

INSOLVENCY LAW REFORMS IN ASIA

A REGIONAL TECHNICAL ASSISTANCE PROJECT OF THE ASIAN DEVELOPMENT BANK

FIRST COMPARATIVE REPORT

SECTION 1 Introduction

1.1 Subject of Study

A market economy (or anything approaching it) would not exist without private investment. This investment is financed either by capital or debt funding.

The corporation is the vehicle through which the great majority of private investment is achieved. A common way of financing the investment activities of most large and medium size corporations is by debt funding.

The banking sector is the primary source of debt funding. Debt funding (albeit more indirect) is also provided, however, through many other sources. Lease financing is one such source. Another is through suppliers of goods and services to corporations. Normally these are supplied on credit. Debt funding is even provided by employees. They may be expected to work before they are paid and to accumulate leave and other entitlements before they receive the benefit of them. Viewed in that way, their services are supplied on credit. Taxes for which a corporation is liable also usually accumulate over a period of time. Not surprisingly, therefore, a typical large or medium sized corporation is likely to have, at any one time, a considerable debt burden.

The businesses and finances of corporations, both large and small, suffer, at times, as a result of the impact of one or a number of factors. These range from internal factors (such as bad management and fraud); extended internal factors (such as product liability, market or product change and competition); to external factors (such as industrial action, micro and macro economic conditions).

Whatever the cause, the corporation is soon in financial difficulty. It struggles to meet debt servicing requirements. It may attempt a variety of remedial actions. Most of this is internalized. Few within and even less outside of the corporation know what the situation is. Finally, the weight of debt becomes too much. The corporation becomes insolvent. It cannot pay debts as they fall due; its liabilities exceed its assets; and it has a cash flow/liquidity problem.

What then happens? A clash of values occurs. One involves support for the basic principle that the making of a loan or the provision of credit carries with it a promise, in the form of a contractual obligation on the part of the debtor, to repay the loan or pay the debt. The exercise of individual remedies to enforce that promise becomes important. As a result enforcement actions may be commenced. Secured creditors might seek to control and realise secured property. Unsecured creditors may take debt recovery actions.

However, support for the principle of enforcing the promise to pay is affected if, in all the circumstances, it is impossible to fulfil the promise. This is the usual consequence of corporate financial difficulty and insolvency. As a result support for another value becomes important - that of an ordered, collective process to protect against the disorder and unfairness which might result if the exercise of individual remedies was permitted to continue unchecked. The onset of actual or potential insolvency on the part of the debtor can lead to

negotiations between the corporation and its lenders. An informal “work-out” might be proposed. Ultimately formal insolvency procedures might be commenced.

This preliminary report presents the results of a study, based on eleven Asian economies, of this inter relationship between corporate debt recovery and corporate insolvency. The eleven economies are Japan, Korea, Hong Kong, China, Thailand, the Philippines, Malaysia, Singapore, Indonesia, India, Pakistan and Taipei, China. These are referred to collectively as the “**RETA economies**”. On that subject the report seeks to identify, observe upon and estimate similarities and differences in the eleven economies regarding corporate debt, debt recovery and corporate insolvency. The report also seeks to develop key areas for discussion and critical evaluation with the eventual prospect of framing a “best practices model” for consideration and possible application in some of the RETA economies. The project was led by Mr Ron Harmer, a consultant to Blake Dawson & Waldron, Solicitors in Paris, and managed by Mr John Lees, a Partner of Ferrier Hodgson & Marfan, Certified Public Accountants in Hong Kong, China.

The report is based on studies conducted in each RETA economy by specialist domestic consultants (the “local consultants”) and field visits to each RETA economy (the “**local studies**”). The local consultants participating in the project are as follows:

Hong Kong, China

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The origins, detail and methodology of the project leading to this report are contained in Annex 1.

1.2 Contents of Report and further development of Project

The report is divided into 10 substantive sections. Most of these sections contain a general survey of the position in the RETA economies regarding the subject matter of the section. The report does not examine the position in each economy in detail. The local studies contain that greater detail.

There is an extended discussion in section 2 of what might be regarded as typical basic elements of a corporate insolvency law and practice regime. A similar discussion appears in section 3 in relation to informal corporate insolvency practices.

Issues arising for discussion are identified together with tentative proposals of the best practices model. Some of the processes and an outline of rescue laws in the RETA economies are presented in graphic form in Section 13.

A summary of the issues and tentative proposals completes the report.

The report, together with the local studies and accompanying legislation and other material, will be discussed at a symposium to be held at the headquarters of the Asian Development Bank, Manila, Philippines on 25-26 January 1999.

It is expected that this discussion will result in amendments to this report and will help in the framing of the best practices model. It is for this reason that the references in this report to suggested components of the best practices model are tentative only.

Finally, the subject will be revisited at the end of 1999 by updating the local studies, this report and convening a further symposium in Manila.

1.3 The Asian Economic crisis and its relevance to this study

Most of the RETA economies have been affected by the economic crisis of East Asia.

The purpose of this study, however, is not to focus solely on the effects and consequences of the economic crisis nor to contemplate or propose immediate or rushed solutions to the many problems presented by it. The study has the very much broader and long term aim of encouraging the greater development of legal and commercial systems, practices and institutions for application in all economic circumstances. But, that said, there probably has not been a better time nor a better environment, unhappy and painful though the economic difficulties may be, in which to focus on the subject of this study.

Eighteen months or so ago, the prospect of engaging many of these economies in discussions concerning the prospect of insolvency law and related reform may not have been treated seriously, such was the buoyant nature of many of the economies in the region. Now, however, there has been dramatic economic change and the legal and commercial institutions and practices relating to debt funding, recovery of debt, security enforcement and the application of both formal and informal insolvency techniques are the subject of critical scrutiny, study and possible correction. It is an ideal time to use those circumstances to advantage and promote the future of this particular study.

1.4 Reform Efforts

One of the positive things that has occurred in many of the RETA economies that have been worst affected by the crisis is that the process of law and commercial reform has already commenced. In relation to the subject of this study some considerable progress toward reform of the insolvency law has occurred in RETA economies such as Indonesia, Thailand, Korea and Malaysia. There are proposals in Hong Kong, China for extensive reforms to corporate insolvency law. Some RETA economies have adopted short-term special legislation to deal with particular aspects of the crisis (for example, in the banking sector). In addition, six of the RETA economies have commenced the promotion of semi official informal work-out processes in relation to insolvent corporations which have large debt exposure to banks and other financial institutions.

These initiatives have done much to foster and encourage the prospect of long-term insolvency law and related reform and development in the region.

1.5 Identification of critical areas of study

In this report (and, more particularly, in the local studies), a number of areas are included for background or information purposes but they are not the subject of extended discussion.

There are areas of the study which are clearly relevant and warrant critical evaluation, discussion, and possible reform development. There are other areas which, for various reasons, are not appropriate for that process. This might be best illustrated by an example from the subject of secured lending.

It is relevant in the context of this study to examine secured lending. That examination, at least for information purposes, should include:

- the extent and adequacy of a property ownership and rights regime or system (for example, a land registration system is particularly relevant in that context);
- the manner in which local law might promote or hinder secured lending (for example, a law which requires that banks engage in secured lending only); and

- an examination of the enforcement of secured property rights, following default by a corporate debtor, including the relationship between that enforcement and the possible liquidation, rehabilitation or rescue of the corporate debtor.

The first two of these areas, while they may be important because of their impact upon, for example, the availability and cost of debt funding, do not have any direct bearing on corporate insolvency or loan recovery. They are areas that are best suited to studies which might seek to examine and critically evaluate a property ownership and rights registration system; or the general regime of secured financing; or problems of access to debt funding by corporations. So, while those areas may be mentioned in this report, they are not the subject of any critical evaluation, except where they might affect an important part of the operation of a corporate insolvency regime or other commercial insolvency technique. For example, the extent to which local law intervention might hinder lending practices may be of some importance because it could affect the availability of urgent cash flow funding for a corporate debtor in serious financial difficulty.

However, the third area, that of security enforcement, is relevant and is subject to some critical evaluation in this study.

1.6 Standards and Judgments

As mentioned, it is intended that a series of elements that might be suitable for a best practices model for dealing with the problems of corporate debt recovery and corporate insolvency should ultimately be presented. This necessarily involves selection of a standard by which some judgment might be made, measurement obtained or opinion expressed when reviewing laws and practices in the RETA economies and proposing elements of the model. If some such standard is not selected much of the discussion of the subject would occur in a vacuum.

This report proposes that basic standards be determined by reference to well established and accepted policies and principles which are evident in the corporate insolvency regimes and related practices of many more fully developed countries. This proposal may possibly attract the criticism that this is tantamount to, in effect, suggesting that such laws and practices be imported into a region which may be far from willing or, even, capable of accepting and applying them. One might also be accused of seeking an excess of homogeneity or of seeking to further expand the spread of globalisation, unwisely and unnecessarily. Even the fact that one of the RETA economies, Singapore, has a modern insolvency law regime, which might be used as a suitable standard in itself, may not avert or deflect that criticism because much of that regime is based on the laws of more fully developed economies.

Those criticisms might be answered by the following. First, the insolvency law regimes of more fully developed countries are not all that common between one another. They vary considerably. Proposals or suggestions about the benefit of harmonising those insolvency laws (to obtain something approaching a model "universal" insolvency law regime), while attractive in theory, have never overcome the problem of substantive real and practical differences between the regimes. As a result, any debate on which type of insolvency law regime is best or better so as to emerge with some type of model standard is relatively useless.

Nonetheless and secondly, it is possible to identify in these regimes some reasonably common basic policies and principles of approach, even though their application in legislation and actual practice varies considerably. This suggests that it is not a difficult task to spell out the basic policy framework of a commercially acceptable insolvency law regime which appears reasonably suited to application in a market economy. The addition

of sensible pragmatism should make it possible to also set out desirable standards of practice and procedure.

Thirdly, it should also be observed that the backdrop or environment in which most corporate insolvency law regimes operate (or are supposed to operate) is relatively similar. For instance, they are all directed at corporations; they have to take account of the fact they compete in a market economy and engage in trade and commerce; that corporations engage in debt funding and secured lending; that there is a complex commercial structure in which the corporation functions; that corporations have employees; that corporations are liable for taxes; that corporations are governed by directors whose standards of conduct may vary, to mention but a few factors.

Section 2 The Basic Elements of a Formal Corporate Insolvency Law Regime

2.1 Introduction

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 endeavour 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.

Graphic 1 endeavours to present the range of interests which need to be accommodated for by an insolvency law. These include the insolvent debtor itself; 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.

2.2 Corporate insolvency law regimes generally

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 which provide for particular circumstances might also form part of the regime.

(a) Liquidation

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 which 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; j
- the appointment of an independent person to conduct and administer the liquidation;
- the immediate closure of the business activities of the corporation; j
- 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.

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 which 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 which 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 an insolvency law regime.

(b) Rescue

An explanation of the term “rescue” is desirable. In the context of this report it 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. A rescue might also take the form of a complex reorganisation 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.
- 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.
- 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.

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.
- 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 which 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.
- 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 favour 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.
- 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.
- 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.

(c) Special insolvency laws

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.

2.3 Important features and standards of an insolvency law regime

This section presents some basic standards regarding the liquidation and rescue processes. The discussion is confined to the following main important features and elements:

- application of the law
- separate/joint process
- access
- immediate/interim effects
- administration
- important liquidation features
- important rescue features
- role of creditors
- priorities between creditors
- avoidance of transactions
- sanctions
- cross border considerations.

Graphic 2 presents a diagram of process for both liquidation and rescue modes.

2.4 Application of the law

- 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 which 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.
- 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.

Tentative proposal

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

2.5 Separate/Dual process

- There is some debate whether the processes of liquidation and rescue should be separate processes or whether they should be both available under a single process. This is sometimes more a matter of form and perception rather than substance. Thus, for example, when a corporation is reported as having “filed for bankruptcy” (as, for example, in USA) one might fear that it is to be liquidated whereas, in fact, this is simply the legal, common or popular name given to the formal route toward either liquidation or the possibility of a rescue.
- There are cost and efficiency advantages if both processes can be accessed under the one procedure. For example, if a corporation seeks a formal reorganisation, but fails, the result should be automatic liquidation without the necessity of having to commence a new procedure for liquidation. Graphic 2 shows two points in the process at which there should be provision for transmission from rescue to liquidation mode. These are when a rescue proposal is rejected by creditors or if the rescue plan cannot be effected.

Tentative proposal

- An insolvency law regime should provide for the possibility of accessing both the liquidation and the rescue processes under a single procedure.

- Another aspect of this area should also be considered. There is a need to safeguard against the rescue process being used as some type of shelter, safe haven or as a delaying tactic on the part of a corporation which has no real potential to be the subject of a rescue. This can be best achieved by either providing for an early assessment of whether there is any real prospect of rescue (for example, by some initial proof of that prospect before the rescue process commences) or permitting the process to commence but ensuring that a definitive and transparent proposal is made without extensive delay.

Tentative proposal

- If a corporation seeks to implement a rescue process the insolvency law regime should provide for an early assessment of whether there is some real prospect of rescue. If the corporation fails that or any subsequent assessment it should be automatically transferred to the liquidation process.

2.6 Access to the process

- Policy considerations suggest that access to the process 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.
- The preferred policy is to make access easy for a debtor corporation by requiring simple threshold proof of the basic criteria (insolvency or financial difficulty). This can be easily provided by reference to balance sheet or cash flow. For a creditor, although there should be a requirement of threshold proof (insolvency), there is also a practical need for a creditor to be able to present proof, in relatively simple form, which establishes a presumption of insolvency on the part of the corporate debtor. It is suggested that clear evidence of a failure of the corporate debtor to pay a matured debt is all that should be required.

Tentative proposal

- Access to the process provided for under an insolvency law regime should provide for a quick, convenient and inexpensive procedure for both a corporate debtor and creditors, but with sufficient safeguards to protect against abuse of the process. Evidence should be provided of insolvency or financial difficulty of a corporate debtor.

