes or problems. Political and government attitudes may also be a contributing factor, especially regarding levels of expenditure to develop and support a legal system and the accompanying institutions. This, in turn, filters down to the qualifications, training, experience and status of judges, judicial officers and the judicial system generally.

(i) Debt Recovery and Security Enforcement Processes

346. It appears that in many of the RETA economies the process of debt recovery through the court system is long and tedious. The following are relevant extracts from some of the local studies:

- **India:** *"The recovery procedure for debt collection is slow and tardy".*
- **Indonesia:** *"Judicial remedies are time consuming and expensive. Even more importantly, the Indonesian judicial system's decisions have been inconsistent and unpredictable and are subject to a variety of extra-judicial influences".*
- **Pakistan:** *"The process is very slow".*
- **Philippines:** *"The judicial and court system for the purpose of debt collection is not so effective".*
- **Thailand:** *"Currently, delay (in the courts) is probably the biggest impediment toward justice".*

347. A review was also made of security enforcement processes in the RETA economies, since secured transactions and their enforcement is a considerably important part of the commercial law system. Although this is more fully discussed in the following article *The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms*, it is relevant to mention what that review disclosed.

348. In many of the RETA economies, secured property enforcement rights require court proceedings to be taken for an order that the security may be enforced. Further, in some of those economies, after such a court order is obtained, the actual enforcement and sale process of the property has to be undertaken through a government execution or similar agency.

349. Additionally, the court processes can be very slow. Evidence of that was provided by a number of the local experts, as, for example:

- **Philippines:** *“If enforcement is sought through the courts, it may take many years for the enforcement to be complete”.*
- **Pakistan:** *“To the extent that enforcement is required to be taken through the courts...the system is very slow and also corrupt”.*
- **Indonesia:** *The process is time consuming, expensive and unpredictable”.*
- **Thailand:** *“The foreclosure laws have come under much criticism recently. They do not allow for expeditious enforcement”.*
- **India:** *Suits involving enforcement of security...get blocked by the ingenious and often fraudulent defenses...The effectiveness of the suits is severely dented by the time frame involved...A trial...usually takes 8 to 12 years to come up for hearing”.*

350. These factors are strongly indicative of two things. First, they show that individual creditors enforcement powers are, in some of the RETA economies, greatly restricted, if not, in a practical sense, almost non-existent. Second, they indicate that in some of the RETA economies the court and judicial processes are slow and ineffective. That is indicative that either the court system and infrastructure is not sufficiently developed or there are severe problems in the administration of that system.

(ii) Implications of Inefficient Court Enforcement Processes for Formal Insolvency Law Processes

351. Indications such as those pose two possible major repercussions for an insolvency law. First, if a corporation cannot pay a due debt, secured or otherwise, it may be assumed, with some degree of certainty, that the debtor is insolvent or fast approaching that state of affairs. If that is so then it is in the interests of all those affected (the creditors, the debtor and its shareholders and management), that the debtor should be required or forced to submit to a form of insolvency administration – whether formal or informal and whether liquidation or reorganization.

352. However, it may be expected that a corporate debtor will not willingly volunteer to such a course unless some pressure is applied. The principal source of that pressure will come from the actions of individual creditors who pursue their individual enforcement rights. If the pursuit of those rights is restricted or delayed because of either an inadequate civil court process or other legal process system, there will be no pressure on the insolvent corporation to do anything. As a result the corporation will not usually take any remedial action with the risk that its financial position will deteriorate to the cost and prejudice of persons who transact business with it.

353. If the legal system fails to provide efficient and sufficient individual creditor enforcement rights, those individual creditors are likely to seek recourse to the insolvency law. It may appear to provide the only effective means for individual enforcement. However, that results in an unwanted and undesirable use of an insolvency law. It creates a warped commercial environment that might be concluded as being ‘debtor friendly’. That can only produce concern among financiers and investors. More importantly, it does not respond to economic expectations and commercial needs. This is possibly most marked in the area of secured property enforcement, which is more fully developed in the following article *The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms*. There is a need for considerable improvement of court and related processes in the RETA economies most affected by these issues.

C. Application of Insolvency Court Processes

354. A final consideration in this section is to review actual court processes in the application of the insolvency laws. An insolvency law is a difficult and complex area of commercial law. The experience in

many jurisdictions is that it is unsafe to leave the jurisdiction to courts or judges that do not have wide commercial experience.

355. In some of the RETA economies there is a negative reaction toward the use of the insolvency law because of problems with the court and judicial system. The processes are slow, judges are not suitably qualified nor experienced and the judicial process is unpredictable and unreliable. A review of the performance of the courts in relation to the application of the insolvency laws in the five economies of Indonesia, Korea, Malaysia, Philippines, and Thailand revealed the following:

(i) Indonesia

356. The judicial handling of insolvency cases has improved. The establishment of the Commercial Court was viewed as an important and necessary step toward judicial reform. Time limits were being enforced, decisions are made public and, generally, the processes of the court were much more transparent. Unfortunately this was not the position regarding formal cases of suspension of payments – very little information is publicized about these. In August 1999 a further four commercial courts were established to help decentralize the work of the court throughout the country. However, problems still exist and some of these appear to be severe.

357. A main problem is the lack of consistency in the decisions. Although not many cases have been before the courts, judicial decisions in insolvency cases often produce seemingly irreconcilable conclusions. Part of the cause of this problem may be due to the fact that there is no system of ‘precedent’ in the Indonesian judicial system, and thus judges are free to apply the law as they see fit. In part, this problem is compounded by an absence of published writings on decisions of the Indonesian courts that might help to establish a base for what might be considered ‘good’ or justifiable decisions. This leads to considerable commercial uncertainty and skepticism about the court system and the judiciary generally.

358. For example, of 59 insolvency cases in which decisions were given, 25 were appealed to the Supreme Court and 14 of these went to a further review before a different panel of the same court. Another major problem is that the judges of the Commercial Court who handle insolvency cases come from a non-commercial background. It appears that many of these judges have little commercial knowledge or experience. The Indonesian expert comments that *‘many of the (cases) involve modern and sophisticated (commercial transactions)’* and the judge *‘presiding over the hearing does not understand the transactions’* which *‘leads to misinterpretations or narrow interpretations of the document’*.

(ii) Korea

359. The main problem is that there are insufficient judges with expertise in cases of bankruptcy and reorganization. Although the judges presently handling such cases are, generally, competent, there are an insufficient number of them. These judges are also required to handle other, non-bankruptcy, cases and their work-load is, accordingly, very heavy. It is suggested that Korea may benefit from the creation of a specialist or dedicated bankruptcy or special commercial division of the relevant civil court.

(iii) Malaysia

360. The main problems were identified as inexperienced judges handling formal insolvency cases with very little understanding or appreciation of the philosophy underlying insolvency law and the commercial application of such law; a significant volume of work load for judges and consequent delays; and considerable delay in appeals processes. Again, it is suggested that a special insolvency court or special commercial division of a civil court may be required along with more experienced and trained judges.

(iv) Philippines

361. This report has mentioned the SEC and its largely administrative role in the application of the formal reorganization law. This has not gone without criticism. Some view the SEC as having too many functions and not sufficient time or resources to administer such an important commercial area. Others are basically distrustful of a non-judicial system of administration. This may be due to the fact that up to now the SEC has largely been its own master and able to conduct its processes as it has seen fit. That has, of course, undoubtedly produced a feeling of uncertainty and the absence of 'rule of law' comfort. The recently adopted *Rules of Procedure on Corporate Recovery*⁵ may help to overcome some of these difficulties. Despite the criticisms, the 'experiment' of this approach appears to have worked in the Philippines. It is a model that should not be dismissed or overlooked.

(v) Thailand

362. The new Bankruptcy Court was established and commenced operation in June 1999. This was regarded as a positive step because specialist judges and court officers can better implement the legislation and proceedings should move more rapidly. Some 16 judges have been appointed. They are said to be handling over 3000 cases, which is a high caseload (these include the many personal insolvency cases). It is the view of some that assessment of the judicial handling of formal insolvency processes under the new law should wait a longer period of trial. Since the new court was established there has been an increase in case numbers. So far only the Central Bankruptcy Court is operating. It is intended to establish regional bankruptcy courts in the future. Changes are also proposed to the administration of the court system in Thailand. At present this is under the control of the Ministry of Justice but a separate agency is now proposed. This may afford better administration of the courts and the judiciary and may give the latter much needed independence and transparency.

363. **Comments and Recommendations.** In relation to the application of the insolvency court processes, the reports of the local experts all appear to underline the need for specialized courts (or divisions of courts) and judges with experience and knowledge to handle insolvency cases. A specialized court need not be one that is solely devoted to cases of insolvency. It may be one with a broad commercial jurisdiction, of which insolvency is a part.

364. The need is for judges who are capable of dealing with cases of corporate insolvency. That requires wide knowledge and appreciation of economic, commercial and corporate affairs. In some of the RETA economies, training and education in those areas would be of considerable benefit. A high priority should be accorded for intensive and ongoing education and training of judges and court officials in those RETA economies.

365. Another area in which assistance might be appropriate (although it is an area that is clearly outside the scope of this technical assistance) is in the organization of the courts, the status and general accountability of judges and court officials.

D. Attitudes to Legal Processes and Problems with the Insolvency Law

366. **Attitudes to Strict Legal Processes.** Earlier in this report, it has been suggested that in many of the RETA economies there appears to be a cultural attitude, particularly evident in the commercial society, which views dispute resolution and problem solving as best suited to non-confrontational negotiation and mediation. Consistent with that, there also appears to be a distinct aversion to the use of strict legal processes (which require a somewhat rigid adherence to legal system organization, function and methodology) for the resolution of commercial disputes and problems.

⁵ The *Rules of Procedure on Corporate Recovery* came into effect on 15 January 2000.