2.7 Immediate/interim effects of commencement of the process

- 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.

(a) The continued management of the debtor corporation

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:

- 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.

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 antagonise creditors.

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.

(b) Stay or suspension of actions

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?

- 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.
- 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.

(c) On-going funding

The 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.

An insolvency law can help this situation by providing power to obtain funding and by providing assurances and protection for the eventual repayment of the funding. Most insolvency regimes do this by, firstly, recognising the need for and sanctioning such funding and, secondly, by creating a “super priority” for its repayment. That is normally effective, however, only from the point in time that a debtor corporation is under the legal control or ambit of the rescue process. There is a problem if there is some gap in time between the initiation of the process and that point. As may be seen later, this is a problem that sometimes confronts the formal rescue process and invariably confronts an informal rescue or “work-out” process.

Tentative proposal

Under the liquidation process

- If the debtor corporation has applied for liquidation or if it is determined that the debtor corporation is only suited to liquidation, the powers of the existing management should be removed and an independent administrator should be appointed to assume those powers and the conduct of the liquidation. Secondly, the stay or suspension of actions and proceedings against the property of the debtor corporation should be confined to unsecured creditors only. Thirdly, since there would be little or no requirement for on-going funding for such a debtor corporation, no particular provision need be made for it.

Under the rescue process

- In the case of a genuine rescue attempt, the position should be quite different. In that case it is suggested that the existing management might continue but with overall supervisory and ultimate power in an independent administrator. Secondly, the stay or suspension of actions and proceedings against the property of the debtor corporation should apply to all creditors (secured or otherwise) for a reasonable length of time, but subject to applications by affected creditors for relief from the stay. Thirdly, the legislation should both sanction and provide a “super priority” (ahead of all creditors) for funding of necessary on-going and urgent business needs of the debtor corporation.

2.8 Administration of the process

An insolvency law will break down and become ineffectual without adequate administration and supervision of the processes provided for in the law. Two areas require particular attention.

(a) Initial process

First, for the initial process, swift and largely rigid time limits are necessary. It is a judicial function or the function of a regulatory authority to ensure that the process is implemented without delay. The experience in most jurisdictions is that a specialist court or

other tribunal (or, certainly, experienced judges or officials) is often required to deal with the initial processing of insolvency cases and then be available to exercise a general supervisory capacity to ensure that the administration takes its course and that the system is not abused.

(b) Subsequent progression

A second requirement is that 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.

Cases of rescue are normally not suited to administration by a government agency. It is preferable for such cases to be administered (or supervised) by an independent private administrator. It is that person who has the task of bringing the various interest groups together and proposing and/or assessing a rescue plan.

Tentative proposal

- The insolvency legislation should provide for swift and strict time limits for the initial processing of an insolvent corporation. The court or other tribunal system must be properly resourced to enable the process to be implemented.
- The longer term administration of an insolvent corporation which is being liquidated may be conducted through a special government agency but with provision to enable more difficult and complex cases of liquidation to be administered by an outside independent specialist insolvency administrator. The government agency must be properly resourced to enable it to perform its functions efficiently.
- Cases of rescue should be administered by an independent specialist administrator.
- All cases of liquidation or rescue should be subject to supervision by the appropriate court or tribunal.

2.9 Particular liquidation features

The main aspects of the liquidation of an insolvent corporation concern the following:

- termination of the business activities; securing the assets, books and records; dealing with outstanding contracts and so forth;
- 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 realisation of assets;
- assessing and adjudicating the claims of creditors;
- investigating the conduct of the corporation and reporting on that investigation; j
- taking action to recover assets of the corporation; setting aside unlawful asset dealings;
- distribution of proceeds of sale of assets to creditors according to the legislative priorities and reporting to creditors;
- dissolution of the corporation.

Tentative proposal

- 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.

2.10 Particular rescue features

The two most important things about the rescue process are:

- the conduct of a thorough independent assessment of the business activities, assets and liabilities and general affairs of the corporation;
- the preparation and objective assessment of a proposal or plan of rescue.

Transparency of the process is important. Creditors must be given full information about the corporation and a full assessment of any proposal. A proper assessment of a proposal normally requires that a comparison is made between the result that might be obtained if the corporation was liquidated and the result that is likely to be obtained if the proposal is accepted.

In some jurisdictions, the plan for the rescue of the corporation is often proposed by existing management. In other jurisdictions the proposal is prepared by an independent administrator, usually in conjunction with existing management or ownership. Either way, there is a need for independent assessment of the proposal.

Tentative proposal

- An insolvency law regime should provide, as part of the rescue process, for an independent investigation and report of the affairs and the financial position of the corporation. It should also provide for an independent assessment of any rescue proposal in respect of the corporation.

2.11 The position and role of creditors

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. In all jurisdictions it is the decision of the creditors which 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).

This raises the issue of the voting rights of creditors and the involvement of other interests.

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.

Yet it is most necessary that the process has binding effect.

The interests of which account should be taken are owners (shareholders), secured creditors, preferred (or priority) creditors, ordinary unsecured 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.

When it comes to decision making as part of the rescue process the interests of creditors should prevail. 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.

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.

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 in number and a majority in value of creditors to vote in favour. 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 other jurisdictions the voting is determined by simple majority in number only.

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 (insiders).

Another difficulty is sometimes experienced in dealing with the voting powers 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.

Tentative proposal

- An insolvency law should make proper provision for the involvement of creditors as part of the liquidation or rescue process. In particular:
- the insolvency law should clearly define the voting rights of creditors and should prescribe minimum requirements for the approval of a plan of rescue;
- provision should be made for voting by classes of creditors, particularly secured creditors, if the rescue proposal is required to bind such classes;
- the law should also 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; and
- the effect of a vote of the requisite majority of a class should be made binding on all creditors of that class.

2.12 Priorities between creditors

A major difference in the insolvency law regimes of different countries 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 endeavour 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.

Tentative proposal

- 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.

2.13 Avoidance of transactions

One of the more extraordinary policies of established insolvency law regimes is to include provisions which have retrospective effect. These are designed to upset past transactions to which an insolvent corporation is a party which 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).

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, 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.

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.

Tentative proposal

- 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.

2.14 Civil sanctions against management and others

The conduct and behaviour 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 nor to police corporate governance policies. However, if the consequence of the past conduct and behaviour 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 behaviour), 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.

Tentative proposal

- An insolvency law regime should contain provisions for the civil sanction of fraudulent and other conduct which causes damage or loss to creditors of an insolvent corporation.

2.15 Cross-border considerations

The growth of both regional and international trade and commerce has focused attention on the many problems associated with cross-border insolvency. The trading and business activities of a corporation may result in the corporation having businesses, assets and trading activities in more than one country. If that corporation becomes insolvent and is subject to an insolvency administration in one jurisdiction it has become increasingly 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 which is proposing a rescue.

Uniform cross-border insolvency legislation which would equip every country with similar legislative provisions regarding recognition, relief and cooperation between and with the courts, regulators and administrators of other countries is a possibility. In this respect the model cross-border insolvency law proposed by the United Nations Commission for International Trade Law (UNCITRAL) of May 1997 is relevant.

Tentative proposal

- An insolvency law regime should include the provisions of UNCITRAL cross-border model law.

Section 3 - The Basic Elements of Informal Corporate Insolvency Practices**3.1 Informal work-out**

The concept of the informal work-out emerged some ten years ago in some countries, notably the USA and England, as a serious 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”, a description which may or may not be unfortunate depending on one’s view.

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.

3.2 Reasons for development

The reasons for its development are important because they suggest that even the more developed and “modern” formal rescue regimes are not 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 greater early pro-active response from creditors which is not normally possible under the formal rescue regimes.

3.3 Necessary conditions

The informal work-out depends, for its effectiveness, on a number of well defined initial premises. These may be summarised as follows:

- the fact that there is a significant size of debt owed to a number of different creditors (mostly these would be 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 availability of relatively sophisticated refinancing, security 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 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; and
- the prospect that there may be a greater benefit for all through the negotiation process than by direct and immediate confrontational resort to the insolvency law.
- To be effective it requires the employment of a number of skills and processes. Graphic 3 presents a diagram of a typical informal process.

3.4 Main processes

- (a) The creation of a “forum” in which both 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 two sides (debtor and creditors), but also for the creditors, between themselves.
- (b) The appointment of a “lead” bank creditor to provide leadership, organisation, management and administration.
- (c) 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.
- (d) 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.
- (e) 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.

3.5 Practical processes and problems

(a) Commencing the process

- 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. None of the overseas examples of the work-out process rely upon a facilitator to impose, initiate or help the process along.
- Sometimes this presents a difficulty. A corporate debtor may, for example, be willing to have dialogue 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 nor contemplate a “collective” approach.

These types of problems can sometimes be overcome. An approach in the main jurisdictions has been to use the sanction of quick and convenient access to formal insolvency law procedures as a “bargaining” factor in the commencement and progression of an informal work-out. The availability of this type of sanction can influence both a corporate debtor and its creditors. If a corporate debtor refuses to participate in an informal process which has been initiated by some of its creditors, it will almost certainly lead either to individual creditor 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 and may find that they are subject to a formal collective process which effectively prevents them from enforcing their individual rights.

(b) Engaging advisors

Few, if any, attempts are made at a work-out without the involvement of independent experts and advisors from various disciplines (legal, accounting, business reorganisation, marketing and so forth). It is often the corporate debtor, sometimes creditors, who will refuse this because of cost, intrusion, surrendering control and so forth. But it is normally a necessity. Information, independently verified, is the prime pursuit of the creditors.

The argument of the creditors, which would seem somewhat indefensible, is that this would happen under a formal insolvency rescue regime so why should it not happen in the informal situation.

(c) Classes of creditors

Creditors will rarely be in the same position as one another. For example, some will have security, others will not. Of those who have security, some 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 seek to recover their equipment. Some creditors may be subrogated to others.

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. The prospect of a work-out breaking down because of the differences between creditors can only be dealt with by a combination of persuasion that there is a prospect of a better result through the work-out process and the threat of the sanction of imposing a formal insolvency process which has the effect of restraining all creditors from pursuing their individual rights.

(d) Dissenting creditors

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 (with the reminder that there may be “other occasions”). 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. 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 traders who might be prepared to acquire the debt. If this occurs the debt trader becomes the creditor and engages in the work-out.

(e) Outside creditors

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, left out from the “forum” though they may be, 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.

It is often the case in an informal work-out that these 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 “favouritism” does not normally cause much harm.

(f) Cash flow/liquidity problem

If a corporation becomes a candidate for a possible work-out it will normally 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 any further credit. This problem can only be dealt with by evaluation and negotiation. If the lender is already secured there may not be a problem in permitting further credit. 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 the creditor or creditors who might be willing to supply this new money can be reasonably guaranteed that, if the worst happens, they will be repaid in full.

- As between the creditors who are participating in the attempted work-out, they may agree amongst themselves that if one or more of their number provide “new money” the rest of those 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.
- However, if the attempt at the work-out does not succeed and the debtor corporation is liquidated, there is a further issue of how a claim for the repayment of that new money will be treated in a liquidation. Unless there is a security for the new money it will be an unsecured claim. And 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 a non secured creditor.

In some countries there are legislative provisions which provide for some type of “super priority” to accommodate this type of problem. It is also desirable that the formal insolvency law requires that a contract of subrogation between creditors may be recognised, applied and enforced in a liquidation or rescue process.

Later in this report the development of the informal work-out process in some of the RETA economies is examined.

Section 4 - Relevant Characteristics of the RETA Economies

In this section a number of areas concerning the RETA economies are raised for discussion. They are areas which appear to be relevant or potentially relevant to the study.

4.1 Influences of other countries; trade and commerce

Each of the RETA economies, with the exception of Thailand, has been the subject at some time of colonisation by, dominance under or the direct influence of another country. Hong Kong, China, Singapore, Malaysia, India and Pakistan were all colonised by Britain. Indonesia was colonised by the Netherlands. Taipei, China and Korea were both under Japanese control. The Philippines was under American control and influenced accordingly. Japan has been influenced by French, German and American systems and practices.

In many cases these influences have produced a lasting and continuing effect on such things as the legal system and the development of industry and commerce.

Additionally, particularly over the last twenty years or so, each of the RETA economies has enjoyed greater participation in both regional and world trade and commerce. This has produced something of the effect known as "globalisation", by which economic, legal and commercial techniques and practices common to many more fully developed countries have had their impact and influence on all of the RETA economies.

There may, in some cases, have been an expectation that these type of influences would effect a continuing development throughout the society of each country so that commercial and legal systems would continue to grow in the image of that which had been established and become widely practised. This expectation, however, appears to have overlooked the fact that many of these institutions and practices were established and, in part, developed or adopted for the benefit of only a small part of the society of many of these countries and often for the main (or, even, sole) purpose of enabling foreign interests to engage in trade and commerce according to their dictates of acceptable commercial and other practices. One might, therefore, doubt their relevance to and overall effect upon the wider society of these countries.

The development and practice of debt recovery and insolvency law appear to provide good examples of areas of law which, although they are important when foreign interests are involved, are not so important and less relied upon when only domestic interests are involved.

4.2 Economy

All the RETA economies may be described as market economies. The degree of development varies. The economies of Japan, Hong Kong, China and Singapore appear to stand out as the most developed market economies in the region. The economy of Malaysia, although a market economy, has been influenced by economic and social changes which were effected to promote greater involvement of the native Malaysian population. The economy of the Philippines, although much influenced by American involvement, is far from fully developed. Both India and Pakistan continue to maintain a significant state enterprise system as part of their respective economies. There has also been significant government intervention in the economy in each of those countries. Indonesia, Thailand, Korea and Taipei, China have all experienced a rapid development of market economy policies in recent years.