367. The following extract from the local study of **Thailand** identifies the type of cultural factors that may be involved: *“Thais are characteristically non-confrontational and conflict averse in their approach to business. Negotiation and compromise are the expectation and practice. Litigation is reverted to relatively infrequently...”*

368. A similar observation was made in the **Indonesian** local study: *“It is customary in Indonesia for debtors and creditors to try to negotiate a settlement of their debts before formal insolvency procedures are commenced. In part, this is because there was no effective bankruptcy law or the courts were perceived as ineffective in implementing the law. In the past, public litigation was seen as an irreparable breach in the business relationship and which ran contrary to cultural norms in dispute resolution”.*

369. The existence of such attitudes should not be the subject of criticism. But, if it is correct that attitudes generally in many of the RETA economies are such that there is an aversion to resort to the application of strict legal processes and rules for problem resolution, it may help to explain why, in those economies, the statistics for the in formal insolvency processes are so low. If negotiation and mediation is a successful way of resolving commercial disputes and problems then so much the better.

370. However, there is a problem in the application of negotiation and mediation to the type of problems produced by the insolvency of a corporation. As mentioned earlier, there are multitudes of interests of which account must be taken because it is a collective remedial process. Often these interests are in conflict with one another. An insolvency law regime requires a significant degree of legal system organization, function and methodology for effective operation.

371. It is difficult to suggest solutions to the problems that arise from this. However, these cultural attitudes towards formal legal processes must be taken into account because there has been a clear endorsement of informal "work-out" insolvency process (which provides, at least, the possibility of a forum for negotiation and mediation). The further development and refinement of these informal insolvency techniques might help to overcome the problem in those RETA economies in which problems of this nature are more critical.

E. Case Management of Corporate Insolvencies

372. The RETA has revealed that many of the RETA economies lack trained and experienced people to administer cases of corporate liquidation and reorganization. That is understandable when the pre-crisis statistics of insolvency cases are considered, because in some of the economies there were no cases of corporate liquidation or reorganization. However, the number of corporate insolvency cases are now beginning to greatly increase as the corporate fall out from action taken within the banking sector begins to take full effect. In Thailand, for example, more than 1000 corporate insolvency cases are expected in the near future.

373. There are two categories of case managers for whom training and education has become vital. The first is in the government department or agency that is expected to administer corporate liquidation cases. Here the need is for considerably greater resources to ensure that the department or agency is managed and staffed by capable people. The functions of such an agency include such important things as taking possession of and securing assets; winding down business operations; assessment and verification of claims of creditors; valuation and sale of assets; recovery of proceeds from fraudulent and other transactions; and distribution of proceeds and dividends to creditors. Training and education in these areas is of considerable and immediate importance in many of the economies.

374. The second category of case managers may be expected to come largely from the private sector. These will be professional insolvency administrators whose functions are primarily directed at cases of reorganization. The functions that they may be expected to perform include pre-insolvency investigative and analysis work; management of the business of a financially distressed corporation; collection and presentation of financial and accounting information concerning the corporation; preparation of

reorganization plans; assessment of plans of reorganization; implementation of a plan of reorganization. They might also be expected to be additionally involved in performing the functions of liquidators, as mentioned above.

375. In many of the RETA economies this category of insolvency case manager has commenced to emerge, but in most cases it is comprised of people who have had limited experience and knowledge. There are moves to form professionally based associations. Some governments have or are contemplating the imposition of licensing and other qualification requirements with the aim of encouraging the development of a strong professional group of private case managers. These initiatives deserve encouragement and assistance by the provision of training and education schemes.

VIII. CONCLUSIONS AND RECOMMENDATIONS

376. The RETA has focused on insolvency - an area that is now recognized and accepted as an important component of economic development and stability for the region. It has contributed to an awareness of the need for the development, revision and reform of insolvency laws and related processes. The RETA achieved this by the studies it produced and by bringing government policy makers together with officials, judges, lawyers, accountants, scholars and multi-lateral agencies to learn from the comparisons and contrasts in the region and international practices.

377. As mentioned in the introduction, reform and further development of insolvency laws is underway in the majority of the RETA economies. Indonesia, Thailand, Hong Kong, China, Korea, Japan, and the Philippines are engaged in that process. And on the eve of the publication of this Report, India has joined that group of economies by announcing the establishment of a committee to consider reform to its corporate insolvency law regime.

378. The combination of this RETA with a study on secured transactions in the region has presented the opportunity to guide policy makers and their governments toward securing unity between these two very vital areas of commercial importance. It has produced an information resource for both the region and outside. The examination and review of insolvency laws and related practices in the region has provided information and critical analysis that were previously unobtainable.

379. However, there is a risk that many of these actual or potential benefits may be dimmed or lost. The economic cycle produces troughs and crests. It is an unfortunate fact of life that the onset of crests erases memories of the troughs. Economic and commercial conditions have commenced to improve in the region and it is, therefore, important that the impetus for review and reform is consolidated. It is appropriate, therefore, that the RETA should conclude with a summary of the assessment of the application of good practice standards and further recommendations for reform.

380. Given the number and the wide number of RETA economies and the differences in legal systems, there is a reasonably high degree of application of the standards in the insolvency laws of the RETA economies. It is clear, however, that some considerable reform is necessary in a number of important areas. This section contains a summary review and identifies the areas in which reform and further technical assistance is desirable. The tables following summarize the assessment of application of good practice standards in the RETA economies.

Economy	Good Practice Standard											
	1	2	3	4.1	4.2	5.1	5.2	5.3	5.4	5.5	5.6	6.1
Hong Kong, China	A	A	N	A	A	A	A	A	P	P	N	A
India	A	A	N	A	A	A	A	N	P	P	N	N
Indonesia	N	P	A	A	P	A	A	N	A	A	N	A
Japan	N	A	A	P	P	A	P	A	A	P	N	P
Korea	N	A	A	P	P	A	P	A	A	P	P	P
Malaysia	A	A	N	A	A	A	A	N	P	P	N	A
Pakistan	A	A	N	A	A	A	A	N	P	P	N	N
Philippines	N	A	A	A	P	A	A	A	A	A	N	A
Singapore	A	P	N	A	A	A	P	A	A	A	P	A
Taipei,China	N	A	A	P	P	A	P	A	A	P	N	P
Thailand	N	A	A	N	N	A	P	N	A	A	P	A

A = Applied

P = Applied in part

N = Not Applied

Economy	Good Practice Standard									
	6.2	7.1	7.2	8.1	8.2	9.1	9.2	9.3	9.4	9.5
Hong Kong, China	A	A	A	P	A	A	A	P	P	A
India	N	P	P	P	N	A	A	P	P	A
Indonesia	A	P	A	A	P	A	A	P	P	A
Japan	N	A	A	A	A	A	A	P	P	A
Korea	N	A	A	A	A	A	A	A	P	A
Malaysia	A	A	A	P	P	A	A	P	P	A
Pakistan	N	P	P	P	N	A	A	P	P	A
Philippines	A	A	A	A	P	P	N	N	N	P
Singapore	A	A	A	A	A	A	A	P	A	A
Taipei,China	N	A	A	A	P	A	A	A	P	A
Thailand	A	A	A	A	P	A	A	A	A	A

A = Applied

P = Applied in part

N = Not Applied

Economy	Good Practice Standard											
	10.1	10.2	10.3	11	12.1	12.2	12.3	13	14	15	16	
Hong Kong, China	P	P	P	A	P	P	N	P	A	A	P	
India	P	P	P	A	P	P	N	P	A	P	P	
Indonesia	P	P	A	P	P	P	P	P	A	P	N	
Japan	P	A	P	P	A	A	N	P	A	P	N	
Korea	P	A	P	P	A	A	N	P	A	P	N	
Malaysia	P	P	P	A	P	P	N	P	A	P	P	
Pakistan	P	P	P	A	P	P	N	P	A	P	P	
Philippines	P	P	A	P	A	A	P	P	A	P	P	
Singapore	A	A	A	A	A	P	N	P	A	A	P	
Taipei,China	P	A	P	P	A	A	N	P	A	P	N	
Thailand	A	P	A	A	A	P	A	P	A	P	N	

A = Applied

P = Applied in part

N = Not Applied

A. The Liquidation Process in the RETA Economies

(i) Coverage

381. The insolvency law regimes of all the RETA economies provide for a liquidation process in respect of an insolvent corporate debtor. In the majority of cases the liquidation process is contained in separate legislation. However, it is recommended that the insolvency laws of some of the RETA economies should make a clear distinction between personal bankruptcy and corporate liquidation.

(ii) Application

382. The application of some of the liquidation laws extends to banking, insurance and securities corporations (**Indonesia, Malaysia and Thailand**) but the consent or authority of a regulatory body governs access.

(iii) Access

383. Access to the liquidation process in the RETA economies for an insolvent corporate debtor is generally easy and uncomplicated. In **Thailand**, however, it is not possible for an insolvent corporate debtor itself to apply for liquidation. In a number of jurisdictions there is a process, in addition to a court sanctioned liquidation process, which enables an insolvent corporate debtor to be voluntarily liquidated through simple administrative actions (see, for example, **Hong Kong, China, India, Malaysia, Pakistan and Singapore**). Of these, that of **Singapore** offers the easiest and most uncomplicated process.

384. The ease of access for a creditor of an insolvent corporate debtor varies. In the **Philippines**, for example, it is necessary that at least three creditors join together to make an application against a corporate debtor. In **Japan** a possible barrier exists because there is no easy or convenient method for a creditor to prove that a corporate debtor is insolvent. In **Thailand** access is difficult because of the insistence on the application of a 'balance sheet' threshold test for insolvency.

385. Each of **Hong Kong, China, India, Malaysia, Pakistan and Singapore** offer relatively easy access to creditors. There is little or no evidence of any abuse of the liquidation process as a result of the ease of access in these jurisdictions. Reform is recommended in the RETA economies in which the law does not apply the entry/threshold standards identified earlier.

(iv) Single/dual Process

386. In most of the RETA economies, once the liquidation process has been initiated, there is little or no opportunity for a rescue attempt to be made in respect of the corporate debtor. That may not be of any real concern because very few corporate debtors might be able to fashion a rescue from a liquidation (cf. **Indonesia** that offers the chance of a "composition"). However, it is of some concern that in a number of the RETA economies there is no provision that enables the rescue process to be converted into the liquidation process if either the rescue process falters or has failed. For example, in **Hong Kong, China, India, Malaysia, Singapore and Pakistan** there is no conversion process. It is suggested that these RETA economies should adopt a unitary based insolvency law system.

(v) Effects

387. All of the regimes provide for a stay or suspension of actions, normally confined to unsecured creditors thus leaving secured creditors unaffected. In **Malaysia** some recent legal opinion indicates that the commencement of the liquidation process may interfere with self help enforcement of a security over land (at least so as to require a court order to effect a sale of the land). In **India**, and **Pakistan** it appears to be the case that the commencement of a liquidation process brings all security enforcement proceedings to a halt and they are transferred to the court in control of the liquidation proceedings. Some

attention should be given to this aspect in those economies because of the possible damaging effect on secured transaction lending.

(vi) Administration

388. The procedure which eventuates after the liquidation process has been commenced is similar in most jurisdictions in the RETA economies. There are, however, some notable differences in procedure and functionaries. One of the most striking differences concerns the actual administration of the affairs of the corporate debtor. All the jurisdictions provide for the liquidation of a corporate debtor to be conducted by an administrator but they vary considerably as to the identity and qualifications of the institution or person who is to conduct or administer the liquidation. They also differ greatly in the degree of skill and efficiency that is applied to the administration. It appears that a technical assistance in this area would be of benefit in some of the economies. The assistance should be directed at training and education in both the public and private sectors of insolvency administration.

B. The Reorganization Process in the RETA Economies

(i) Coverage

389. Some of the RETA economies must establish modern and efficient reorganization processes. A number of the RETA economies must review their respective laws to ensure that a corporation in financial difficulty has easy and efficient access to, in particular, the reorganization process. It is also necessary that access for a creditor is reviewed to enable that sector to exercise a fundamental 'last resort' commercial right. If an insolvency law does these two things it establishes a necessary commercial balance by providing insolvent corporations with the possibility of relief and, at the same time, driving corporations toward that relief.

390. All of the insolvency laws provide for a rescue or reorganization process. However some of them are seriously out of date and in urgent need of reform. For the 'English' based insolvency law economies, particularly **India, Malaysia and Pakistan**, the judicial management reform in **Singapore** and the proposed rescue reform in **Hong Kong, China** would provide suitable alternative models upon which that reform might be based. The multi-law processes of **Japan, Korea and Taipei, China** do not appear to be necessary and could be converted into a single reorganization law.

(ii) Access

391. The threshold commencement criteria for reorganization in some of the insolvency laws require revision. This seems to be particularly critical in **Thailand** where the entry criterion is far too high to encourage rehabilitation. The criteria in the **Singapore** and **Indonesian** reorganization laws provide very good models.

(iii) Conversion to Liquidation

392. Many of the reorganization laws do not provide for conversion to liquidation if the attempt at reorganization fails. It seems essential that they should if cost and delay is to be avoided and if debtors and creditors are to be provided with the exercise of commercial choice. Thus a review of this area is important in **Hong Kong, China, India, Malaysia, Pakistan, Singapore** and **Thailand**. It is surprising that in **Singapore** there is no integration of the processes of judicial management and liquidation so that there can be conversion from one process to the other. Under the Singapore law, if a corporation seeks a possible rescue under the judicial management process but fails, there is no automatic conversion to liquidation. Likewise, there is no conversion process for a corporation that faces liquidation when there is a fair or reasonable prospect of a rescue. The result is that time and cost are expended on the commencement of new proceedings.

(iv) Effects of Commencement

393. The absence in some of the laws of an immediate or early automatic stay and suspension of all creditor rights and powers against a debtor corporation or its property upon the commencement of the reorganization process is of some concern. The reorganization processes of **Hong Kong, China, India, Japan, Korea, Malaysia, Pakistan** and **Taipei,China** do not provide for an automatic stay. Even though it is possible in all of those jurisdictions to obtain interim orders from a court for a stay, that process causes unnecessary delay and expense.

394. The effect on the powers of management is another area where some revision is desirable, particularly in economies where there is a considerable cultural aversion to complete loss of control. The complete removal or suspension of powers of management in some of those economies appears to be causing some considerable apprehension in volunteering for a possible reorganization. This might be tempered by revising the laws to enable powers of management to be subject to supervision by an independent administrator.

(v) Provision of Urgent Working Capital

395. All the laws in the RETA economies are deficient in this respect. It is an area in which the Asian region would benefit from a regional technical assistance to review the area in more detail with the aim of proposing a choice of legislative models for possible adoption.

(vi) The Timely Processing of Reorganization

396. The laws of some of the economies do not provide for a swift and efficient timetable for the progression of the reorganization process. In other economies the process is labored. In, for example, Japan and Korea part of the problem lies in the interventionist role that the court is required to perform. The process could be simplified and made less dependant on judicial involvement. This would give it a more commercial, rather than legal, focus. In some cases the problem is centered on the general inefficiency of the court and judicial system. The type of court structure that has recently been employed in **Thailand** provides a good model for efficiency.

(vii) Priority Provisions

397. Many of the RETA economies should review the provisions of their respective insolvency laws regarding the nature and extent of priority provisions. Some of these, particularly those relating to government fiscal claims and claims of employees, should be reviewed and abolished.

(viii) Assessment and Objectivity of Reorganization Plans

398. In some of the economies there are significant problems regarding the availability and appointment of suitably qualified and experienced professional administrators to assist in the reorganization process. This is another area in which training and education technical assistance would be beneficial.

399. There is also an absence in some of the laws of the RETA economies a legislative standard that the effect of a reorganization plan must provide for creditors (for example, that the intended or anticipated result will provide a greater benefit than that which would be possible under a liquidation).

(ix) Involvement of Creditors

400. Some attention is required regarding voting requirements for approval of a plan. In some of the economies the law is not sufficiently clear to protect the general body of creditors from manipulation by 'insider' voting.

(x) Implementation, Amendment and Termination of a Plan

401. Some of the laws are not sufficiently explicit in these areas and should be reviewed and revised.

C. Other Aspects

(i) Application of Transaction Avoidance and Civil Fraud Provisions

402. The civil prosecution of claims in respect of transaction avoidance and owner and management fraud. The provisions of the insolvency laws that provide for these matters are not being enforced in many of the economies. It is an area in which training and education in the investigation and prosecution of such transactions would greatly assist.

(ii) Cross-border Co-operation and Assistance in Insolvency Cases

403. The laws of all the RETA economies are deficient in providing for cases of cross-border insolvency. This is an important area for the region as a whole. A regional technical assistance to promote regional and international co-operation and assistance in cross-border insolvency matters is recommended. A regional judicial symposium to advance the prospects of the adoption of the UNCITRAL model law on cross-border insolvency is likewise desirable.

(iii) Maintaining the Informal Work-out Process

404. The development of this area will leave the RETA economies with a permanent legacy. It cannot be expected, however, that the quasi-government-structures that have promoted forms of informal processes in some of the RETA economies will remain intact for much longer. It is therefore important that continued training and education in the banking and professional sector is maintained. Some of the RETA economies should also contemplate the establishment by the banking sector of a permanent secretariat to maintain and advance the practice of this important commercial process.

405. In addition, it is desirable for the future that a regional conference be convened to consider the experiences and knowledge gained in each of the RETA economies that have employed the structured informal work-out process. Such a comparative exercise would provide valuable information for other countries in times of economic stress.

(iv) Court Processes

406. There is a need for considerable improvement of court and related processes in some of the RETA economies. In particular, there is the need for judges who are capable of dealing with cases of corporate insolvency. That requires wide knowledge and appreciation of economic, commercial and corporate affairs. In some of the economies, training and education in those areas would be of considerable benefit. A high priority should be accorded for intensive and ongoing education and training of judges and court officials in those RETA economies.

(v) Statistical Information

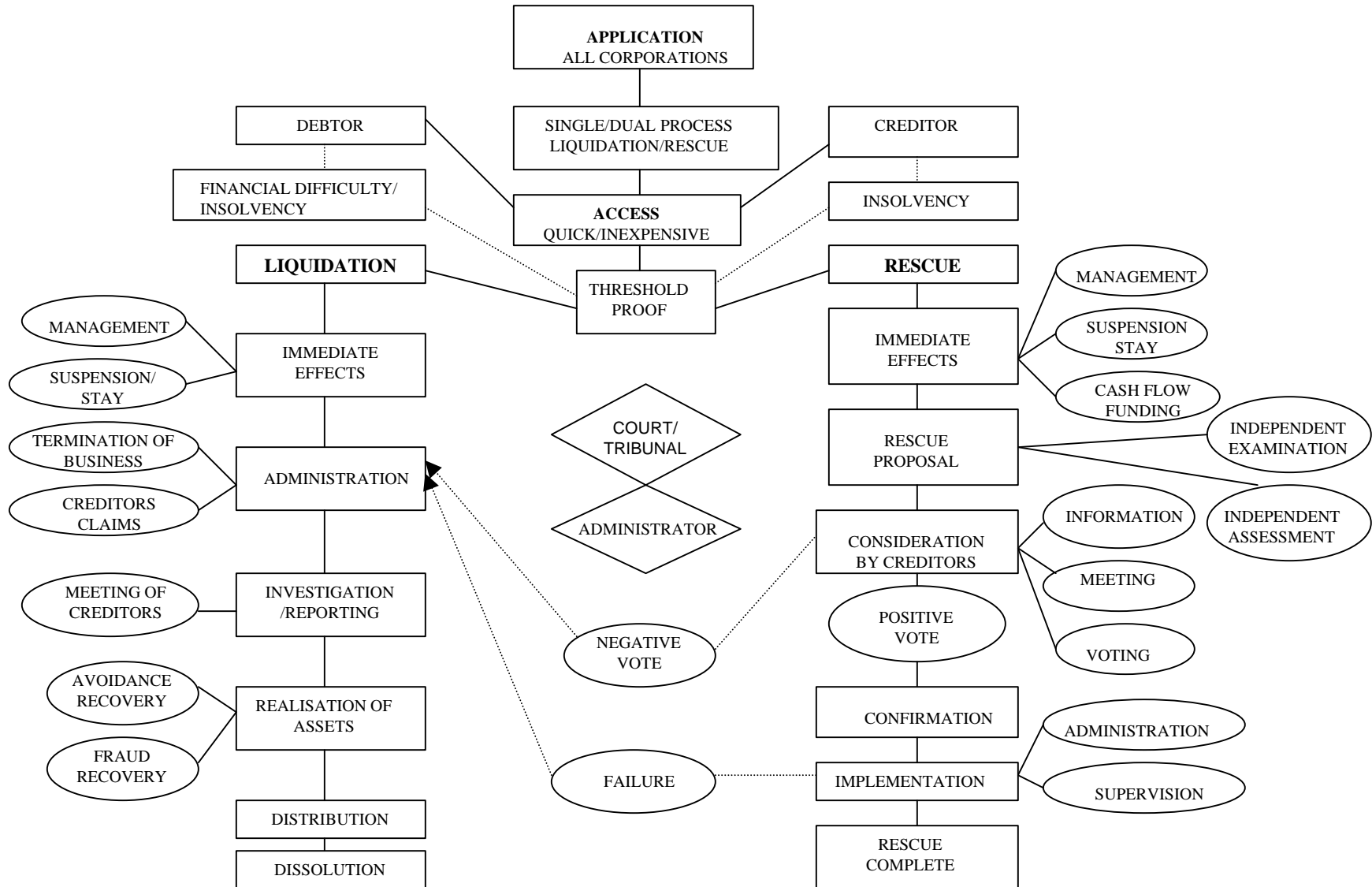
407. Statistical information on corporate insolvency should be published by the responsible authority on a quarterly basis with a yearly summary. The process of gathering and recording statistical insolvency information should be also extended to informal processes, particularly those that are under the guidance of central bank or other government agencies. There is also a need for reports, writings, opinions and critical analyses of insolvency cases and on the operation of the insolvency law system.