The fact that all these economies have market economies (or practice market economics) suggests that the development of an insolvency law or of commercial practices to deal with insolvent enterprises would (or should be) of some importance. It may be

anticipated that the effect of normal (and, sometimes, abnormal) market forces will produce an inevitable number of insolvent enterprises with which the legal and commercial systems will have to deal. However, the experience of many of the RETA economies appears to defy such logic.

4.3 Legal system and institutions

One consequence of the extensive influence of other countries is that different legal systems have developed among the RETA economies. Legal systems tend to fall into either the common law tradition, the civil law tradition or a mixture of different elements, including both of those two main streams. Singapore, Hong Kong, China, Malaysia, India and Pakistan can be clearly said to have a dominant common law based legal system. Indonesia and Thailand appear to embrace the tradition of a civil law system. Japan, the Philippines, and Taipei, China present a mixture of both common law and civil law elements. Indonesia and Pakistan have each developed an Islamic legal system. Many of the RETA economies also have an element of native, tribal or local customary law as part of their legal systems.

The presence of different legal system traditions can make the task of comparison more difficult. For example, it is often said that the difference between a common law based and a civil law based legal system are quite marked. Two main illustrations of these differences are that in the latter the legislation tends to be more in the nature of an exhaustive code and the exercise by the judiciary of that which may be termed "discretion" is very limited. Also, under a civil law system there is much less scope for the development of the doctrine of precedent.

However, and despite these differences, in the area of insolvency law and practice there should not be any great difficulty in making comparison and developing elements of policy within the different systems. A comparison, for example, between the insolvency law regimes of typically civil law and common law countries does not disclose many differences in approach, principle and policy.

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 which 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. In general, it may be said of the RETA economies that the more developed economies have a relatively sound economic, financial, legal and commercial infrastructure. The less economically developed of these economies invariably lack that depth of infrastructure.

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 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 its accompanying institutions. This, in turn, filters down to the qualifications, training, experience and status of judges, judicial officers and the system generally.

In short, for some or other of those reasons, there may be little demand and not much respect for highly developed legal systems and institutions in some of the RETA economies.

This aspect commands significant attention in this study. As will be observed, the general approach to the policy and content of an insolvency law regime does not greatly differ between the RETA economies. There is, however, considerable diversity in the application of such laws. This, in most cases, seems to be the product of the varying degrees of development of a legal system and necessary institutions.

4.4 The private enterprise system

All the RETA economies have developed a relatively strong private enterprise system in which the corporation is the dominant vehicle. In some of the RETA economies the private enterprise sector is sometimes dominated by very significant sized corporations or conglomerates of corporations which can have an affect on the private enterprise sector generally.

Apart from that, however, there is very little difference in the RETA economies in the manner in which corporations are established and thereafter become involved in private enterprise. Indeed, of all the aspects of the RETA economies examined in this study, the similarities are greatest in this area.

Likewise, the development of the commercial sector and the development of commercial practices has produced a recognizable pattern throughout the RETA economies. For example, secured or collateral lending is widely practised in these economies, particularly secured lending on land. That would not be possible without a relatively well developed land ownership and property rights system together with laws which provide for the enforcement of such securities. This is an area that is reasonably well developed in most of the RETA economies. The development of other related areas, such as chattel mortgaging and lease financing, are not as well defined nor developed. In part, this is a result of an insufficient legal regime which might be used to support that form of financing.

4.5 The banking and finance system

All the RETA economies have developed a financial system with some common characteristics. Each RETA economy has developed a banking sector, the pivot of which is a central bank. Some of the economies accord their central banks strong independence or autonomy. Other economies do not. In most of the economies there is a strong domestic private commercial bank sector. However, in some there is a heavy concentration of state owned commercial banks.

The degree of control and regulation of the commercial banking sector varies considerably between some of the RETA economies.

Also, the equivalent of a finance or economic ministry is sometimes involved, along with the central bank, in exercising control and influence within the banking sector and in the financial system generally.

4.6 Social, cultural and other influences

An extensive range of cultural influences are evident in the RETA economies.

Three of the most important of these influences for the purposes of this study concern attitudes to strict legal processes, attitudes toward insolvency and attitudes about loss of control.

(a) Attitudes to strict legal processes

In many of the RETA economies there appears to be a cultural attitude, particularly evident in 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 organisation, function and methodology) for the resolution of commercial disputes and problems.

The following extract from the local study of Thailand identifies the type of cultural factor which is involved here: "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, although more so in recent years e.g. it is common practice for banks to require and directors to give personal guarantees as security for corporate lending, but there has been a notable reluctance for banks to sue on such personal guarantees, as opposed to looking at other alternatives - extending the term or repayments, etc. This cannot be explained by legal difficulties for creditors, as there are few defences available to guarantors under Thai law".

This attitude should not be the subject of criticism. If negotiation and mediation is a successful way of resolving commercial disputes and problems then so much the better. However, there is a distinct 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 a multitude 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 strict legal system organisation, function and methodology for effective operation.

If it is correct that attitudes generally in many of the RETA economies are such that there is not much inclination to resort to the application of strict legal processes and rules for problem resolution, it may explain why there appears to be a distinct aversion or reluctance to become involved in formal and, even, informal insolvency processes.

It is difficult to suggest solutions to the problems which arise from this. However, the development, as mentioned earlier, of the informal "work-out" insolvency process (which provides, at least, the possibility of a forum for negotiation and mediation) might help to overcome the problem in those countries in which problems of this nature are more critical.

(b) The "stigma" of insolvency

The so-called "stigma" of insolvency is part of the culture of every country, everywhere. Simply stated, it means (or represents) financial failure, to which few persons would care to admit. Transposed to a corporation it means that, in the minds of the owners or directors of a corporation, the failure of the corporation represents their failure. That is sometimes accompanied by "peer" judgment resulting in business and social disgrace.

One suspects that the presence of cultural elements in many of the RETA economies possibly heightens a greater sense of "stigma" in relation to business or financial failure and insolvency than might be found elsewhere. For example, the expression "loss of face" commands considerable respect as a compelling and potentially destructive cultural influence. The effect of the "stigma" of insolvency should not, therefore, be ignored in the RETA economies.

The main problem produced by this type of cultural influence in relation to corporate insolvency is that its presence makes it very difficult to encourage those in charge of a corporation in financial difficulty to admit the difficulty and take early and positive measures in conjunction with their creditors to try and deal with it. The problem is often a breeding

ground for desperate and ill-conceived actions which may take the form of denial, avoidance, escape, cover-up, secretiveness or manipulation. Often it might result in plain theft.

(c) Loss of control

Another factor, which is linked to but is not quite the same as the “stigma” influence, concerns a reluctance, based on commercial considerations, to access a formal or informal corporate insolvency regime. There is evidence that a principal factor which occupies the minds of “owners” of financially troubled corporations in many of the RETA economies is the fear of loss of control of the corporation. Whether that is the product of commercial egotism, elitism, stigma or something else, does not really matter. What does matter is that it produces an aversion to anything that might put the corporation in a position where its immediate and long term future might be dictated by others. The result is that relief or remedy, if and when it is eventually sought or imposed, comes far too late.

These are all problems of human nature and the surrounding environment. They are universal problems. They are difficult to deal with. When these influences are brought together, as must be done to obtain a sense of the practical difficulties, a very significant barrier to the application and operation of both a formal corporate insolvency law regime and an informal insolvency practice becomes apparent.

Some measures can help to overcome although not avoid the effect of such influences. The type of policy that a country exhibits toward financial difficulty or insolvency through its insolvency law can produce a counter influence. For example, the United States is often credited with policies in its insolvency law which promises a “fresh start” to the insolvent and which is generally considered to be “debtor friendly”. As a result, it is contended, there is a more positive attitude toward accessing the law. Australian insolvency law endeavours to confront the difficulty by providing easy and inexpensive access to formal insolvency procedures, particularly for debtors. This, however, is also coupled with the possibility of sanction if advantage is not taken of that access. It is, thus, a “carrot and stick” approach. In some other countries there is more dependence on the use of sanctions to compel resort to the insolvency law. Directors may be disqualified or otherwise punished if they do not cause the corporation to access the insolvency law.

The development of modern formal rescue processes is, in itself, an advance to help arrest the effect of some of these influences. The availability of a relatively simple and largely non-confrontational process is an advantage to which may be added the prospect of continued ultimate control and ownership of an insolvent corporation.

4.7 Corruption, bribery and fraud

Corruption may be described as the misuse of public or private office for personal gain. It includes bribery. Fraud, in the context of this report, 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.

(a) Corruption

Corruption is harmful, 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. To contemplate, for example, that the proper commercial enforcement of a security over property of an insolvent corporate debtor or a properly based 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, speaks for itself. It undermines proper and normal legal and commercial practices and processes.

Another example presents itself. A corporation obtains a loan from a bank as a result of political or government influence or direction. At the time the loan is made there may be no sufficient nor any commercial assessment of the financial position of the corporate borrower. The corporation becomes insolvent. The same or similar political or government influence now endeavours to ensure that the insolvent corporation is protected (for example, the bank agrees to wait or not do anything). That type of intervention and manipulation is, again, damaging because it can create an unreal commercial position. The bank in that example may be a major creditor and its influence may be dominant, to the prejudice of other creditors, in determining what should happen to the insolvent corporation.

To say, as is sometimes the case, that corruption and bribery is simply part of the “way of life” or that it is acceptable, customary and natural conduct in a country is not acceptable. The probability that corruption might intervene 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 commercial conditions to bring debtor and creditors together is absent.

Evidence of the existence of corruption is not always easy to establish. But it undoubtedly exists in many of the RETA economies. How else does one explain, for example, section 8 of the Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act 1997 of Pakistan? It provides that a bank may take proceedings to recover “any amount written off, released or adjusted under any agreement, contract or consent ... if (the bank) can establish that the amount was written off, released or adjusted for political reasons or considerations other than bona fide business considerations” (emphasis added).

(b) Fraud

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 which makes the corporation insolvent.

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).

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, cannot be recovered, it is as though the corporate debtor (or persons associated with it) hold an additional tool in the bargaining or negotiating process.

Resources of some 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). Sometimes, therefore, 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.

4.8 Issues for discussion

- 1 To what extent has the past influence of other countries hampered or contributed to the development and practical application of an acceptable insolvency law or insolvency based practice in many of the RETA economies?
- 2 Would it be preferable for a number of the RETA economies to abandon completely their existing, largely inherited, insolvency law and practice system and develop completely new laws and practices?
- 3 What effect does the process of “globalisation” have on the development of insolvency laws and practices?
- 4 Are there difficulties in accommodating different legal system traditions in a basic approach to insolvency law and practice?
- 5 How significant are the problems of attitudes to strict legal processes, stigma and loss of control in relation to insolvency law and practice? How best might these be overcome?
- 6 How real are the problems of corruption and fraud in the context of insolvency law and practice? What might be done to counter such problems?

Section 5 The Private Corporate Sector in the RETA Economies

5.1 Introduction

One thing which is certainly common to all the RETA economies is the predominant use of the corporation as the vehicle for conducting large and medium size private enterprise. Accompanying that is a broadly similar regulatory system which prescribes the formalities to establish and thereafter operate corporations.

As a result, for example, all corporations:

- must have and are managed by directors;
- must maintain statutory records and books of account;
- must file annual financial information;
- must have a minimum amount of paid-up capital, which varies in amount from type of corporation (for example, private and public) and from economy to economy;
- are subject to regulatory control, which at a basic level requires annual filings of accounts, details of directors and so forth and at a public listed level involves a securities commission and a separate stock exchange authority.
- Some divergences occur, however, which are relevant to this study. The following are relevant examples.

5.2 Accounts and accounting standards

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. Secondly, it is important externally as an information system to financiers and suppliers (although one suspects that, in the case of the latter, this may be overstated). Thirdly, it can be crucial to the prospect of rescue or work-out (for example, as providing some comfort to existing investors and lenders; to determine a plan of rescue; to satisfy the inquiries of potential investors, purchasers or financiers).

A review of 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 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. Generally speaking [the] disclosure system in Japan is good but pursuit of liabilities in window dressing accounting will become more rigid in order to secure high standard transparency".

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".

5.3 Directors and Corporate Governance

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.

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 certainly persons who are controlled by others. This alone suggests that standards of corporate governance responsibility are either far from developed or of not much consequence in some of the RETA economies. The Hong Kong, China local study observes that: “...it is not uncommon for listed companies in Hong Kong, China 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”.

In **Korea** something similar is evident. There is a requirement that a corporation has a minimum of 3 directors. There is nothing particularly extraordinary about that. However, when that requirement is coupled with the fact that private ownership or proprietorship or control of a corporation is culturally and commercially important in Korea, it emerges 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. Yet it will often be a requirement of a lender that all directors guarantee the borrowings of the corporation. This can produce some unhappy consequences for the employee directors.

In **India** the concept of a “nominee” director is recognised, both at a commercial and a legal level. As a result, it is not uncommon for a lender or lenders to be represented on the board of directors of a borrower corporation, through nominee directors. This enables the lender to become reasonably well informed about the financial condition and to exert some influence or control over transactions proposed by the corporation. It should be added, however, that this involvement would not extend to day-to-day management of the corporation.

In **Japan** it is not at all uncommon for a “main” bank to be represented on the board of directors of a corporate borrower. Sometimes this is a result of the fact that the bank owns equity in the corporate borrower.

In some of the other RETA economies a bank is strictly prohibited from having any relationship or association with a corporate borrower other than the relationship of lender.

5.4 Banks as equity holders in borrower corporations

The treatment of bank lenders as shareholders in a borrowing corporation varies in the RETA economies. For example, in India a lending bank is permitted to hold up to thirty (30) per cent of the issued shares of a borrower corporation. In Japan it is five (5) per cent. In Taipei, China, unless there is some special permission, a lending bank is not permitted to hold equity in the corporate borrower. In Pakistan there is no limit on the amount of equity that a lending bank may hold in a corporate borrower. In Korea it is permissible for a lending bank to own up to fifteen (15) per cent of the issued shares in a corporate borrower.