(vi) Secured Transactions

408. Many of the RETA economies lack an effective secured property enforcement regime. These RETA economies should conduct a thorough review of their secured property enforcement regime. Issues considered in the following article *The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms* should be taken into account in framing good practice guidelines for the development of efficient and effective secured transactions law regimes.

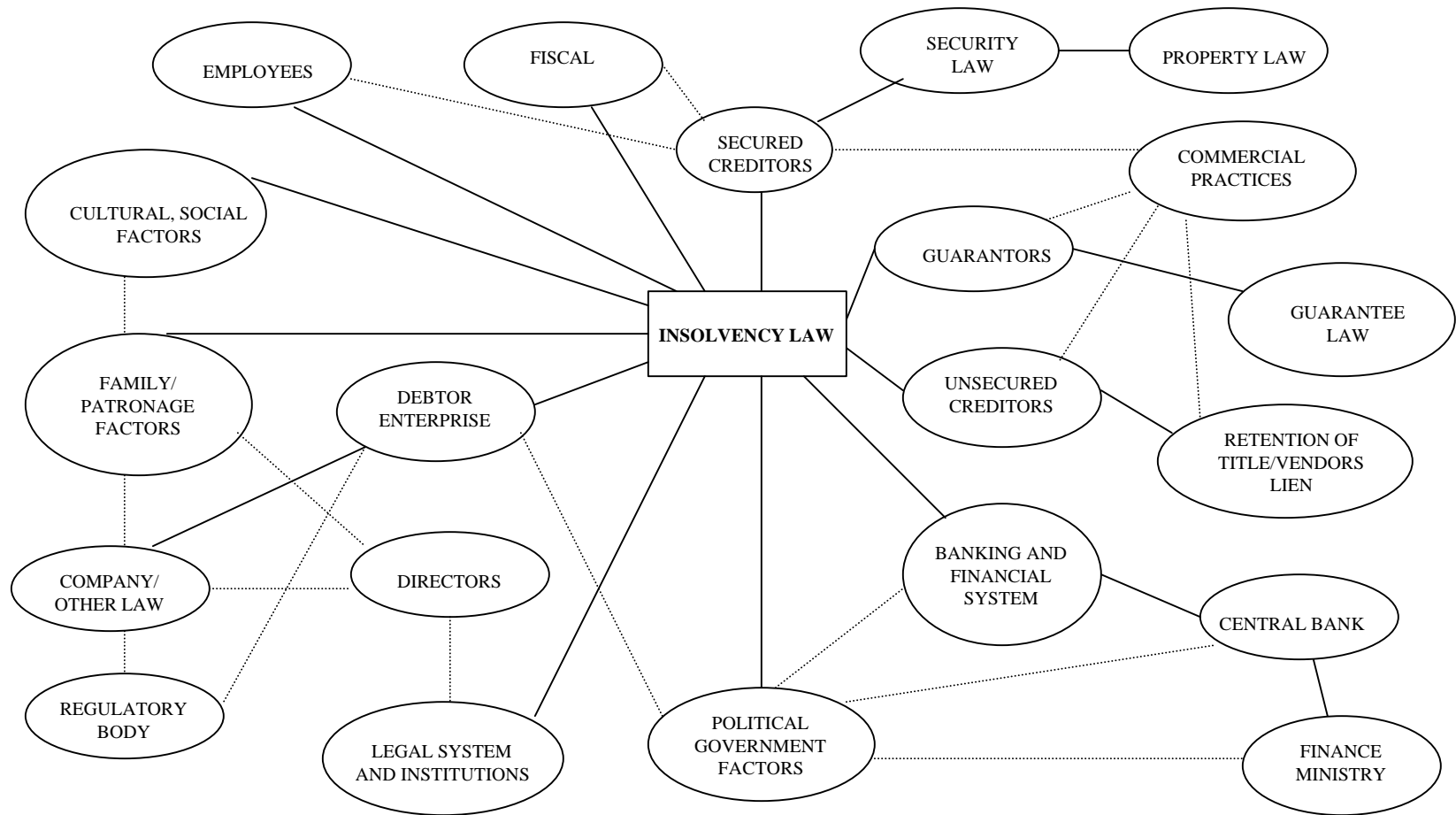
409. It is suggested that reform to any insolvency law system must be carried out with due consideration of the secured transactions system, as both are part of the same system of legal and commercial regulation and vice-versa. The lack in one area poses an unhealthy burden on the other. Therefore, it is suggested that an integrated approach should be adopted for the reform of both insolvency and secured transactions laws.

Insolvency Law Regime Outline



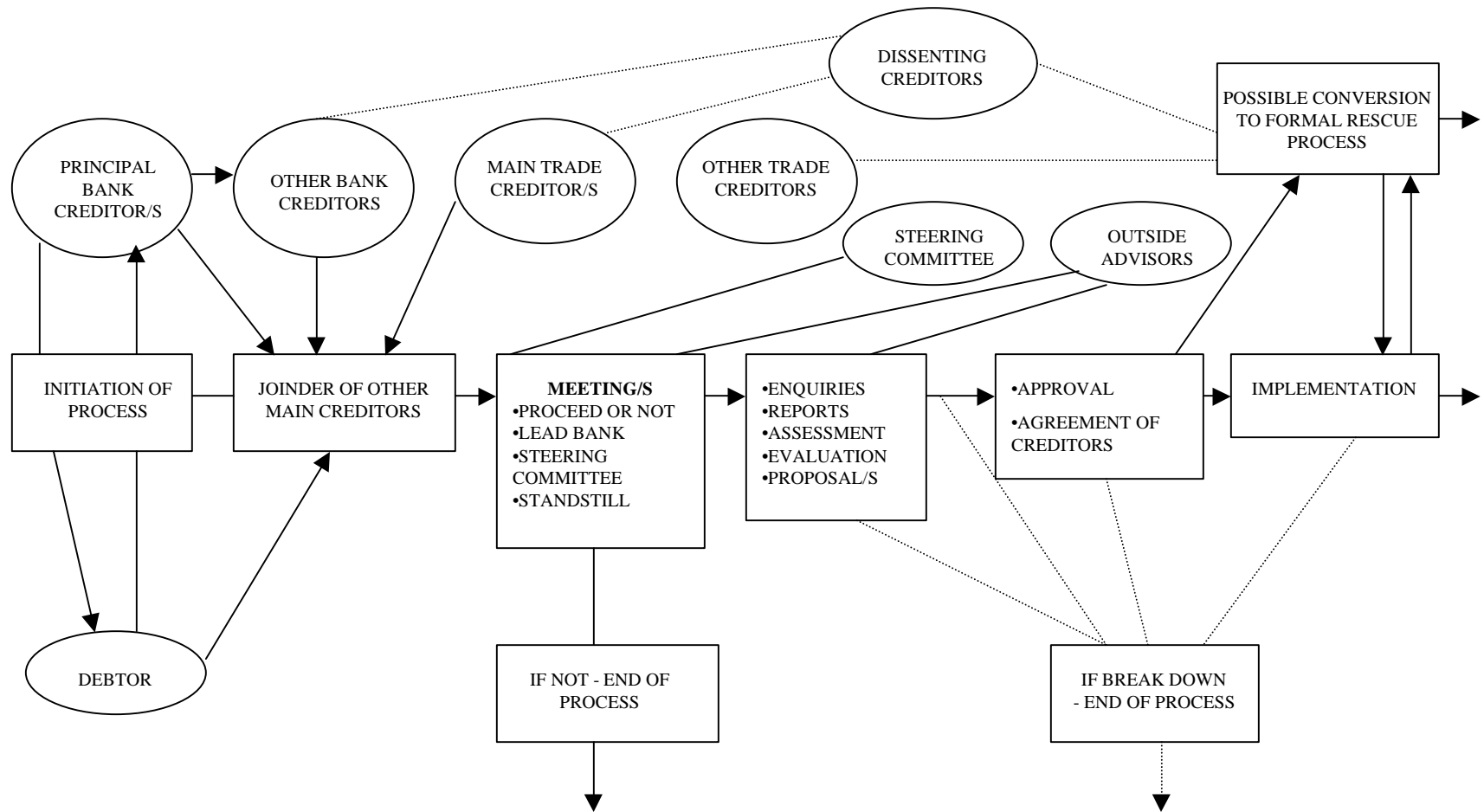
Appendix 2

Insolvency Law Influences



Appendix 1

The Informal Work-Out Process



Appendix 3

The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms

THE NEED FOR AN INTEGRATED APPROACH TO SECURED TRANSACTIONS AND INSOLVENCY LAW REFORMS*

I. INTRODUCTION

1. The Office of the General Counsel (OGC) of the Asian Development Bank (ADB) is currently involved in the carrying out of two regional technical assistances to survey the secured transactions and insolvency laws of several of its developing member countries.¹ From 25 to 28 October 1999, the ADB hosted two symposiums at its headquarters in Manila, Philippines, on secured transactions and insolvency law reforms. On 26 October 1999, the participants from both these symposiums (participants from the insolvency symposium are hereinafter referred to as the “Insolvency Team” and participants from the secured transactions symposium are hereinafter referred to as the “Secured Transactions Team”) were brought together for a joint session to discuss various economic and legal issues arising from the intersection of secured transactions and corporate insolvency (hereinafter “Joint Session”).

2. The Joint Session presented a rare opportunity to consider the underlying policies and principles and the consequent goals and aims of secured transactions regimes in conjunction with those of insolvency law regimes. In this regard, participants from both symposiums brought a different focus to the issues involved.² It is doubtful that such a forum has previously been assembled, at least for the purpose of a general consideration of the intersection of the two areas. It is surprising that the two areas have not been considered together more often. Particularly as, in a wider international context, such a need has been increasingly recognized.³

3. While not discussed at the Joint Session, it is worth noting the context in which secured transactions and insolvency regimes operate and influence. Insolvency and secured lending are part of the larger system of commercial law, and as such each occupies its respective area of influence and

* This report was prepared by Mr. Ronald Winston Harmer, ADB lead consultant for TA No. 5795-REG and Ms. Clare Wee, Senior Counsel, OGC. This article has benefited from a report of the Joint Session prepared by Mr. Charles D. Booth (local consultant for Hong Kong, China) as well as from comments provided by Mr. H. Sharif, Senior Counsel, OGC, Mr. Arjun Goswami, Counsel, OGC, and Mr. Heywood W. Fleisig, ADB consultant for TA No. 5773-REG. Mr. Booth's report may be viewed on www.insolvencyasia.com.

¹ Respectively, TA No. 5773-REG: Secured Transactions Law Reforms (hereinafter “RETA 5773”), covering Indonesia, India, Pakistan, People’s Republic of China, and Thailand; and TA No. 5795-REG: Insolvency Law Reform (hereinafter “RETA 5795”), covering Hong Kong, China; India; Indonesia; Japan; Korea; Malaysia; Pakistan; Philippines; Singapore; Taipei, China; and Thailand. The design and methodology of this regional technical assistance (RETA) is more fully addressed in the following report in this publication. The design and methodology of RETA 5773 will be presented in Vol. II of this publication. The economies covered by both RETA 5773 and 5795 are collectively referred to as the “Economies”.

² The participants included local experts, judges, bankruptcy practitioners, policy makers, scholars, lawyers, bankers and accountants. Also present were delegates from various legal institutes and other multilateral institutions, including the World Bank, the International Monetary Fund, and the Organization for Economic Co-Operation and Development.

³ Both UNCITRAL and UNIDROIT have recognized the importance. UNCITRAL in its work on a draft convention on assignment of receivables in international trade (which includes securitization of receivables) has convened a number of sessions to take the opinions and advice of insolvency law specialists regarding insolvency related aspects of the draft convention. UNIDROIT in its work on a draft convention on international interests (including security interests) in mobile (particularly aircraft) equipment, has convened special working groups comprised of both insolvency and secured transaction experts to consider insolvency related implications. Both of those projects have benefited considerably from the interaction. Additionally, the Group of 22 Report, Report of The Working Group on International Financial Crises, published October 1998, also recognized the importance of adopting an integrated approach to secured transactions and insolvency law reforms.

importance within the wider framework of commercial law. Both are concerned with debtor-creditor relationships, an area that, in turn, is part of a wider commercial law system. As such, improved secured transactions and insolvency regimes have an important role to play in the promotion of better corporate governance. Debtor-creditor relationships, particularly those arising from secured transactions, are based on contractual obligations. Any breach of such contractual obligations by a corporation will, normally, signal financial distress and the need for remedial action. Ultimately that may lead to the removal of those responsible for the management of the debtor corporation and/or the redeployment of assets to create more value. For example, some secured transactions regimes give secured creditors the power to interfere or replace management in the event of a breach of the contractual obligations that underlie the secured transaction.

4. Most insolvency law regimes will provide for the possibility of interference with or replacement of management of an insolvent corporation as a means of structuring a reorganization of the corporation and its assets. The prospect of these types of sanctions can produce a powerful incentive on the part of corporate management to take, for example, a responsible attitude toward the incurring of debt; honoring debt contractual obligations; and taking affirmative action in the event of financial distress (by, for example, seeking an informal work out with creditors). Responsible attitudes of that nature may be regarded as consistent with the application of proper standards of corporate governance. On the other hand, if the means to enforce debtor-creditor contractual obligations (either through the application of a debt enforcement regime or an insolvency regime) are weak or inefficient, it is highly likely that the management of a corporation will choose to ignore such governance standards.

5. While secured transactions and insolvency law regimes may have in common desired benefits on corporate governance, both may in case of an insolvent enterprise have different objectives. There is therefore room for considerable potential tension and irreconcilable conflict between the two areas. The differences between them may be expressed in a variety of ways, but the more essential differences may, perhaps, be best stated as follows:

- **Each postulates a different approach to debt.** Insolvency may be viewed as a system of law that endeavors to deal with debts that cannot be paid as they fall due or cannot be paid in full. Secured transactions may be viewed as a system of law that endeavors to assure that debts will be fully paid even if the business enterprise can no longer be profitably run.
- **Each endeavors to uphold different rights.** Insolvency is concerned with enhancing or at least maintaining the value of a firm's assets by preventing a destructive race between individual creditors to grab a firm's assets through uncoordinated individual enforcement action, and maintaining rights based on collective treatment of creditors with equal rights. Secured lending is concerned with maintaining creditors' asset-based rights and promoting individual enforcement.
- **Each has a different stakeholder constituency.** Insolvency is concerned with maximizing the value of the whole of the property of the debtor for the benefit of all creditors. Secured lending is concerned with maximizing the value of the particular secured property of the debtor for the benefit of an individual creditor.

If the central aims of one area are pursued without a consideration of those of the other, clash and disharmony is inevitable.

6. With this in mind, Joint Session participants sought to:

- Define those instances when the collective or public interest justified allowing bankruptcy to interfere with the rights of secured creditors;
- Define the types of interferences that should be permitted; and

- Propose mechanisms to protect the interests of secured creditors whose rights have been adversely affected by such interference.

7. A challenge presented by the intersection of secured transactions and insolvency laws is to address and resolve the problem presented by competing claims to the property of an insolvent corporate debtor. Or, to put the challenge another way, any insolvency law reform must address the competing claims to an insolvent debtor's property or to the funds realized from that property. At the epicenter of this competition are the claims of those whose rights are derived from secured transactions.

8. In a mature market economy, it may be expected that the great majority of the debt incurred by corporations will be secured transaction debt. Secured lending in such an economy will be based on a highly developed legal framework supported by equally highly developed commercial techniques and practices. In short, secured transaction lending will constitute a major part of the commercial law and practice of such an economy.

9. In some of the Economies, the insolvency law regime is not sufficiently definitive regarding the treatment of secured property interests. The areas of concern include the absence of a clear statement in the insolvency law of the effect of a bankruptcy upon a secured property interest and the absence of a clear statement of the extent to which preferred creditors claims (e.g., tax authority claims) have priority to the proceeds of the sale of secured property over the interests of secured creditors.

10. A basic principle that should be followed in the creation or reform of an insolvency law is that, as far as possible, it should relate to and support well-settled commercial laws and practices. It follows, from that statement of principle, that an insolvency law should endeavor to relate to and support secured transaction lending on the basis of a stable and predictable legal framework.

11. However, it may also be expected that an insolvency law will be subject to the application of other principles and policies to which it must endeavor to also respond. One of these is the more modern economic policy that an insolvency law regime should endeavor to maximize the value of the property of a debtor for the collective benefit of all creditors. Another policy is based on principles of fairness. This policy maintains that transactions involving the property of a debtor that have offended basic principles of commercial and legal fairness or that have unfairly interfered with the principle of equal sharing between creditors should be set aside. Yet another policy is one that requires that particular creditor interests, such as claims of employees of an insolvent debtor or the fiscal claims of the state, should be protected and preferred. The application of that policy may require that the property of a debtor (or the proceeds of the sale of that property) be distributed first in favor of those interests above all others, including secured creditors rights.

12. The 'challenge' mentioned above arises when the 'property' referred to in relation to the application of those latter policies and principles is the same, or includes, 'property' that has been secured as a result of a secured transaction. It is this that creates the potential conflict of interest and disharmony between principles of secured transactions and insolvency laws. The following discussion explores how the interplay of these principles of law may be harmonized.

II. AN EXAMINATION OF THE ISSUES ARISING FROM THE INTERSECTION BETWEEN SECURED TRANSACTIONS AND INSOLVENCY

13. The intersection between secured transactions and insolvency may be examined in a number of different ways. The Joint Session took the approach of considering this by reference to three time periods – pre-insolvency commencement, upon the commencement of a formal insolvency proceeding, and post-insolvency commencement.

14. The first of these embraces the creation of secured property interests and, more specifically, a registration and information system regarding such interests and the enforcement of secured property

rights. The second is concerned with the effect of the commencement of a formal insolvency process upon secured property interests. The third is directed at other (and, possibly, continuing) effects on secured property interests after the commencement of a formal insolvency process.

A. Pre-Insolvency Commencement

15. This time period is concerned with the creation of secured property interests; registration and information systems concerning secured property interests; and enforcement of secured property interests. This may, at first, appear to be outside the ambit of the focus and aims of insolvency because it is concerned with the core of a secured transaction legal regime. Nonetheless, much of it is highly relevant to corporate debt and insolvency.