This can have some effect and some consequence concerning the insolvency of a corporate borrower. It might be anticipated, for example, that a “main” or housebank to a corporate borrower in Japan would normally own equity in the corporate borrower and would more than likely occupy a position on the board of directors of the corporate borrower. It is likely, therefore, that such a “main” bank would obtain early warnings of any financial difficulty or instability.

In an insolvency rescue or work-out situation, the prospect of converting debt to equity on the part of a bank might be more facilitated in, for example, Korea and India than in Taipei,China.

5.5 Family control of corporations

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. This is consistent with that which occurred in more fully developed countries some decades ago when it was common for large and powerful corporates to be dominated by the interests of a family. With the greater growth of most of these corporates (and a lessening of the cultural importance of “family” empires), the extent of powerful family influence, control or dominance in the more fully developed countries has lessened.

The extent of “family” control or influence can have an appreciable effect if the corporation becomes insolvent because of the type of cultural factors mentioned in the preceding section.

5.6 Conglomerates of corporations

In some of the RETA economies the private corporate sector is sometimes dominated by large conglomerates. These are often a group of companies which 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 which 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”.

5.7 Political/Government associations

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”.

Taipei,China: “....a number of conglomerates are owned or controlled by powerful families or political parties”.

5.8 Issues for discussion

- 1 Should accounting and related practices be improved in some of the RETA economies?
- 2 Do the standards of corporate governance need to be improved, particularly as they relate to duties of directors in the face of the insolvency or probable insolvency of a corporation? Should sanctions be imposed to enforce such standards (for example, through a law which enables persons to be disqualified from acting as directors of corporations if they are found to have breached duties/standards)?
- 3 Do restrictions on banks owning equity in a debtor corporation have any significant effect on plans of restructure and rescue?
- 4 Should issues such as family control; conglomerates of corporations; and political involvement or association be addressed in the context of insolvency law reform?

SECTION 6 The Banking Sector and Lending Practices in the RETA Economies

6.1 General financial control and regulation

It is desirable to commence with a brief examination of the issue of general financial control and regulation in the RETA economies. This is important for at least two reasons.

The first is that lending and recovery practices may be dictated, to varying degrees, from central bank or finance ministry level. This control can have an effect on the availability of funds for lending and on policies of debt recovery and enforcement. The Banking Act of Pakistan provides, for example, that a domestic bank cannot lend on an unsecured basis.

Secondly, central bank or finance ministry intervention in a time of general economic and financial difficulty or crisis, may not only be directed at the banking sector itself (as, for example, is presently the case in Indonesia, Malaysia, Thailand, Korea and Japan) but also (and more relevantly for the purposes of this study) at the methodology to be applied by banks in an endeavour to rationalise problems of bad debt and non performing loans.

There are some wide differences within the RETA economies in this area. Central financial control ranges from a policy of heavy regulation to a comparatively free and "laissez faire" policy.

At one end of the scale is Pakistan which appears as the most heavily regulated of the RETA economies. In Pakistan, the control of government, despite the existence of a theoretically independent central bank, is most evident. To some degree, this is a product of history. Domestic banks in Pakistan were nationalised in the 1970's and remain government controlled. That control has also produced a history of bank lending according to government, executive or political directions or dictates. Much of this lending has been made without any adequate or any proper assessment of the assets of the corporate borrower or of the capacity of the corporate borrower to repay. Often, also, there has been no control over the disposition of the loan funds. There have been many instances in which the loan funds have not been applied to the business of the corporate borrower but have been used for private purposes. Because of the political links or association of the borrower, recovery of the loan is difficult, if not impossible. In such circumstances, the employment of debt recovery, security enforcement or the insolvency law regime processes offers little prospect of recovery.

In Korea there has been considerable control of the commercial banking sector through the Ministry of Finance and the Economy. The banks in Korea are mainly

government owned or, certainly, government controlled. Although there may have been far less “directed” lending in Korea than in Pakistan, the overall control exercised by the government of Korea appears to have been such that much of the bank lending has been state controlled or directed. A report by *The Economist* (November 14, 1998) touched upon this. The report suggested that the corporate conglomerates of Korea (the “chaebol”): “...were deliberately fattened by successive governments with favours and state directed credit....and grew big ...by recklessly loading up with debt” (emphasis added). The same report maintained that a present consequence of this “directed” lending is that “.... the pain of restructuring is falling on small and medium sized firms, ten of thousands of which have gone bust, often because they are unable to get bank loans”.

In Malaysia the balance of control was recently tipped toward greater government intervention by banking and monetary policy measures announced in September 1998. One of those measures, which is relevant to this study, was that the repatriation of the proceeds of the sale of secured property to an overseas lender could be delayed by up to one year.

The involvement of a central bank or government ministry in relationships between corporate debtors and bank creditors can, however, produce positive results. For example, in Malaysia, the central bank, Bank Negara, has been primarily responsible for the formation of the informal Corporate Debt Restructuring Committee. In Thailand, the Ministry of Finance and the Bank of Thailand will monitor the progress of debt restructuring under the recently proposed informal Framework for Corporate Debt Restructuring in Thailand. In Hong Kong, China, the Hong Kong Monetary Authority expressed its support for the informal Guidelines on Corporate Difficulties which were issued by the Hong Kong Association of Banks in April 1998.

6.2 Secured lending

Secured or collateral lending, as it is popularly known, by which property of a corporation is used as security for the eventual repayment of a loan, depends on a number of factors if it is to be considered reasonably safe, predictable and commercially risk free. The most important of these factors relates to the development of an efficient and stable property ownership and property rights system. This requires an adequate legal regime through which precise and reliable information concerning ownership and other interests in property may be conveniently accessed.

All of the RETA economies possess a reasonably well developed land ownership and property rights regime and in most of the RETA economies it is a reasonably simple and commercially efficient process to take security over land.

It is not surprising, therefore, that asset based secured lending (particularly over land) is by far the most widely practised financing technique throughout the RETA economies. Security over shares, by way of a pledge, is also quite widely practised and, in most cases, is simple and expedient.

However, the taking of security over property other than land or shares is not as popular and, in some cases, presents some difficulties. The practice of taking security over chattels (by way of a chattel mortgage) varies in the RETA economies. In Hong Kong, China, Malaysia and Singapore, it is a popular form of secured financing mainly because each of those countries inherited the concept known as the “floating charge” from England. It is a reasonably safe and predictable form of security. It is also popular for lenders because it covers all the assets of a corporation and may be enforced by appointing receivers and managers to take control of the corporation. In most of the other RETA economies, however, the concept of the chattel mortgage, although practised, can be more difficult and less safe

because of the absence of a developed or any system of registration or recording of a chattel mortgage.

Lease financing does not appear to be widely practised in some of the RETA economies, nor is the taking of security over receivables (debts) a common or popular form of secured lending.

In summary, there is a heavy concentration and emphasis on secured lending over land and, to a lesser extent, shares. Secured lending over other forms of property is not as concentrated nor popular.

Issues regarding enforcement of security and the inter-relationship between enforcement and the application of the insolvency law regimes are discussed later in this report.

6.3 Income (cash flow/profitability) based lending

Cash flow or profitability based lending (which is largely based upon an assessment of the ability of a corporation to derive income and deploy part of the income to meet recurring debt on a regular cycle) is not so apparent on an examination of lending practices in the RETA economies.

A number of aspects arise from this of which two are relevant to this study. The first is that dependence on collateral based lending often means that a lender may not make any sufficient or any assessment of the ability of the corporation to service a loan and ultimately repay it (otherwise than from the proceeds of sale of the collateral). This is because attention is focused primarily on the value of the collateral. There may be little or no measurement nor assessment of income, cash flow and profitability. When this occurs not only is there little or no understanding or assessment of the overall financial position of the borrower at the time of the borrowing proposal, it almost inevitably follows that there may only be cursory monitoring of the borrower's financial position after the making of the loan.

When the corporate borrower experiences financial difficulty, the lender may know very little about and have a poor understanding of the business and financial position of the corporate borrower. This makes it difficult for the lender to react in a positive, objective and considered manner when the loan becomes a non performing loan. It must make it a more difficult task to objectively assess the causes of the financial difficulty and consider how, if at all, the financial difficulty might be arrested and improved. The local study of Hong Kong, China expressed it this way: "...there (is) agreement that banks are often provided with much more information at the time they try to collect an overdue debt than at the time a loan is made. There was also agreement that many medium-sized local banks continue to emphasise asset protection rather than cash flow analysis".

Another side effect may result. The comfort which comes from asset based lending, coupled with the lack of continuing monitoring, information and enquiry into the overall business and financial position of the borrower, presents the obvious possibility that the borrower may become overcommitted to debt from a variety of other sources (many of whom may have committed similar errors or omissions of judgment in the lending process).

The point that may be made from these observations is that, for a variety of reasons, the lending practices of domestic banks in some of the RETA economies may lack a degree of commercial responsibility and experience. Most of the RETA local consultants agreed in their respective reports that the lending and associated practices of foreign banks, particularly those from more fully developed countries, were decidedly more intense, strict and responsible compared with some domestic lending practices.

Much of this may be traced to “pre-economic crisis” practices and it might, of course, be suggested that no amount of diligent initial assessment and continued monitoring of corporate accounts and the like could have altered or lessened the effects of the consequence of the regional economic crisis. This caused the value of collateral to fall dramatically. It resulted in corporate insolvency, non performing loans and bad debt. That may be so, but it can not overcome the fact that asset based secured lending without more does little to encourage or foster collaboration between lender and borrower in times of financial difficulty, no matter what the cause of the difficulty. When cash flow and liquidity becomes of vital importance, a thorough knowledge and understanding of the borrower’s business and financial position on the part of a bank creditor can be of critical importance.

The other point that arises from the economic crisis is that in many RETA economies the commercial banks were discovered to have breached their own liquidity requirements and to have also exceeded lending limits to corporate customers. So at least part of the problem may be the responsibility of the lending and other practices of the banks.

6.4 Conclusion

It does not seem appropriate for this study to make proposals in this area.

The main purpose of the above observations is to draw attention to elements of background or influence which need to be considered in framing insolvency law and related policies. Quite clearly, policies of central banks and finance ministries will have considerable impact on the relationship between the banking and corporate sectors. Governments should carefully consider this impact. Governments can also assist by promoting both formal and informal corporate insolvency practices (see, in particular, the promotion of informal practices presented in Section 10 of this report). But a careful balancing of general banking and financial sector policies and those practices is required.

As to actual banking practices, some might argue that irresponsible or imprudent lending practices might be reduced by the imposition of some type of “penalty” within the framework of an insolvency law (for example, in a case of liquidation by deferring payment of claims resulting from such practices to a position below all other creditors). However, such a policy has never found its way into an insolvency law regime.

What is more important, however, is that if banks and other financial institutions fail to exercise reasonably prudent lending practices they should expect to suffer loss. That is something which is highly relevant to rescue proposals, both formal and informal. It needs to be brought to and recognised at the negotiation table.

Section 7 The Formal Corporate Insolvency Law Regimes of the RETA Economies

7.1 Introduction

Each of the RETA economies has an insolvency law regime. In most cases it is possible to detect that significant parts of each regime have been imported from or based upon models in other countries. Thus, for example, the corporate liquidation (or winding up) laws of Hong Kong, China, Singapore, India, Pakistan and Malaysia have been modelled on English (or in some cases Australian) law. The Indonesian bankruptcy law (which, when applied, can lead to a liquidation) has come from Dutch law. Some of the Japanese insolvency processes may be traced to German then, later, American influence. Elements of the insolvency law of Korea resemble those of Japan. Taipei, China, has a liquidation (bankruptcy law) which, although initially applied in and then brought from mainland China, has elements of civil code origins. The Philippines insolvency law regime contains elements

of American influence. The judicial management (rescue) law of Singapore has elements of English and Australian law behind it.

On the surface this presents something of an admixture. However the actual processes are not all that different nor is the basis upon which they supposedly operate all that different from the suggested elements of the “model” insolvency law regime described earlier.

7.2 The liquidation process in the RETA economies

(a) Coverage

The insolvency law regimes of the RETA economies all 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 (usually termed bankruptcy act or law).

(b) Application

The application of some of the liquidation laws extend to banking, insurance and securities corporations (for example, Indonesia and Thailand) but the access of those corporations to the liquidation process is governed by the consent or authority of a regulatory body.

(c) Access

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, Singapore, Malaysia, India and Pakistan). Of these, that of Singapore offers the easiest and most uncomplicated process.

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 nor convenient method for a creditor to prove that a corporate debtor is insolvent.

Each of **Hong Kong, China, Singapore, Malaysia, India and Pakistan** 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.

(d) Single/dual process

In most jurisdictions, 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 which offers the chance of a “composition”). However, it may be of some concern that in a number of jurisdictions there is no provision which 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.

(e) Effects

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 it appears to be the case that the commencement of a liquidation process brings all security enforcement proceedings to a stop and they are transferred to the court in control of the liquidation proceedings.

(f) Administration

In general, the procedure which eventuates after the liquidation process has been accessed 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 that the liquidation of a corporate debtor 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.

7.3 The rescue process

(a) Coverage

All of the RETA economies have a rescue process. Some RETA economies have more than one. Japan, for example, has three separate types of rescue process under three separate laws. Korea, Taipei, China, Malaysia and Singapore each have two separate rescue processes.

Some of the rescue processes are of very recent origin (for example, the PDNB Act of Malaysia, the amended bankruptcy act of Thailand and the amendments to the bankruptcy law of Indonesia). It is difficult to judge their operation because there are, as yet, few instances of completed cases.