16. **The Creation of Secured Property Interests.** If secured transactions are to be commercially effective, a legal regime is required that enables secured property interests to be created, identified and recognized. Such a regime would provide for (and, possibly, govern) the consensual creation of such interests by agreement. It might also extend to identifying secured property interests that may arise by operation of law; an area that may be of some importance in common law based jurisdictions.

17. The importance of such a codified legal regime for commercial purposes is that it provides an efficient system by which secured property interests may be identified and recognized. That is obviously important for the commercial community as a whole. But it also has an important practical benefit for insolvency law purposes. Upon the insolvency of a debtor whose property has been secured, the person or institution administering the insolvency is able to recognize such interests more easily and with more certainty than in the absence of codification.

18. There was no disagreement between participants at the Joint Session that the implementation of an efficient system of secured lending produces important economic and social benefits. It was posited at the Joint Session that secured lending supports a sevenfold increase in credit with no additional risk. It was also claimed that as the quality of collateral increases the interest rate decreases up to a factor of fifty percent and the ratio of debt/income rises more than eight-fold. Similarly, as the quality of collateral improves, the loan size dramatically improves, as does the term length.⁴

19. However, participants noted at the Joint Session that secured lending could create a moral hazard. It was pointed out that this was the recent experience in many of the Economies where banks relied primarily on asset-based or name lending rather than on cash-flow analysis. As borne out during the Asian financial crisis, the consequences can be dire for lenders when borrowers are unable to repay their debts and the value of the collateral collapses. It was even queried whether the law should penalize reckless lending. Despite the foregoing, it was agreed at the Joint Session that an effective system of secured lending is important, and that an effective secured transactions system acts as an engine of economic growth.

20. It was noted that in most of the Economies secured lending was solely focused on mortgages of land or pledges of shares. In only a few of the Economies had there been much, if any, development of secured lending over movable and other property. This, in part, was because of the absence of a developed secured transactions legal regime. In many of the Economies the secured transactions legal regime was very under-developed; and the range of secured transaction lending was extremely limited. Further, the system of creation and registration of secured property interests was, in some cases, inefficient and uncertain.

21. Moreover, secured lending on mortgages over land and pledges of shares appeared to be accompanied by weak loan assessment and loan monitoring practices of banks and other financiers. This was because loan assessment and subsequent review was concentrated on the value of the land or the shares as security. There was very little evidence of any widespread credit assessment practices that

⁴ See the report of RETA 5773, titled *Integrating the Legal Regimes for Secured Transactions and Bankruptcy: Economic Issues* (hereinafter "RETA 5773 Report"), at p.10.

were concerned with the business of a corporate borrower, its income, profitability and cash flow. In those Economies in which secured lending over movable property was more practiced there was a far greater assessment of the ability of the corporate borrower to service the borrowing.

22. **Registration and Creation of Secured Property Interests.** Issues concerning the validity and enforceability of a secured property interest may, as between the parties to its creation, be determined by reference to the agreement by which, or the circumstances under which, it was created and the relevant law concerning creation. In that respect, a system of registration of such interests may not be of critical importance.

23. However, it is critical to determine whether such a secured property interest will be valid and enforceable against other persons, for example persons who claim security over the same property or a purchaser of the property. That determination may depend on other requirements of a secured transactions law. These might insist that the creation of such an interest be registered or notified on a public register.

24. It appears to be generally recognized that the interests of a commercial community will be better served if the creation of secured property interests is subject to such a registration or notification system. This is usually linked to the concept of 'perfection' of a security interest. In jurisdictions that provide for 'perfection', a secured property interest will only be valid and subsist against third parties if registration or notification perfects it.

25. Many systems of law provide for such a registration or notification system. Participants at the Joint Session indicated a strong preference for registration systems. These systems can serve a number of important functions that are both directly or indirectly related to insolvency.

26. First, the registration or notification of a security interest can provide important information regarding both the asset worth and the credit worth of an enterprise. It may be regarded as important that persons who deal with an enterprise (for example, existing or prospective creditors) know or, at least, are afforded the opportunity to know if the property of an enterprise has been secured in favor of a lender or credit provider. This assists in the assessment of loan and other credit requests. It may be readily determined if a corporation has created security interests over its property and the terms and effect of those interests. It may also help to expose or lessen the possibility of a debtor pretending to possess that which is sometimes referred to as 'false wealth'.⁵

27. An insolvency regime will function more effectively as a result of the availability of informed credit assessment information. It may result in a lesser number of insolvent corporations or there may be less insolvent corporations that are hopelessly burdened by debt and better candidates for possible rescue or reorganization.

28. Second, a registration system that is used as a means of perfecting and validating security interests provides more certainty of recognition of secured property interests. From an insolvency perspective, it may mean (depending on the policy that is adopted under the secured transactions registration regime) that an unperfected secured property interest will be invalid against the person who administers the liquidation or other insolvency administration of an insolvent corporation. That enables the property to be dealt with free from claims of such interests.

⁵ The phenomenon of 'false wealth' arises when an owner of property can pretend or give the appearance that the property is owned outright and is not subject to any secured debt interest. This can occur as a result of an undeveloped or defective secured transactions legal regime, as, for example, if secured property interests cannot or do not have to be registered or notified. The owner can claim that his 'wealth' includes the full value of the property without revealing that the property is, in fact, security for a liability and deducting that liability from his 'wealth'.

29. Third, if a registration system is used to create or enhance the certainty of a priority system between possible competing security interests in the same property it will make issues of priority between secured creditors more certain and reliable. That, in turn, will assist in the administration of an insolvent corporation. It means that an insolvency administrator can determine the relative order of priority between secured creditors in respect of the same property and can further determine and assess their relative position of power and influence. These are important pragmatic considerations in the context of, for example, the practicalities involved in proposing a plan of reorganization. Account must be taken of secured creditors and the possible continued availability of secured property for the purposes of a reorganization.

30. For the above reasons it may be submitted that a registration and information system in respect of the creation of secured property interests serves an important purpose for an insolvency regime. It contributes to a more certain and predictable debtor-creditor legal regime of which, as mentioned earlier, the insolvency law regime is part.

31. **Enforcement of Secured Property Interests.** It may be expected that a secured transactions legal regime or some other law will deal with the enforcement rights of secured creditors. This will usually cover such things as the right to enforce a debt obligation by foreclosure and sale of the secured property, the process of enforcement and the ultimate sale of the secured property. It is an area that is of vital importance to secured transactions.

32. Indeed, an efficient enforcement system is a key component of an effective secured transactions system. It also has some considerable indirect importance for an insolvency law regime. Participants at the Joint Session strongly agreed that the efficiency of the enforcement system is a key factor for parties in determining whether to pursue informal or formal workouts. It was agreed that an inefficient system of security enforcement often leads to an ineffective and overburdened corporate rescue system. This is because secured creditors seek to use the corporate rescue system as a means of debt collection.⁶

33. Default by a debtor in relation to a secured debt will often signal that the debtor is in severe financial difficulty. The creditor will normally seek to exercise powers of enforcement in relation to the secured property. If the creditor is constrained or impeded in exercising those powers by weaknesses in the relevant law or by inefficient application of the legal processes that must be followed, a number of consequences may follow. First, the debtor may be encouraged to take every possible advantage of the ineffective legal system to delay and frustrate the enforcement process. Second, the debtor will not be encouraged nor feel compelled to seek relief from its financial predicament under, for example, the reorganization process of the insolvency law. In the meantime, the financial affairs of the debtor may deteriorate. Third, the creditor may be driven to employ other remedies and may, for example, seek to bankrupt or liquidate the debtor under the bankruptcy law.

34. None of these possible consequences are desirable. For insolvency law purposes, a strong and effective secured property enforcement law and process can be a valuable ally to encourage an insolvent corporate debtor to volunteer for reorganization at an early stage. The absence of or weaknesses in such an enforcement regime means that there is no pressure or persuasion on an insolvent debtor to take remedial action to prevent dismemberment of the property of the debtor. It is also not a desirable

⁶ When a creditor is forced, because of inefficient debt enforcement remedies, to resort to insolvency remedies it will sometimes result in an agreement between the debtor and the creditor and the termination, withdrawal or lapse of the insolvency proceeding. Yet, an insolvency proceeding should not be lightly terminated simply because the debtor and creditor have reached an agreement. An insolvency proceeding is or should be regarded as a 'collective' procedure, one that is brought for the benefit of all creditors, whether they know about it or not. Despite that a creditor who brings an insolvency proceeding and the debtor against whom it is brought may have reached some agreement between themselves, the court may have to order an inquiry to determine if there are other creditors and whether they might wish to participate in the insolvency proceedings. This creates cost, delay and it is time consuming for the court. It can mean that the insolvency court becomes, in a de facto sense, a debt collection court, which is far from its proper function and purpose.

consequence that a secured creditor seeks to apply an insolvency law as a method of debt enforcement. This puts an unwanted strain on the insolvency law system.

35. An effective and efficient secured property enforcement regime is, therefore, important for insolvency law purposes. It was noted at the Joint Session that many of the Economies lack an effective enforcement regime. Overall, it was acknowledged that the enforcement processes in many of the Economies take too long, are too expensive, and are commercially inefficient.

36. For instance, in many of the Economies (particularly Pakistan, India, Philippines, Thailand and Indonesia) there were considerable problems regarding the enforcement of secured property rights. The reasons for this varied. In most of these Economies, secured property enforcement has to be conducted through the courts.⁷ Court processes and defensive debtors resulted in extensive delay. Also, in some of the Economies, after a court order is obtained that permits foreclosure, the sale and realization of the secured property has to be conducted through a government agency. It is not generally possible for a secured creditor to employ self-help enforcement remedies even if the law provides for it since the general inefficiency of the law (and order) regime does not provide adequate protection to a creditor who seeks to enforce such self-help remedies (e.g., India and Pakistan).

37. The difficulties associated with enforcement create a situation in which a corporate debtor has no real concern about threats of or actual resort to enforcement proceedings. This not only has a serious impact on secured transaction lending but it also means that one of the most effective debtor-creditor sanctions to apply to an insolvent corporate debtor is absent or ineffective. It also often results in secured creditors using the insolvency law to enforce their individual rights. Consequently, the debtor-creditor commercial system becomes considerably twisted.

38. It is possible that the insistence in many of the Economies upon court and government agency regulation in relation to the enforcement of secured property rights is due to an understandable concern to protect certain classes or categories of borrower, for example consumers, farmers and small business people. It is difficult, however, to understand why it is necessary to apply the same degree of regulation to secured transactions involving corporations.

B. Commencement of Formal Insolvency Proceedings

39. A number of issues arise concerning the immediate effect of the formal commencement of insolvency proceedings on secured transactions and related issues. Three areas are addressed. The first is concerned with recognition of rights over secured property; the second deals with the power to avoid secured transactions, and the third considers the effect on enforcement powers of secured creditors.

40. **General Recognition of Secured Property Interests.** It is necessary that the law, whether through an insolvency or some other law, clearly state if secured property interests will be recognized upon the commencement of a formal insolvency administration. Without such a statement there will be doubt and uncertainty.

41. The law may thus provide that security interests that do not conform to or comply with the law relating to the creation and registration of a secured property interest shall be invalid and unenforceable in the administration of the debtor. This does two things. First, by creating a sanction in the form of potential invalidity and unenforceability, it reinforces the necessity to conform to and comply with the formalities associated with the creation and perfection of secured property interests. Where the law includes registration of secured interests, this promotes greater transparency with respect to the debtor's assets and avoids the problem of 'false wealth' mentioned above. Second, as mentioned previously, it provides for certainty of recognition and continued rights in relation to secured property interests. That is important for commercial predictability.

⁷ Even where special tribunals have been created (e.g., India), they have not lived up to their promise.

42. **Power to Avoid or Invalidate Secured Property Interests.** Although a secured property interest may have been validly created and perfected according to the relevant secured transaction legal regime, it may have been created or procured by means or in circumstances that conflict with insolvency law regime policies and principles.

43. It is common for insolvency law regimes to provide for the invalidation or avoidance of certain types of transactions. This is designed to protect creditors from fraudulent or uncommercial transactions concerning the property of an insolvent debtor, particularly if the transaction has been made between an insolvent debtor and a person closely connected with the debtor. Thus, a transaction that effects a fraud upon creditors (for example, the creation of a security over property to secure a fictitious loan) or otherwise prejudices or disadvantages creditors (for example, the creation of a security over property by way of gift or in return for no or no sufficient payment or value) may be avoided. Both Teams at the Joint Session were in agreement on this point.

44. An insolvency law may also seek to promote and reinforce the principle of maintaining equality between creditors by providing that a transaction that benefits or advantages one creditor of a particular class over other creditors of the same class may be avoided. For example, an unsecured creditor of a debtor may require payment of the debt. The debtor, who cannot pay, is required to create a security over its property in favor of the unsecured creditor to secure payment of the debt. Thus, the unsecured creditor becomes a secured creditor and, by doing so, secures a right to be paid from the secured property ahead of all other unsecured creditors. Depending on the time at which and the circumstances under which such a transaction was effected, the policy of an insolvency law may be to avoid and invalidate such a transaction.

45. The policy issue is whether such avoidance provisions should apply to secured transactions. There may, of course, be a view that these types of transactions should not attract avoidance because they may be commercially justified. Indeed, the Secured Transactions Team took the position that any interference with the rights of secured creditors was wrong; and that if insolvency laws pose threats to lenders, reasonable lenders might well decide not to lend.⁸ However, that questions the soundness and justifiability of the general policies behind such avoidance laws. It does not justify a claim that a secured transaction should in all circumstances be exempt or distinguished from other transactions.

46. No argument was advanced during the Joint Session that possible avoidance of secured transactions in specified cases might in some way weaken or undermine the policy of endeavoring to ensure that a secured transactions regime was certain, predictable and safe. There does not appear to be any policy reason why a secured transaction should not be subject to the same rules of potential avoidance as any other commercial transaction. There is no justification for any exception to be made or for any immunity simply because the transaction was a secured transaction. If the rules of potential avoidance are known and clearly stated, they should apply to all transactions.

47. **Effect on Secured Property Enforcement and other Rights and Powers.** This appears to be the area of greatest potential conflict. It should, however, be stated at the outset that if the law follows a policy that, in general, a perfected secured property interest will be recognized in an insolvency, then there should be no question about any interference with or avoidance of the *substance* of such a security interest. Rather, what is at issue here is whether the *enforcement rights and powers* of a security holder in relation to the secured property might be interfered with.

48. On that issue a number of matters need to be considered, as follows:

⁸ The Insolvency Team posited that the claims of potentially dire consequences might well be illusory. For example, it was noted that much of the data presented by the Secured Transactions Team is drawn from the US. The US is in fact far from being a secured creditors' paradise as the insolvency laws feature avoidance and stay provisions which curtail the rights of secured creditors. Nevertheless, the data shows that the United States has about the lowest interest rates and that creditors continue to lend. Moreover, seventy percent of the credit in the US is nevertheless secured. There was agreement between both Teams that further investigation on this point would be useful.

- First, if security or enforcement action or proceedings have been commenced in respect of secured property before the commencement of the insolvency administration, should they be halted or suspended.
- Secondly, should the initiation of enforcement action be stayed or suspended as a result of the commencement of insolvency proceedings.
- Thirdly, for what length of time should any such suspension of enforcement extend.
- Fourthly, should any conditions apply to such suspension and may it be lifted or modified.
- Fifthly, who should have the conduct of the enforcement procedure and the sale of the secured property?

49. It is best to consider these issues in the context of the type of insolvency proceedings –liquidation (or bankruptcy) proceedings and reorganization proceedings. However, some general observations should first be made regarding justification or otherwise for interference with the enforcement powers of a secured creditor.

50. **Contractual and Commercial Issues.** A secured transaction is like any other transaction founded on a contract. The rights and obligations of the parties to a secured transaction will be largely set out in the contract (and possibly enhanced, regulated or controlled by a secured transactions law). The contract will include a right for the creditor to foreclose on, realize and otherwise deal with the secured property in the event of default in repayment of the loan or other money obligation of the debtor.

51. The contractual right to enforce a secured debt payment obligation by the sale of the secured property is an important right. It is primarily for this that a secured creditor and the debtor will, at least in a notional sense, have bargained. The considerations involved in striking such a bargain may include:

- the availability of loan funding at all;
- the amount of the loan;
- the terms and conditions of the financing (such as the term or length of the loan, repayment conditions); and
- the rate of interest for the loan.

52. The available economic data strongly suggests that it may be expected that secured financing is more available and at a lower cost than unsecured financing.

53. It is in the area of enforcement of a secured debt payment obligation by the sale of the secured property that the importance of a developed, efficient, predictable and safe secured transactions regime may be most appreciated. Unless such a regime exists, the availability, cost and the terms of borrowing are likely to be considerably higher and more restrictive. The availability and cost of borrowing will, to a large degree, correlate to the probability that a secured lender will be paid expeditiously and efficiently from the proceeds of the secured property. That involves enforcement rights and powers.

54. **Interference with Commercial Practices and Contractual Rights.** If an insolvency law is to promote the policy of an ordered, collective process and the fundamental principle of *pari passu* sharing between creditors, it has to intervene and restrict, limit and prohibit enforcement of individual creditor contractual rights. The law reinforces that interference by stopping debt recovery or collection practices. The law converts contractual rights into a collective right to claim and share in the estate of the debtor.

55. That position has long been accepted as justified in the case of unsecured creditors. It was developed and applied for the purpose of liquidation or bankruptcy because under that process it can be expected that the business of an insolvent debtor will be terminated and the property of a debtor dismembered and sold. The rights of secured creditors were not normally interfered with or restricted in such a case because there was no justification for converting individual secured creditor rights into collective rights. Thus under the traditional form of liquidation or bankruptcy regime there was little or no interference with the contractual rights of a secured creditor.

56. However, the more recent development of the concept of 'rescue' or corporate reorganization has resulted in the development of other policies and principles that in most cases extend to reach secured creditors, by, for example, automatically suspending the enforcement rights of secured creditors for some period of time during which the prospect of a 'rescue' may be investigated. The justification is largely economic but, to a degree, is capable of being translated into collective policy principles. Greater benefit may be obtained by keeping the component parts of the business operations of an insolvent corporation together. That opportunity cannot be taken if the property can be sold off and dismembered by creditors (including secured creditors) in exercise of their individual contractual enforcement rights. For a secured creditor, the prospect of some restraint on enforcement rights affecting all secured creditors may be considered, in some cases, to have some collective advantages.

57. Except in some jurisdictions where it is possible to secure all the property of a corporation under the one secured transaction (for example, through the device known as the 'fixed and floating charge' as practiced in some common law jurisdictions), it will normally be the case that a secured creditor will have security over only part of the property of the debtor. The value of that property may be greater if it and the other property can be retained together or sold or transferred together. As an example, consider a security over plant and equipment of a manufacturing corporation. It may be extremely doubtful that the dismemberment, removal and sale of such property will produce as great a value for it than if it was retained as part of the property of a business that was sold as a going concern.

58. The justification is that greater benefit may be obtained by keeping the component parts of the business operations of an insolvent corporation together. The opportunity to obtain a greater economic benefit cannot be taken if the property of the corporation can be sold off and dismembered by creditors in exercise of their individual contractual enforcement rights. Therefore, it is at least necessary to impose some type of temporary restraint on the exercise of those contractual and other rights for the purpose of (a) determining whether reorganization is a possibility; and (b) promoting and obtaining agreement to a plan of reorganization.⁹

59. This promotion of the possibility of reorganization also serves another purpose. It encourages corporations that are in financial difficulty to volunteer for such a process. If the reorganization law limits the prospect of piece meal dismemberment by individual creditor enforcement action, there is a greater incentive for corporations to seek reorganization.