The following is a table of the rescue processes in the insolvency laws of the RETA economies:

- (i) Scheme of arrangement - Hong Kong, China, Singapore, Malaysia, India and Pakistan
- (ii) Judicial management - Singapore
- (iii) Sick Companies - India and Pakistan
- (iv) PDNB scheme - Malaysia
- (v) PD902A Corporate reorganisation - Philippines
- (vi) Corporate reorganisation; composition - Korea
- (vii) Corporate reorganisation; company arrangement; composition; - Japan
- (viii) Company reorganisation; composition - Taipei, China
- (ix) Business reorganisation - Thailand
- (x) Suspension of payment/reorganisation - Indonesia

These are now briefly considered in turn. A summary of them is presented in Graphic 4.

(i) Scheme of arrangement - Hong Kong, China, Singapore, Malaysia, India and Pakistan

This is a formal procedure which provides for the possibility of effecting an arrangement and compromise between an insolvent corporation and its creditors. It has long been part of the company legislation of England and of the RETA economies mentioned above. Except in Malaysia it is little used, mainly because of the formalities, cost and time involved. The procedure is cumbersome and, except possibly in Malaysia, there is insufficient protection for a corporation from its creditors, particularly secured creditors, during the lengthy process. In short, it lacks the essential elements of a modern rescue process. It is no doubt for these reasons that there is a government proposal for a completely new law in Hong Kong, China (the detail of this is in the Hong Kong, China local study). There is some suggestion of a similar proposal in Malaysia. Singapore has already created a new rescue process.

(ii) Judicial management - Singapore

This is an example of a modern rescue process. It enables a company in financial difficulty (or a creditor of such a company) to apply for the appointment of a judicial manager. The application is made to a court. The court must be satisfied that there is a prospect of effecting a proposal between the company and its creditors which would provide for the rehabilitation of the company or, at worst, would be more beneficial to creditors than if the company was liquidated. A judicial manager (an independent private insolvency administrator specialist) is appointed and has all the powers of management of the company. The management of the company is effectively displaced. A stay or suspension of actions and proceedings against the property of the company becomes immediately effective. The process may, however, be completely defeated by a creditor who is secured over all the assets of the company (via the device of the floating charge). Some might regard this as a weakness in the process (cf. England, Canada and Australia). The judicial management order remains in force for a period of 180 days. The judicial manager must present a proposal for consideration by creditors within 60 days (the time periods can be extended by order of the court). A meeting of creditors determines whether to approve the proposal. A proposal is approved if the majority in number and value of creditors (present and voting) accept the proposal. If the proposal is rejected the judicial management process is terminated. There is no automatic conversion to liquidation which may be a weakness. If the proposal is accepted it is the task of the judicial manager to implement the plan.

Throughout the process the court has a supervisory role and creditors have a right of application to the court.

(iii) Sick Companies - India and Pakistan

The treatment of an insolvent corporation in India was and remains largely dealt with by liquidation. In the 1980's, however, it was recognised in India that a law such as this was not meant and was not able to deal with the systemic problems of financial disability, particularly in the state-owned industrial sector. In the absence of any alternative, enterprises in financial difficulty lived on until they were eventually forced to cease production, close down and be liquidated under the law. In the industrial sector of India this had a number of repercussions. It could lead to a shortage of supplies in important or critical economic areas; it could have a "domino" effect on other enterprises; and it led to extensive unemployment. In 1981 a special committee was appointed to examine the difficulties encountered in the rehabilitation of enterprises in financial difficulty and to suggest remedial measures, including changes in the law. The work of the committee was largely focused on industrial enterprises whose financial affairs might be aptly described as "sick". The definition adopted for such a "sick" industrial enterprise was one that has incurred losses in consecutive years and whose asset to liability ratio had deteriorated to below a minimum nominal standard of 1.1.

The committee recommended that special legislation was needed to enable speedy and effective action be taken for the rehabilitation of sick “units” by the creation of a specialised body devoted to their possible revitalisation.

As a result, in 1985, the Sick Industrial (Companies Special Provisions) Act was enacted. Under that legislation a Board for Industrial and Financial Reconstruction was established. The board was given powerful administrative powers. Under this legislation a “sick” company is required to report its condition to the board within 60 days of finalising its audited accounts. In addition, banks and other financial institutions to whom such a company is indebted have the power to make a report on the company to the board.

Once the company is reported a moratorium or stay takes effect which prevents civil proceedings or other action from being taken against the company or its assets except with the consent of the board.

The board is required to conduct an enquiry into the financial position of a reported company and determine whether the company might, within a reasonable time, recover; whether a scheme of rehabilitation should be proposed; or whether it should be liquidated. The board may compel liquidation by requiring that the relevant court make an order to that effect under the relevant insolvency law.

There appears to be very little or no formal involvement of creditors in this process. Whether there is informal involvement of creditors is unclear.

The Companies Ordinance (1984) of Pakistan contains special provisions dealing with the “rehabilitation of companies owning sick industrial units”. They are much less elaborate than the comparable Indian provisions. The Pakistan provisions apply to a company which “is declared as a sick company by the Federal Government”. The legislation enables such a company to submit a plan of rehabilitation for approval to the government; for the plan to be notified to creditors; and for the government to approve and arrange for implementation of the plan. If the plan is approved by the government it becomes binding on all persons. Again, there appears to be no involvement of creditors.

(iv) PNDB Scheme - Malaysia

The Pengurusan Danharta Nasional Berhad Act was enacted in 1998. This legislation established a government controlled corporation which is empowered to acquire debt owed by insolvent companies to a bank (and the assets of those companies, if they are secured to the bank) and to sell and otherwise deal with those assets. The powers of the government corporation also extend to appointing a special administrator to a corporate debtor (ie. a corporation which is indebted to the government corporation as a result of the acquisition of a debt as mentioned above) which is shown to be insolvent. The appointment of a special administrator results in a moratorium over all the property of the insolvent corporation and permits the administrator to propose a plan in respect of the corporation. The government board may approve or veto the plan. If it is approved a meeting of creditors must be convened to seek a majority vote on the acceptance of the plan. If the plan is accepted by the creditors, it becomes binding and it is then implemented under the direction of the special administrator.

This is possibly a better example of a special insolvency process but is included here because it does resemble a “rescue” regime. It is instructive that it is done through an administrative body. It also enables an insolvent corporation (by a somewhat convoluted means) to be forced into possible rescue or liquidation.

(v) Presidential Decree 902A - Philippines

A procedure of rescue known as “suspension of payments” which is provided for under the insolvency law of the Philippines has now been largely subsumed under the jurisdiction of the Securities and Exchange Commission. A presidential decree gave the commission jurisdiction to receive and deal with applications by corporate debtors for suspension of payments. This has now become the preferred “rescue” process in the Philippines. In effect, a corporation files a petition, a provisional suspension order is made, creditors are notified of the petition and the Commission may then appoint a management committee and rehabilitation receiver. Once such an appointment is made there is a stay or suspension of actions against the corporation. Control of the corporation passes to the management committee or rehabilitation receiver. The management committee, however, will normally include representatives of shareholders of the corporation.

A proposal must eventually be put for the rehabilitation of the corporation. If such a proposal is not made or if the Commission refuses it, the Commission may order the liquidation of the corporation. Although there are no specific rules providing for the involvement of creditors in this process, as a matter of practice it seems that a rehabilitation plan would be referred to a meeting of creditors for comment. However, the ultimate decision is that of the Commission.

This process is quite remarkable for a number of reasons. In effect, it has shifted what was once a judicial process into a quasi-judicial process. There appear to be few, if any, but the most basic rules to govern the process. It gives the appearance of being far from a transparent process. The involvement of creditors appears problematic.

It should be noted that there is a proposal in the Philippines to amend the law and transfer jurisdiction over rescue cases from the Commission to the regular courts.

(vi) Corporate reorganisaiton; composition - Korea

In Korea there are two forms of rescue process. A composition is governed by the Composition Act. 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. A meeting of creditors considers and votes for the approval or otherwise of the composition. If the composition is not approved, the corporation cannot be transferred to a liquidation process. The management of the corporation continues in power. It appears that an agreement must be reached for the debtor to perform its debt obligations in full.

The corporate reorganisation process is provided for under the Company Reorganisation Act. This differs from the composition procedure because it is aimed toward reorganising or rebuilding a debtor corporation. Under the reorganisation process the company makes an application to a court which then determines if the reorganisation 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 time table is set for the submission of a reorganisation plan.

A reorganisation 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 authorise the

reorganisation plan to be implemented. The implementation of the plan is under the control of the receiver.

(vii) Corporate reorganisation; company arrangements; composition - Japan

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

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.

The composition process requires that an application is 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. The plan is then considered by unsecured creditors. 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 favour 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.

The corporate reorganisation process 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. Because there is no automatic stay or suspension, an application for an interim stay is made at the same time. 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.

If the court is satisfied that the conditions necessary for the commencement of the case are satisfied, it issues an order to that effect. As a result 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 information concerning the corporation is given by the trustee and management. The trustee is required to prepare a plan of reorganisation. 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 quarters majority of secured creditors and a majority of shareholders.

The plan must also be sanctioned by the court. If the plan is not approved the corporation will normally be liquidated.

(viii) Company reorganisation and composition - Taipei, China

In Taipei, China the position is similar to that in Korea and Japan. However, the reorganisation process is only available to a public company. The company must show that without reorganisation it would have to cease its business activities. The process may be commenced by the corporation, shareholders or creditors. The court must decide to commence the reorganisation process. If it does the court appoints reorganisers who take control of the company. A reorganisation 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 reorganisation process breaks down or if a plan for reorganisation is not approved the court may order that the corporation be liquidated.

A composition may be initiated only by a debtor corporation. A composition plan is prepared which is then considered by the creditors. 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.

[One of the problems that is common to the reorganisation procedures in Korea, Japan and Taipei, China is the delay between the filing of the application and its acceptance by the court. There is a process of inquiry and consultation at this vital stage. This would seem to be part of a negotiation/mediation process, facilitated by the court and its officials, to determine attitudes toward and support for a possible rescue. Viewed in that way it may be a valuable part of the process, despite that it delays the real commencement of the rescue and is not accompanied by automatic and immediate effects.]

(ix) Business reorganisation - Thailand

The rescue process of Thailand now appears in the Bankruptcy Act. It applies not only to corporations but also to bank, security and insurance corporations. An application may be made for business reorganisation either by a debtor corporation, a creditor of a debtor corporation or the respective regulatory authorities of the banking, insurance and securities sectors.

A request for reorganisation is filed with a court which determines 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 government official (the official receiver) is given the legal authority to manage the affairs of the corporation; interim managers may be appointed to perform that task under supervision of the government official. All the assets and property of the company are in the control of the government official. A plan of reorganisation is prepared by a "plan preparer". The plan must be prepared within three months of the appointment of that person 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 plan must then be approved by the court.

(x) Suspension of payments/reorganisation - Indonesia

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 it is approved by creditors, the plan takes effect. If a plan is not proposed the "insolvency" of the debtor is confirmed and the debtor is liquidated.

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.

7.4 Conclusion

The above survey reveals that most of the RETA economies possess the basic elements of a typical insolvency law process (at least when viewed against the standard set by the “best practices” elements). But, clearly, some depart from the model and might benefit from substantial reform. However, the laws themselves should not be considered alone and in the abstract. The actual application of these laws also needs to be considered.

Section 8 Corporate Financial Difficulty

8.1 Introduction

In this section the matter for consideration is not what causes financial difficulty but the effect of it and the relationship, if it can be described as such, which then eventuates between the debtor corporation and its creditors, particularly its bank creditors.

8.2 Attitude

Earlier in this report attention was drawn to the issue of culture, both societal and commercial, as an important influence or factor on attitudes to insolvency generally. In particular, it was suggested that cultural influences might pose a considerable barrier toward the application of both informal and formal insolvency processes, notwithstanding that a law or a set of informal “rules” provides convenient access to those processes.

In the section on insolvency law it was observed that, in the modern context, insolvency processes, particularly the formal rescue process and the informal work-out process, rely for their effectiveness on early initiation, before the financial position of a debtor corporation has so deteriorated that no attempt at rescue or a work-out might be contemplated.

The majority of the local studies clearly evidence that the financial difficulty of a corporation is, more often than not, accompanied by an attitude of concealment and denial on the part of owners and managers. The local consultants were asked to identify attitudes of both corporate debtors and lenders to financial difficulty. The following selection of excerpts from the local studies are instructive:

- **Philippines:** A corporate debtor in financial difficulty generally has an attitude of “concealment” or “denial” toward the admission or exposure of that financial difficulty. The corporate debtor fears that by admitting their financial difficulty, credit will be harder to get. Also, it fears that the creditors will immediately enforce on their security.

The reason may be based on their experience with the creditors. If they feel that they can turn to a particular creditor who is sympathetic to their plight and is willing to help them then they might disclose their financial difficulties. Otherwise, if they are not

close with the creditors or do not have a long standing relationship with their creditors, they will be reluctant to disclose their financial difficulties for fear that they are not sure how these creditors will react”.

- **Taipei,China:** Yes, there is an attitude of “concealment” or “denial”. This is based on cultural factors, e.g. the owner being not willing to face the reality that the company is poorly managed and has thus become insolvent, or the owner lacking the concept of abiding by the law.
- **Indonesia:** “Corporate debtors will generally try to conceal or deny financial difficulties from their creditors and governmental authorities. If lenders discover a debtor’s financial difficulties, they may be quick to react and declare the corporate debtor in default. The reason for this is the unpredictability of the Indonesian judicial system and substantial questions whether creditors can effectively use the judicial system to recover outstanding debt.”
- **Hong Kong, China:** “There usually is an attitude of both concealment and denial by corporate debtors toward the admission or exposure of the financial difficulty. But, it must also be noted, corporate lenders are also frequently in denial.”

“Chinese family-controlled companies in Hong Kong, China prefer to disclose as little information as necessary to their bankers. The complex organisation of many of the family-controlled groups in Hong Kong, China lack transparency and make it easier to conceal developing difficulties.”