60. Another benefit (and aim) of a possible reorganization may be to turn the business of a corporation around to produce profits and the necessary income to enable debts and other money obligations to be eventually satisfied. A secured creditor, though just as interested in being paid as any other creditor, will normally not have the power to control and manage a corporation to turn it around (an exception is found in jurisdictions that permit an all embracing fixed and floating charge and the appointment of a receiver by the secured creditor to manage the debtor corporation). A reorganization will normally result in management by a skilled and experienced administrator. Secured creditors need to

⁹ It should be noted that one of the basic tenets of RETA 5773 is that there is little evidence of economic gain resulting from reorganizations in general (and from Chapter 11 proceedings in the United States (US) in particular. It was argued that a "market-based mechanisms that convert lenders into shareholders are more efficient and may ultimately be no less socially progressive and equitable than judicially-administered reorganization proceedings." RETA 5773 Report, p. 18. It was also argued that the effect of the duration of temporary restraint upon secured lending should be further examined.

be involved in the reorganization process and, at the same time, restrained from enforcing their rights against the secured property.

61. Both Teams at the Joint Session agreed that it would be best to determine the length of restraint on secured creditors on the basis of practical experience, rather than *ad hoc* or doctrinaire legal edicts. The issue can now be examined according to whether the insolvency will result in liquidation or a possible reorganization.

62. **Upon Commencement.** In jurisdictions that follow a unitary corporate insolvency system there will be a single commencement entry followed by a determination of whether the form of administration should be liquidation or a possible reorganization.¹⁰ Up to the time at which that determination is made it is desirable that enforcement action by a secured creditor should be suspended and restrained. Otherwise, it may not be possible to promote a reorganization if the process of dismemberment has commenced and is allowed to continue. However, this should be a quick and decisive process.

63. In jurisdictions that follow a modified unitary system, there will be either an entry into the liquidation process or the reorganization process, with the possibility of conversion from reorganization to liquidation if it is determined that reorganization is not possible. The issue of suspension of secured creditor enforcement rights should, accordingly, be determined by whether liquidation or reorganization is the end result of the process.

64. **In Case of a Liquidation.** Once it is determined that an insolvent debtor is to be liquidated, it is suggested, for the reasons given earlier, that there should be no restraint or restriction on the exercise of secured creditor enforcement rights against the secured property. There is no real justification for any such restraint. However, for the sake of efficiency, such claims should be dealt with in the same court to prevent conflicting judgments and forum shopping, etc., as indeed is provided by many liquidation regimes.

65. **In Case of a Reorganization.** For as long as a real prospect exists that the affairs of the debtor might be reorganized it is suggested that there should be a restraint on the exercise of individual secured creditor enforcement rights. If enforcement has already commenced but is not complete, the restraint should suspend the enforcement process.

66. The period of restraint should be for a limited, and certain period of time, but it may be necessary to enable such time periods to be extended by a court order in complex cases. The restraint should be capable of being lifted on the application of a secured creditor if it can be shown that the restraint is unnecessary or is causing irreparable damage to the secured creditor.

67. Secured creditors should be afforded the opportunity to consider and vote on a proposed reorganization plan or similar. The issue of whether a secured creditor should be bound to a plan is dealt with in a later section.

68. **Conduct of Security Enforcement Powers.** In some of the Economies, the commencement of an insolvency administration has the effect of requiring the sale of secured property to be conducted by the person administering the insolvency. It is difficult to appreciate why this is necessary. Once any restraint on the exercise of secured property enforcement powers has lapsed there is no reason why a secured creditor should not be able to employ enforcement rights outside of the insolvency administration. It is suggested, therefore, that the actual exercise of realization rights should not be withheld from the secured creditor.

69. If, in some jurisdictions, it is considered necessary that a liquidator or similar functionary should exercise realization and sale powers, the insolvency law should make it clear that the proceeds of the sale of secured property should belong to and be paid to the secured creditor.

¹⁰ For a fuller discussion on the pure unitary and modified unitary approach, see Section IV.C., *Insolvency Law Reform in the Asian and Pacific Region*, *supra*, at 29.

70. **Preferential Creditor Rights.** The final issue in this section concerns whether preferential creditors should be entitled to be paid from the proceeds of secured property.

71. Preferential rights are created primarily in response to taxation and employment concerns and policies of government.¹¹ They usually afford protection to government and protection to workers. The justification for them is highly debatable (in a number of jurisdictions the debate has disappeared as the priority rights have been abolished), but it is not appropriate here to engage in that debate.¹² However, and assuming that the claims of some creditors should be given priority of payment ahead of other creditors, it is suggested that any such priority should be confined to a priority over those creditors whose rights are not secured, and who therefore, cannot have any expectation of priority.

72. In jurisdictions that provide for the fixed and floating charge form of secured transaction, a creditor who has security rights over all the property of a corporation may be required to satisfy preferential creditors from the proceeds of the secured property. But this might be justified on the ground that it is similar to a private quasi-liquidation and preferential creditor rights should not be excluded.

73. Aside of that exception, there does not appear to be any fundamental reason why the rights of secured creditors should be affected by preferred creditor rights. To so affect them can only result in uncertainty and a lack of predictability. It is likely to affect the cost of secured transaction borrowing. It is suggested, therefore, that claims of preferred creditors should not be entitled to payment in priority to the claims of secured creditors.

C. Post-Insolvency

74. This part reviews possible issues that arise subsequent to the commencement of a formal insolvency administration that concern secured property interests. The issues include the effect of a plan of reorganization on secured property and the possible use of secured property to finance the provision of urgently required working capital requirements of an insolvent debtor.

75. **Binding Secured Creditors and Secured Property to a Reorganization.** In most cases a plan of reorganization will require the continued availability and use of the property of a corporation. This will include secured property. It may be expected that the plan will, as far as possible, incorporate consensual arrangements or agreements between secured creditors and the plan administrator or debtor regarding the secured property and the rights and powers of the secured creditors under the plan. If it is not possible to obtain such consensual arrangements, then the question is to what extent may a plan be imposed upon a secured creditor?

76. This is a far different position from imposing some form of temporary restraint upon the exercise of secured property enforcement rights during the period that it may take to determine if a corporate debtor may be reorganized, for which there may be some pragmatic economic and other justification as mentioned earlier. The same justifications are not entirely appropriate here.

77. The policy should have full regard for the rights of a secured creditor. There are a variety of different approaches in a number of jurisdictions. Some favor automatic imposition of a plan on all secured creditors if the majority of a secured creditor class has voted affirmatively for a plan. Others favor no imposition other than by a consensual arrangement. A middle course approach is one that only imposes a plan upon a dissenting secured creditor if a court makes an order to that effect. In such a case, it is generally necessary for the proponent of a plan to show that the rights of the secured creditor are protected by the plan and that the position of the secured creditor will not further deteriorate under or

¹¹ For a fuller discussion on preferential rights, see, *Insolvency Law Reform in the Asian and Pacific Region*, supra.

¹² By way of brief examples, it is debatable whether preferential creditor rights should be accorded to government tax liens. The argument against affording such rights is that this encourages inefficient government tax collection systems. Similarly, granting workmen's compensation such preferential rights may be one disincentive to the promotion of efficient social safety net systems.

as a result of the plan (for example, that payments of future interest will be made and the value of the security will not be affected).

78. There is no convenient solution to the issue. Again, it is clearly important to take proper and full account of the effect of a radical approach upon the availability and cost of secured transaction financing and to provide for as much certainty and predictability as possible.

79. **Financing of “New Money”.** The local studies carried out under RETA 5795 exposed the problem of providing urgently required working capital requirements for a corporation that is seeking a reorganization.¹³ The problem arises in part because very few insolvency law regimes make any provision to both sanction and protect the repayment of loans provided after the commencement of a formal insolvency administration.

80. In relation to secured transactions, the issue necessarily involves a consideration of the possibility of imposing additional or further security on existing secured property interests for the purpose of protecting a lender of new money. Specifically, should an insolvency law provide for a form of ‘secured priority’ for a lender of new money which would have the effect of giving that lender priority over existing secured creditors?

81. The discussion on this issue in the Joint Session left no doubt that such a bald prospect would be regarded as seriously damaging to a secured transactions regime. It was argued that this would undermine predictability and create uncertainty. While there was ultimately support for the general policy that a debtor genuinely seeking to rehabilitate should have access to “new money” and that security would be needed for such “new money”, there was less support for the mechanisms to regulate such transactions.

82. The provision of security for “new money” might be made less offensive by a requirement that such a priority might only be created by consensual agreement with existing secured creditors or by a court order after a careful review of the effect upon existing secured property interests. The general sentiment of participants at the Joint Session was that such a prospect needs to be further examined and assessed.

III. CONCLUSION AND RECOMMENDATIONS

83. In the area of creation, registration and enforcement of secured property interests there is a high degree of compatibility between secured transactions and insolvency. Indeed, most of the aims of a developed secured transactions regime in this area would benefit an insolvency law regime and certainly not adversely affect it.

84. In respect of the initial effects of a formal insolvency administration upon secured property interests, there is high compatibility concerning:

- recognition of the substantive rights of secured property interests in an insolvency of the debtor;
- lessening and, hopefully, removing the effect of unsecured creditor priority rights on secured property interests; and
- non-intrusion into secured property enforcement rights in a case of liquidation or bankruptcy.

85. There may be less compatibility concerning the treatment of secured property enforcement rights in a case of reorganization, but that may be greatly lessened if the insolvency regime provides for

¹³ For a fuller discussion of “new money”, see *Insolvency Law Reform in the Asian and Pacific Region*, supra.

sensible limits on the period and the conditions of restraint and also provides for the possibility of application by a secured creditor for the lifting of the restraint.

86. The prospect of long term continued or further effects upon secured property interests under a plan of reorganization has the potential to cause considerable tension with a secured transactions regime unless the interests of the secured creditor are properly protected. The prospect of creating a priority over existing secured lenders for the purpose of providing urgent working capital funding for an insolvent corporation would require very careful consideration and should not be proposed without taking full account of the possible seriously damaging effect upon secured financing generally.

87. Future Development. It is suggested that reform to any insolvency law system must be carried out with due consideration of the secured transactions system, as both are part of the same system of legal and commercial regulation. Any weakness in one area poses an unhealthy burden on the other. Therefore, it is suggested that an integrated approach should be adopted for the reform of insolvency and secured transactions laws. Further, it is suggested that the issues considered in this report be taken into account in framing good practice guidelines for the development of both secured transactions legal regimes and insolvency law regimes in the Economies.