“In Hong Kong, China, there is much less accountability to shareholders. Some bankers feel that local companies are often run more to favour the interests of the controlling tycoons’ family than the interests of shareholders.”

“Many local companies do not have independent managers - or if they do, have brought in managers to raise money rather than to impose financial controls - so the controlling family often does not hear contrary views being voiced by senior members within the company.”

The Hong Kong, China local study further observes that if companies have sought the advice of professional advisers or independently thinking managers, they are often able to avoid difficulties and, if not, would be more willing to volunteer the facts relating to the company’s financial difficulty. Companies which are reluctant to get the advice of professional advisers or to hire independently thinking managers (which, it is suggested, comprise seventy per cent of corporations in Hong Kong, China) often remain reluctant to disclose any adverse information.

- **Thailand:** “The loss of face involved in admitting difficulties is also a factor.”
- **Singapore:** “There is a perceptible tendency for entrepreneurs who have established a business enterprise and still manage it to be pro-active in seeking independent financial assistance to structure debt, refinancing and rescheduling scheme[s].”
- **Pakistan:** There is normally an attitude of concealment or denial toward the admission or exposure of financial difficulty. The reason is based on “cultural factors to the extent that a social stigma is attached to such difficulty. The desire to put off the attending and consequential problems that occur once the issue of financial difficulty gets publicly known also play a part. Also in a large number of cases there is mala fide in that the projects for which loans are taken are unviable right from their inception and therefore there is a continued effort to cover up.”
- **India:** “The attitude of “denial” towards the admission or exposure of financial difficulty [is] extremely common in India.... most Corporate Debtors dispute the debt due when.... insolvency action is commenced.”

There appears, therefore, to be an overwhelming tendency toward concealment and denial of financial difficulty. It is not, of course, suggested that this is peculiar to some or all of the RETA economies. It is not much different from attitudes found in most countries. To that extent, therefore, efforts in the RETA economies to encourage greater transparency and a greater willingness to deal with financial difficulties at an early stage are no different from those faced in most other countries.

8.3 Taking advice, submitting to investigation

The local consultants were also asked about attitudes and practices once the financial difficulty of a corporate debtor had been admitted or exposed. In particular, they were asked whether there might be negotiation; whether corporate debtors and/or lenders might employ or agree on the employment of professional expert assistance; to what extent one might contemplate full access and disclosure of the financial position and business activities of the debtor corporation; whether lenders might act in combination or act independently and secretly from one another; and whether there would be sufficient knowledge, experience and expertise within domestic banks to endeavor to analyse and try and find some solution to the financial problems.

The response in the local studies reveals that there is a general reluctance on the part of corporate debtors to seek outside professional assistance and some reluctance on their part to accept the imposition of experts and advisers employed or retained by lenders. However, in the majority of cases, it appears that debtor corporations would ultimately accept the need for some type of "outside" assessment, although both corporate debtors and lenders preferred that this assessment be conducted by the lenders themselves.

From some observations in the local studies (for example, Japan, Hong Kong, China and Singapore) it seems clear that if the relationship between corporate debtor and lender has been close, particularly if the lender has had a good understanding and knowledge of the business and finances of the corporate debtor, it is far easier to initiate a constructive joint effort between corporate debtor and lender toward endeavoring to solve the problem than in a situation where such a relationship, knowledge and understanding does not exist. This tends to support some earlier observations in this report regarding the desirability of lenders, in particular, initiating and maintaining close and informative links with borrowers. The practice of lenders might, as a result, be greatly improved.

8.4 Lender attitudes

It cannot be expected that the lenders of a corporate debtor will necessarily, or at all, engage themselves in any attempt to rescue or assist the corporate debtor. Probably, in the majority of cases, the reaction of a lender to the financial difficulty of a corporate debtor will be to take action to recover the outstanding debt. This leads to the issue of enforcement, particularly the enforcement of securities.

As mentioned earlier in this report, it is a common banking practice throughout the RETA economies to engage in the practice of secured lending, particularly on the security of land and shares. In Hong Kong, China, Singapore, Malaysia, India and Pakistan, lenders also have the facility of the "floating charge" (or something similar) as security over all the assets of a corporate borrower. In some of these latter jurisdictions the common method of enforcement is to appoint a receiver (which can normally be done without recourse to the courts) who becomes the manager of the debtor corporation and is empowered to collect and otherwise sell all the assets of the corporation for the benefit of the secured creditor. Enforcement by way of a receiver is a popular method, particularly in Hong Kong, China, Singapore and Malaysia. Except in Malaysia, the appointment of such a receiver will normally rule out any possibility of a rescue process for the corporate debtor. None of the

rescue processes of Hong Kong, China and Singapore restrict the rights of the appointment of a receiver by a secured creditor. In the case of Singapore, judicial management would be declined to a corporate debtor if a receiver has been appointed or if there is a likelihood that a receiver will be appointed. Thus in those countries, the enforcement of the security by the appointment of a receiver can forestall and prevent any type of corporate rescue.

In Malaysia, however, there has been some significant incursions into the right to appoint or continue with the appointment of a receiver. If a creditor who holds a floating charge over all the assets of a corporate debtor threatens to or appoints a receiver, the corporate debtor responds by commencing proceedings for a scheme of arrangement or compromise and then seeks, and usually obtains, interim orders from a court which restrain the secured lender from enforcing the security. This development of case law in Malaysia runs contrary to English and Commonwealth precedents. It provides a good example of the tensions that are created between, on the one hand, legislative attempts to provide for a rescue process and, on the other, commercial practices which suggest that there should be no restraint on the rights of secured creditors to pursue their independent remedies.

In the other RETA economies (where most attention focuses on the ability of secured creditors to realise or enforce their security, particularly, as mentioned, over land and shares), the local studies reveal a quite varied position.

First, on enforcement processes generally. If one takes, as an example, enforcement of a security over land, the position appears to be as follows:

- **Philippines:** A security over land can be enforced without recourse to the courts provided the security documentation permits this. If enforcement was sought through the courts, it may take many years for the enforcement to be complete. However, both judicial and extra judicial enforcement will be restrained if the debtor corporation applies for rescue under PD902A.
- **Korea:** Enforcement is through the courts which is normally a quick and efficient process. However, if the commencement of a reorganisation is ordered, enforcement of the security will be suspended.
- **Pakistan:** To the extent that enforcement is required to be taken through either the civil courts or the banking tribunals, the process is considered to be effective (in that time frames for final adjudication are prescribed). However, in practice, “the system is very slow and also corrupt.” If a corporate debtor seeks a scheme of arrangement or compromise, applications for enforcement of securities over land may be transferred to the court hearing the application and may be suspended.
- **Taipei, China:** Enforcement is through a court which orders an auction of the property. This is normally a swift and efficient process. The reorganisation of a corporate debtor is likely to result in a suspension of the enforcement of secured property rights.
- **Indonesia:** Enforcement is through a court which is described as “.... ineffective....” The process is “time consuming, expensive and unpredictable”. Enforcement of security rights will be suspended once an application for bankruptcy has been filed.
- **Thailand:** Enforcement is through a court. The Thailand country study comments that: “The foreclosure laws have come under much criticism recently. They do not allow for expeditious enforcement. The debtor or interested parties may easily raise certain objections and delay the process.”
- **Japan:** Enforcement is through a court and the court system is regarded as effective. However, enforcement will be suspended if the Debtor Corporation applies for corporate reorganisation.
- **India:** “Suits involving enforcement of security... get blocked by the ingenious and often fraudulent defenses propagated with substantial degree of success by the

borrowers and their lawyers_j. The effectiveness of the suits is severely dented by the time frame involved_j. A trial.... usually takes 8 to 12 years to come up for hearing.”

It may be observed from this survey that some considerable tensions can arise between a corporate debtor which is insolvent or in financial difficulty and its secured creditors. In Indonesia, for example, it could be argued that a debtor corporation, despite the fact that it is insolvent, is in a relatively strong position. It appears that such a debtor corporation might easily obstruct and delay enforcement of security rights; equally obstruct or delay any attempt of a creditor to apply for the debtor corporation to be liquidated (as to which see the next section); and, if all else fails, apply for suspension of payments under the revised bankruptcy law and obtain the benefit of a suspension of secured enforcement rights.

By utilizing slightly different processes, a similar position might be said to prevail in Malaysia. A corporate debtor can commence proceedings for the possibility of a scheme of arrangement or compromise and obtain orders suspending the enforcement of security rights and any liquidation proceedings against it. At least, however, in that instance, the debtor is forced into the possibility of a rescue process.

The issue of suspending or restraining the rights of secured creditors in the context of the development of a modern rescue process does present a number of difficulties. Ideally, an insolvency law should relate to and support the usual commercial processes of the community. There is little sense in promoting a law that it is decidedly at odds with accepted, entrenched and commercially justified processes. However, support for the principle of an ordered and fair form of insolvency administration has normally dictated the necessity to apply some restraints on rights arising from commercial transaction. Notable in this regard are restraints (limited in both nature and time) in regard to the enforcement of security rights over assets of an insolvent debtor corporation which has applied for rescue.

8.5 Unsecured debt recovery

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 country studies:

- Thailand: “Currently, delay (in the courts) is probably the biggest impediment toward justice”.
- India: “The recovery procedure for debt collection is slow and tardy”.
- Pakistan: The process is “very slow”.
- Philippines: “The judicial and court system for the purpose of debt collection is not so effective”.
- Indonesia: In general, the Indonesian judicial system has not been an effective tool for the purposes of debt collection or bankruptcy proceedings. “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”.
- Taipei, China: “In comparison to the foreclosure of collateral by secured creditors, the debt collection by unsecured creditors is much more time consuming”.

This puts unsecured creditors at a considerable disadvantage. Their main bargaining strength may be to refuse further supply unless past indebtedness is paid and/or unless further supply is paid for in cash. That, however, is only relevant if continued supply is important to the corporate debtor.

Unsecured creditors are also disadvantaged if, as appears to be the case in some of the RETA economies, their attempts to bring liquidation proceedings against a corporate

debtor are frustrated. Liquidation proceedings can be long drawn out and the result is difficult to predict. (see next section).

8.6 Lease finance creditors

The usual “enforcement” which follows from a failure to meet lease payments is to recover the leased equipment. In a number of the RETA economies this presents a problem. If, for example, entry is refused to the place where the leased property is located (despite the terms of the contract which would normally create a positive obligation to permit such access and recovery) enforcement has to be by court order. That process can be long and tedious. Note, for example, these observations from some of the country reports:

- Taipei,China: “Formal court proceedings will have to be proceeded with for the recovery in case the lessee rejects the owner’s access to the place where the equipment is located A final court judgment could possibly take about a year.”
- Malaysia: “In practice the process is fraught with difficulties of a practical nature”
- Indonesia: The exercise of recovery rights requires court process “.... since the leased property is under the control of the lessee, the lessor must file a (request for seizure upon the lessee’s property) with the Court.... In actual practice, it is difficult to recover leased equipment.... This difficulty is primarily due to inefficiencies in the Indonesian judicial system.”
- Thailand: The exercise of repossession rights requires court process.

8.7 Conclusion

There is nothing much that an insolvency law can do about deficiencies concerning the exercise of individual creditor rights. But there is a real problem when, at the same time, there are deficiencies in both that area and in the rights of creditors to seek the application of insolvency processes against a debtor corporation. If a creditor cannot, in a practical and effective sense, seek either individual or insolvency remedies against a debtor, a considerable bias is created for the benefit of the debtor. This does not make commercial sense.

Although the issue of enforcement of individual creditor rights is relevant to this study (at least for background and information purposes) it is beyond the province of the study to make detailed recommendations in that area. Perhaps, however, a convenient “model” approach might follow these suggestions:

8.8 Tentative proposal

- It is important that there is support for the value that contractual obligations should be honoured. This requires that individual enforcement and recovery rights may be effectively taken and efficiently processed. This is not only important for individual creditors. It is also important because it operates as a pressure point on a corporate debtor who cannot fulfill a contractual obligation because of financial difficulty or insolvency. A corporate debtor who wants to otherwise survive may then have to seek remedy or relief under the insolvency law or informal insolvency process.
- Remedy or relief for a corporate debtor from the enforcement of individual creditor rights should support the value of a fair and orderly collective process. The existence of an effective and efficient formal insolvency process serves that purpose.
- A formal collective process should provide for a restraint on enforcement of all individual creditor rights for a limited period of time and should only be extended if there is a certain probability of a successful rescue proposal. Otherwise the enforcement of secured and lease creditor rights should not be restrained.

SECTION 9 - The Application of Insolvency Law in the RETA Economies

9.1 Introduction

The review of the insolvency law regimes of the RETA economies in the preceding section suggests, with a few notable exceptions, that many of the basic aims and policies of an insolvency law which is suited to the involvement of private corporations in a market economy are contained in those regimes.

What, however, of their application?

There are a number of methods by which this might be tested. One method is to review the statistics of the number and types of cases. Another is to review reports of difficulties in the application of the law in relevant case law. Yet another method is to take the comments and perceptions of persons and institutions who have been involved in insolvency cases and issues.

9.2 Statistics

It is important that there is readily available pertinent statistical information about insolvency. The number of cases of formal insolvency administrations is a relevant economic statistic. This 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, the regulation of forms of corporations and so forth.

Unfortunately, statistics on insolvency cases in many of the RETA economies are either barely sufficient or, worse, non-existent. This, of course, refers only to bare numbers of cases. In the RETA economies where statistics do exist, the statistics rarely present any analysis of the type of information that a basic statistical recording system should show. Hong Kong, China at least, appears to be a notable exception. Reference to the statistical information contained in the Hong Kong, China local study, gives not only the number of cases of insolvent corporations but also gives details of the industries or business activities in which those corporations were engaged.

Before, therefore, proceeding to analyse the statistical information that is available, it is desirable to frame a proposal as follows:

9.3 Tentative proposal

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.

It would also assist if, upon the completion of each corporate insolvency administration, the responsible authority recorded the following information to which the public would have access, namely:

- 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 realised) and liabilities (estimated and realised); 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.

The local studies provide the following statistical information:

- (a) Philippines: There have been no liquidation cases for a number of years. It is suggested that this is because the availability of suspension of payments through the SEC has become the preferred form of process. However, over a period of sixteen years, the number of cases filed with the SEC for suspension of payments was only eighty-nine. Almost two thirds of these cases were filed during the last two years.
- (b) Korea: The incidence of liquidation cases is “low” and the incidence of reorganisation cases is “high”.
- (c) Taipei, China: In the three years between 1995 and 1997 there were two cases of composition, eight cases of reorganisation and forty-seven cases of liquidation. Perhaps, more relevantly, 111 cases were “withdrawn” and 373 were “overruled”.
- (d) Indonesia: Prior to the 1998 amendments to the insolvency law there were practically no cases of liquidation or suspension of payments in Indonesia. The most recent statistic suggests that some 17 cases have been filed since the revised law took effect.
- (e) Hong Kong, China: In 1997/1998 there were 459 cases of compulsory liquidation. For the period 1998/1999 there have been 491 cases of compulsory winding up. In the same period there has been a minimal number of cases of formal rescue.
- (f) Thailand: The number of liquidation cases is “low” and the number of reorganisation cases is “very low”.

- (g) Japan: The number of liquidations and reorganisations over the last two years has been high by comparison with previous years.
- (h) Pakistan: The only available statistic shows that there are presently 110 cases of liquidation pending and no cases of rescue.
- (i) Malaysia: The number of liquidations is “high” and the number of rescues is “high”.
- (j) Singapore: Cases of liquidation and rescue are “medium” in number.
- (k) India: There are no reported cases of rescue. In Delhi, over the last 3 years, there have been 125 orders for corporate liquidation but only 45 have actually gone into that process.

One of the most compelling observations that can be made from that survey is that in some of the RETA economies there are no or only a few cases of insolvency. This suggests, taking into account both normal and exceptional economic circumstances, that there is very little recourse to formal insolvency procedures in those economies.

9.4 Reported difficulties

There is very little relevant information from reports of actual insolvency cases. In Indonesia, however, there appears to have been some widespread reporting of particular cases under the newly revised insolvency and the newly established commercial court. A particular example concerns the Metrac case in Indonesia in which a group of financier creditors commenced liquidation proceedings against some related corporate debtors. The case appears to have been dismissed as a result of procedural technicalities despite that the debtor corporations were clearly insolvent and refused to seek relief under the insolvency law. The procedural issues may have been crucial because of civil law practices but there has been considerable criticism and concern expressed about the decision in this case.

9.5 Comments and perceptions

The local studies contain some valuable observations regarding the application of the insolvency law regimes. A selection of the more relevant and important of these is as follows:

- (a) Indonesia: “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”.
- (b) Philippines: The liquidation process is “.... Very expensive, very difficult, very inefficient and very slow because: (1) the court process takes up a lot of time, (2) claimants are likely to delay the process through judicial means and (3) difficulties are encountered in disposing of unwanted and non marketable assets”. The rescue process is: “inefficient because there are no laws in the Philippines providing for restructuring, consents are difficult to obtain”.
- (c) Thailand: “The court system in relation to the handling of formal insolvency proceedings is quite effective except for procedural delays involved with the hearing of cases”.

- (d) Malaysia: “The courts are only moderately effective in the handling of formal insolvency proceedings as procedures can be cumbersome and there is some element of delay owing to heavy judicial lists and schedules. Moreover, some judges may not have special experience or qualifications that enable them to deal with the underlying philosophical and conceptual issues”.
- (d) India: “The company court does not readily wind up companies unless there is a persistent default of several creditors or the magnitude of unsecured debt is adequate and of sufficient extent”.

In summary and based on the above material it seems that in at least some RETA economies there is an aversion to formal insolvency procedures, particularly those which involve judicial process. In some RETA economies there is also 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.

In RETA economies where there is an “attitude” problem it is difficult to suggest what might be done to overcome this. It may be that attitudes might change in the long term as the process of commercial globalisation continues. It might also be assisted by education.

In RETA economies where there is a clear problem with the court and judicial system, that problem can only be overcome by intensive reform of those institutions which requires considerable resources and expenditure.

9.6 Issues for discussion

- 1 What are the main:
 - (a) strengths; and
 - (b) weakness of each insolvency law regime in the RETA economies?
- 2 What are the main barriers to access in each regime? How can these be lessened?
- 3 What is the evaluation of judicial/tribunal case processing and management in each regime? How can this be improved?
- 4 What is the evaluation of the general administration (e.g. through government department or private specialist administrators) of insolvency cases in each regime? How can this be improved?
- 5 What are the reasons for so few cases of formal insolvency administrations in some of these regimes?
- 6 What is required to improve the statistical information regarding cases of insolvency in some of the RETA economies?

Section 10 Informal Workouts in the RETA Economies

10.1 Introduction

As mentioned earlier in this report, 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 may be 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.

An outline was given earlier of what is meant by and involved in the informal approach known as the informal “work-out”. It is now appropriate to consider the development of this process in the RETA economies.

10.2 Development of the informal work-out

Initiatives to promote the concept of the informal work-out have been taken in a number of the RETA economies. They are:

- Indonesia: the endeavor is known as the “Jakarta initiative”;
- Thailand: something similar is popularly known as the “Bangkok Rules” (the more formal title is Framework for Corporate Debt Restructuring in Thailand);
- Malaysia: the approach to the informal work-out is titled the “Corporate Debt Restructuring Committee Framework (CDRC)”; Korea: the initiative is called the “Financial Institution Agreement for Promotion of Company Restructuring”;
- Hong Kong, China has the Guidelines on Corporate Difficulties; and
- Singapore

These initiatives are important and deserve appropriate recognition, response and support.

They are all largely modeled on the informal work-out technique developed in the USA and in England. Because most are of very recent origin, it is too early to determine their level of acceptance and application or whether there have been any confirmed positive results. In Hong Kong, China however, there has been some successful results from the informal process (see the Hong Kong, China local study).

10.3 Consideration of work-out models

The Hong Kong, China and Singapore guidelines are largely based on the “London approach” and should not need any detailed analysis. They are essentially non-intrusive, voluntary and non-prescriptive. The basic framework was outlined in Section 3.

The initiatives of the other four RETA economies are of more comparative interest.

The Indonesian, Malaysian and Korean approaches each provide for a facilitating agency to assist the process.

In Indonesia this 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. Under 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.

In Malaysia the facilitator is a Steering Committee which “convenes meetings between debtors and creditors to consider debt restructuring”. The Steering Committee is also required to ensure that deadlines are met, mediate in disputes, expedite approvals, provide guidance in the selection of appropriate consultants and generally 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 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”.

Korea has established an “Administrative Committee” under its informal process. In turn it has appointed a “Company Restructuring Committee” to act as facilitator. However, the Korean approach differs quite markedly from the other RETA economies. 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 who 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.

The approach in Thailand is, again, different. Although it does not provide for a “facilitator”, it appears more heavily “regulated”. For example, the framework says that: “Any non-traditional restructuring approach such as debt forgiveness should only be considered as a last resort. To the extent that debt forgiveness is requested, it must be compensated in some manner such as stock and warrants”. One might suspect that this type of intervention in a process of negotiation is dictated by a desire to maintain the balance sheets of banks.

10.4 Possible barriers to informal work-outs

Some of these proposals have also been the subject of some criticism and doubt about their acceptance and application in some of the RETA economies. It is appropriate to consider the possible barriers to the acceptance and adoption of the informal work-out approach and what might be done to overcome those barriers.

Reactions to the informal process

The local consultants were asked generally about the work-out process and provided with a copy of the “Jakarta Initiative”. They were asked to assess the practical implementation of the informal work-out in their respective economies and comment upon strengths and weaknesses of this approach. The response was favourable to the concept of the work-out, but a number of constructive problem areas were raised.

The following is a summary of the responses:

- Japan: Some concern was expressed about the extent of knowledge and experience in Japan of sophisticated refinancing and other like techniques. “In Japan there is a problem as to how companies find advisors who are experienced in corporate and debt restructuring.” Also the concept of subordination is not known in Japan. Finally, it may be difficult to protect a financier who was willing to provide “new money”.
- Taipei, China: Here it was considered that the formal composition proceedings under the Bankruptcy Law came closest to the concept of the informal work-out but the problem was that secured creditors, for example, were not restrained under that law. There was also little involvement of professional advisors and experts to assist in a restructure. It is also thought that the idea of having a government agency to assist the informal focus would be an advantage.

- Korea: The government of Korea favours the informal work-out approach (and has, accordingly, encouraged adoption of the Company Reorganisation Agreement) because, in part, it can help to preserve a debtor corporation and employment and assist creditor financiers. Problems are encountered, however, regarding professional advisors and experts (because of some concern over their potential or possible liability); in the speed of the process (it is considered to be slow); and, the “conservative” position adopted by banks in negotiating debt restructuring (as a result of the effect of the economic crisis on the banks themselves).
- Malaysia: Concern was expressed about a work-out which involved all creditors. It is suggested that the work-out is more practical and manageable if it is confirmed to financial institution creditors only and, in particular, if such financial institutions are under central bank supervision. These comments seem to reflect the framework of the Corporate Debt Restructuring Committee which is “sponsored” and, in part, administered by a secretariat attached to the central bank.
- Indonesia: It is doubted that the present insolvency law, in practice, provides an effective sanction to encourage resort to the work-out. The effects of the economic crisis have also limited any real attempt at refinancing or restructuring because of the fact that:

many debts are denominated in foreign currencies and the devaluation of local currency means that there are simply “insufficient rupiah earnings to generate the necessary U.S.\$ to service debt”; and

the banking sector collapsed and “a new government appointed management has been placed in control of many Indonesian banks. This makes negotiations more difficult because the lenders’ management now has different interests in dealing with debtors”.

There is a need for government assistance in the negotiation process which is provided for under the Jakarta Initiative process.

- Philippines: Doubts were raised whether the sanction of the possible application of insolvency law in the Philippines processes is sufficient.
- Pakistan: It is considered that the employment of specialist advisors would be difficult and the threat of a sanction under the existing insolvency law of Pakistan may not be very effective.
- India: “The law requires to be strengthened in relation to swift and effective resort to the application of an insolvency law and the sanction of the break down of a negotiation process for ensuring financial viability.... The process for presenting a negotiation scheme has to be made the burden of a company or creditor j. rather than that of an operating agency”.
- Thailand: There is a legal problem with the protection of new money. There is also a problem regarding the appointment of specialist advisors and the costs associated with that. Another difficulty in Thailand concerns the provision of information and breach of confidentiality agreements.

The main points of those collective opinions may, perhaps, be summarised 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 a few jurisdictions) that the insolvency law, in practice, 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;
- agreement that some type of government or quasi-government facilitating agency is required;
- concern regarding the provision of on going funding (or “new money”).
- 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.

(a) Experience and commercial knowledge

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. 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 one suspects that, at least 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.

A successful work-out also involves a considerable degree of commercial experience and knowledge in a number of complex areas (for example, 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 (which often involves dealing with creditors who have security over assets comprised in those business activities), the possible conversion of some debt into equity (which would necessarily involve a reduction or watering down of existing equity); and other complexities that might extend to inter party agreements between some of the creditors themselves). 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 probably, therefore, a need for training and education in this area.

(b) The problem of “new money”

As mentioned previously, some of the insolvency law regimes (and, possibly, other laws) of some of the RETA economies may have to be altered to provide for the protection of creditors who are willing to provide urgent cash flow funding for a debtor corporation in an informal work-out (see the section dealing with formal rescue regimes).

(c) The level of sanction

As mentioned in the earlier section in which the concept of the work-out was examined, it is a fact that despite the overall appeal and commercial sense that an informal work-out might suggest, the prospect of engaging a corporate debtor and its variety of creditors in such a process may 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 is not present in some of the RETA economies.

10.5 Issues for discussion

- 1 Is there a place for the operation of an informal work-out process in each of the RETA economies?
- 2 What should be done to encourage the development of this type of process?
- 3 To what extent is there a need for education, knowledge and experience in the:
 - banking and finance sector;
 - corporate sector; and
 - advisory/specialist sector to assist the process?
- 4 Is it desirable to provide for some type of facilitator to assist in the commencement and continuity of the process and to otherwise monitor and further develop the process generally?

10.6 Tentative proposals

- 1 The banking sector (ideally with the endorsement and assistance of a central bank and/or finance ministry) should promote the introduction and development of a “code of conduct” directed toward the use of an informal out-of-court work-out process for dealing with corporate financial difficulty or insolvency.
- 2 If necessary the work-out process might be facilitated by establishing an independent office or secretariat to perform the following roles:
 - acting as a centre to enable both corporate debtors and banking and finance institutions to initiate a forum for the possible commencement of the process;
 - assisting, if necessary, the commencement and continuation of the process through negotiation and mediation;
 - providing continued education and training for corporations; bank and finance institutions; and creditors generally of the work-out process and techniques relating to refinancing, restructuring and rehabilitation;
 - referring problems and difficulties that may be encountered in proposing elements of a work-out (in particular, problems caused by the absence of suitable laws or the presence of restrictive or non-facilitative laws, rules and regulations) to government with recommendations for their improvement or reform; and
 - providing references to an established panel of independent specialist experts and advisors whose services may be required for the development of refinancing and reorganization proposals.
3. If necessary, insolvency laws providing for rescue should be amended to enable proposals developed as a result of the informal process to be referred to a relevant court or tribunal for the purpose of seeking approval from creditors and the sanction of the court or tribunal in accordance with the provisions for such approval and sanction as contained in the relevant insolvency law.
4. An insolvency law regime should provide for the protection of “new money” in order to encourage and enhance the prospect of a successful informal work-out (and formal rescue).
5. To encourage and facilitate the development of informal work-out processes, an insolvency law regime should provide convenient and quick access to its procedures.

Section 11 Summary of Issues for Discussion

From Section 4

- 1 To what extent has the influence of other countries hampered or contributed to the development and practical application of an acceptable insolvency law or insolvency based practice in many of the RETA economies?
- 2 Would it be preferable for a number of the RETA economies to abandon completely their existing, largely inherited, insolvency law and practice system and develop completely new laws and practices?
- 3 What effect does the process of “globalisation” have on the development of insolvency laws and practices?
- 4 Are there difficulties in accommodating different legal system traditions in a basic approach to insolvency law and practice?
- 5 How significant are the problems of attitudes to strict legal processes, stigma and loss of control in relation to insolvency law and practice? How best might these be overcome?
- 6 How real are the problems of corruption and fraud in the context of insolvency law and practice? What might be done to counter such problems?

From Section 5

- 1 Should accounting and related practices be improved in some of the RETA economies?
- 2 Do the standards of corporate governance need to be improved, particularly as they relate to duties of directors in the face of the insolvency or probable insolvency of a corporation? Should sanctions be imposed to enforce such standards (for example, through a law which enables persons to be disqualified from acting as directors of corporations if they are found to have breached duties/standards)?
- 3 Do restrictions on banks owning equity in a debtor corporation have any significant effect on plans of restructure and rescue?
- 4 Should issues such as family control; conglomerates of corporations; and political involvement or association be addressed in the context of insolvency law reform?

From Section 9

- 1 What are the main:
 - (a) strengths; and
 - (b) weakness of each insolvency law regime in the RETA economies?
- 2 What are the main barriers to access in each regime? How can these be lessened?
- 3 What is the evaluation of judicial/tribunal case processing and management in each regime? How can this be improved?

- 4 What is the evaluation of the general administration (e.g. through government department or private specialist administrators) of insolvency cases in each regime? How can this be improved?
- 5 What are the reasons for so few cases of formal insolvency administrations in some of these regimes?
- 6 What is required to improve the statistical information regarding cases of insolvency in some of the RETA economies?

From Section 10

- 1 Is there a place for the operation of an informal work-out process in each of the RETA economies?
- 2 What should be done to encourage the development of this type of process?
- 3 To what extent is there a need for education, knowledge and experience in the:
 - banking and finance sector;
 - corporate sector; and
 - advisory/specialist sector. to assist the process?
- 3 Is it desirable to provide for some type of facilitator to assist in the commencement and continuity of the process and to otherwise monitor and further develop the process generally?
- 4

SECTION 12 - Tentative Proposals for Model of Best Practices

From Section 2

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

From Section 2

An insolvency law regime should provide for the possibility of accessing both the liquidation and the rescue processes under a single procedure.

From Section 2

If a corporation seeks to implement a rescue process the insolvency law regime should provide for an early assessment of whether there is some real prospect of rescue. If the corporation fails that or any subsequent assessment it should be automatically transferred to the liquidation process.

From Section 2

Access to the process provided for under an insolvency law regime should provide for a quick, convenient and inexpensive procedure for both a corporate debtor and creditors, but with sufficient safeguards to protect against abuse of the process. Evidence should be provided of insolvency or financial difficulty of a corporate debtor.

From Section 2

- Under the liquidation process

If the debtor corporation has applied for liquidation or if it is determined that the debtor corporation is only suited to liquidation, the powers of the existing management should be removed and an independent administrator should be appointed to assume those powers and the conduct of the liquidation. Secondly, the stay or suspension of actions and proceedings against the property of the debtor corporation should be confined to unsecured creditors only. Thirdly, since there would be little or no requirement of ongoing funding for such a debtor corporation, no particular provision need be made for it.

- Under the rescue process

In the case of a genuine rescue attempt, the position should be quite different. In that case it is suggested that the existing management might continue but with overall supervisory and ultimate power in an independent administrator. Secondly, the stay or suspension of actions and proceedings against the property of the debtor corporation should apply to all creditors (secured or otherwise) for a reasonable length of time, but subject to applications by affected creditors for relief from the stay. Thirdly, the legislation should both sanction and provide a "super priority" (ahead of all creditors) for funding of necessary ongoing and urgent business needs of the debtor corporation.

From Section 2

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

The longer term administration of an insolvent corporation which is being liquidated may be conducted through a special government agency but with provision to enable more difficult and complex cases of liquidation to be administered by an outside independent specialist insolvency administrator. The government agency must be properly resourced to enable it to perform its functions efficiently.

Cases of rescue should be administered by an independent specialist administrator.

All cases of liquidation or rescue should be subject to supervision by the appropriate court or tribunal.

From Section 2

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.

From Section 2

An insolvency law regime should provide, as part of the rescue process, for an independent investigation and report of the affairs and the financial position of the corporation. It should also provide for an independent assessment of any rescue proposal in respect of the corporation.

From Section 2

An insolvency law should make proper provision for the involvement of creditors as part of the liquidation or rescue process. In particular:

- the insolvency law should clearly define the voting rights of creditors and should prescribe minimum requirements for the approval of a plan of rescue;
- provision should be made for voting by classes of creditors, particularly secured creditors, if the rescue proposal is required to bind such classes;
- the law should also 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; and
- the effect of a vote of the requisite majority of a class should be made binding on all creditors of that class.

From Section 2

An insolvency law regime should, as far as possible, preserve the principle of equal treatment for all creditor

Accordingly, the insolvency law should limit the number of priority claims to as few as possible.

From Section 2

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.

From Section 2

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

From Section 2

An insolvency law regime should include the provisions of UNCITRAL cross-border model law.

From Section 8

It is important that there is support for the value that contractual obligations should be honoured. This requires that individual enforcement and recovery rights may be effectively taken and efficiently processed. This is not only important for individual creditors. It is also important because it operates as a pressure point on a corporate debtor who cannot fulfill a contractual obligation because of financial difficulty or insolvency. A corporate debtor who wants to otherwise survive may then have to seek remedy or relief under the insolvency law or informal insolvency process.

Remedy or relief for a corporate debtor from the enforcement of individual creditor rights should support the value of a fair and orderly collective process. The existence of an effective and efficient formal insolvency process serves that purpose.

A formal collective process should provide for a restraint on enforcement of all individual creditor rights for a limited period of time and should only be extended if there is a

certain probability of a successful rescue proposal. Otherwise the enforcement of secured and lease creditor rights should not be restrained.

From Section 9

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;
- 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.

It would also assist if, upon the completion of each corporate insolvency administration, the responsible authority recorded the following information to which the public would have access, namely:

- the name of the corporation and date of incorporation;
- the names 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 realised) and liabilities (estimated and realised); 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.

From Section 10

- 1 The banking sector (ideally with the endorsement and assistance of a central bank and/or finance ministry) should promote the introduction and development of a “code of conduct” directed toward the use of an informal out-of-court work-out process for dealing with corporate financial difficulty or insolvency.

- 3 If necessary the work-out process might be facilitated by establishing an independent office or secretariat to perform the following roles:
 - acting as a center to enable both corporate debtors and banking and finance institutions to initiate a forum for the possible commencement of the process;
 - assisting, if necessary, the commencement and continuation of the process through negotiation and mediation;
 - providing continued education and training for corporations; bank and finance institutions; and creditors generally of the work-out process and techniques relating to refinancing, restructuring and rehabilitation;
 - referring problems and difficulties that may be encountered in proposing elements of a work-out (in particular, problems caused by the absence of suitable laws or the presence of restrictive or non-facilitative laws, rules and regulations) to government with recommendations for their improvement or reform; and
 - providing references to an established panel of independent specialist experts and advisors whose services may be required for the development of refinancing and reorganisation proposals.

- 3 If necessary, insolvency laws providing for rescue should be amended to enable proposals developed as a result of the informal process to be referred to a relevant court or tribunal for the purpose of seeking approval from creditors and the sanction

of the court or tribunal in accordance with the provisions for such approval and sanction as contained in the relevant insolvency law.

- 4 An insolvency law regime should provide for the protection of “new money” in order to encourage and enhance the prospect of a successful informal work-out (and formal rescue).
- 5 To encourage and facilitate the development of informal work-out processes, an insolvency law regime should provide convenient and quick access to its procedures.

Section 13 Graphics

Graphic 1. Insolvency law influences

Graphic 2. Insolvency law regime outline

Graphic 3. The Informal Work-Out Process

Graphic 4. Evaluation of formal RETA economies rescue processes

Section 14 Annex

Details of Project

This is a regional technical assistance project of the Asian Development Bank.

The broad aims of the project are to:

- study the relationship between corporate debt and the insolvency or financial difficulty of corporate debtors in the region;
- suggest the components of a model of “best practices” which are suitable for the region to effectively deal with a problem or corporate insolvency and recovery of debt;
- make available, through an Asian Development Bank Home Page on the internet, the insolvency and other related legislation of RETA economies and the studies and reports produced as a result of the project.
- The project commenced on 12 October 1998.
- The ADB project officer is Clare Wee. The project is managed by John Lees of Ferrier Hodgson & Marfan, accountant of Hong Kong, China. The project is lead by Ron Harmer, a consultant to Blake Dawson & Waldron, Australian lawyers.
- The approach to the study has been as follows:
- A consultant’s work guide was prepared. This was divided into 21 sections of enquiry. The sections of enquiry included forms and structures of business organizations (concentrating on those which may be termed “large and medium size enterprises”); the banking system and the availability and forms of financing for such enterprises, including secured financing and enforcement; unsecured financing and enforcement; attitudes towards financial difficulty and insolvency; informal processes; the insolvency law regime; foreign and cross-border aspects of insolvency law; the inter relationship between lenders and borrowers; and a general assessment of various processes arising from the previous sections. These sections required response to some 162 issues. In this the objects was to discover the tangible form or substance of the issues and processes but also the more intangible influences that might intervene on the form and substance (for example, political, governmental, cultural and other such like influences).

- A local consultant was appointed in each of the 11 economies to furnish a local study based on the economies work guide.
- The local consultants were required to work with representatives of the finance sector, entrepreneurs, professionals and government.
- A field visit was undertaken to each economy during the preparation of the local studies.
- The local reports were furnished, together with the relevant insolvency law legislation and other material (for example that dealing with informal work-out practices).
- This preliminary comparative report was written based on the above.

Comparative Table

Country	Name of Process	Application	Access
HK, CHINA, SING, MAL, INDIA, PAK	SCHEME OF ARRANGEMENT/ COMP	CORPORATIONS	COURT
SINGAPORE	JUDICIAL MANAGEMENT	CORPORATIONS	COURT
INDIA	"SICK" COMPANIES	CORPORATIONS IN SPECIFIED INDUSTRIES	ADMIN. BOARD
MALAYSIA	PDNB SCHEME	CORPORATIONS (SPECIAL CASES ONLY)	ADMIN. BOARD
PHILIPPINES	PD902A (SUSPENSION OF PAYMENTS)	CORPORATIONS (INC. BANKS, etc.)	ADMIN. BOARD (S.E.C.)
KOREA	COMPOSITION	CORPORATIONS	COURT
KOREA	CORP. REORGANISATION	CORPORATIONS	COURT
JAPAN	COMPOSITION	CORPORATIONS	COURT
JAPAN	COY. ARRANGEMENT	CORPORATIONS	COURT
JAPAN	CORP. REORGANISATION	CORPORATIONS (LARGE)	COURT
TAIPEI, CHINA	COY. REORGANISATION	PUBLIC CORPORATIONS ONLY	COURT
TAIPEI, CHINA	COMPOSITION	CORPORATIONS	COURT
THAILAND	BUS. REORGANIS.	CORPORATIONS (INC. BANKS, etc.)	COURT
INDONESIA	SUSPENSION/ REORGANISATION	CORPORATIONS (INC. BANKS, etc.)	COURT
PAKISTAN	"SICK" COMPANIES	CORPORATIONS	GOVERNMENT AUTHORITY

COUNTRY	INITIAL AUTOMATIC EFFECTS			X OVER TO LIQ
	MANAGEMENT	SUSPENSION	PROTECTION OF CASH FLOW FUNDING	
HONG KONG, CHINA, SING, MAL, INDIA, PAK	NO CHANGE	NO (EXCEPT ON APPLICATION)	NO	NO
SINGAPORE	POWERS TO JUDICIAL MANAGE	ALL ACTIONS (BUT NOTE FLOATING CHANGE)	FUNDING ENJOYS PRIORITY	NO
INDIA	NO CHANGE	ALL ACTIONS	UNCLEAR	YES
MALAYSIA	POWERS TO SPECIAL ADMINISTRATOR	ALL ACTIONS	YES	YES
PHILIPPINES	POWERS TO MANAGEMENT BOARD/ RECEIVER	ALL ACTIONS	UNCLEAR	YES
KOREA	POSSIBLE SUPERVISION BY COMMISSIONER	NO (EXCEPT ON APPLICATION)	UNCLEAR	NO
KOREA	NO (EXCEPT BY COURT ORDER)	NO (EXCEPT BY COURT ORDER)	UNCLEAR	YES
JAPAN	NO CHANGE	NO (EXCEPT ON APPLICATION)	NO	YES
JAPAN	NO CHANGE	NO (EXCEPT ON APPLICATION)	NO	YES
JAPAN	NO CHANGE	NO (EXCEPT ON APPLICATION)	YES	YES
TAIPEI, CHINA	NO CHANGE	NO (EXCEPT ON APPLICATION)	UNCLEAR	YES
TAIPEI, CHINA	NO CHANGE	NO	NO	YES
THAILAND	NO CHANGE	ALL ACTIONS	NO	YES
INDONESIA	JOINT MANAGEMENT BY DEBTOR AND ADMINISTRATORS	ALL ACTIONS	NO (UNCLEAR)	YES
PAKISTAN	UNCLEAR	UNCLEAR	UNCLEAR	UNCLEAR

