Insolvency is a by-product of market economies. In market economies, some businesses fail. Bankruptcy laws and procedures provide the safety net for financial failures in market economies. Specifically, bankruptcy laws and procedures promote the distribution, re-distribution, or use of assets from a failed business in a more economically efficient, effective, and fair manner, albeit through the liquidation or reorganisation of the business. The importance of effective and efficient bankruptcy laws in market economies cannot be overstated. Bankruptcy laws and procedures provide a collective norm for all creditors, as opposed to a first-come, first-served “grab law” that benefits only the most aggressive creditors. The articles that follow are intended to encompass a wide range of perspectives on bankruptcy and insolvency laws and encourage a dialogue to foster the development of fair, effective, and efficient laws in transition countries.

The first article by Craig Averch, counsel of the Corporate Recovery and Litigation Team in the EBRD’s Office of the General Counsel, explores several theories used to evaluate the fundamental fairness of bankruptcy laws in the context of the treatment of a secured creditor. The article points out that there is no “one size fits all” set of bankruptcy laws and procedures. Certainly, some bankruptcy laws and procedures wholly fail to fulfil any meaningful bankruptcy or economic theory. There are, however, a wide range of bankruptcy laws and procedures that could satisfy many policy concerns. The article concludes that the procedure a country chooses or should choose may depend on other factors, e.g., the country’s culture and legal tradition. The second article, by Anita Ramasastry, Lieve Vandenhoek, and Stefka Slavova, examines the state of insolvency systems in the region as measured by a survey conducted by the EBRD.

The next article, by United States Bankruptcy Judge Steven A. Felsenthal, discusses the role of courts in the bankruptcy institutional framework and the need for consistency in decision-making throughout the system. Judge Felsenthal has served as a bankruptcy judge for 14 years and was the appointed mediator in the large and complex bankruptcy cases of MCorp and Cajun Electric Power. Following this, there is an article by Nicholas Frome that explores multi-creditor restructurings outside the judicial system and their utility. Mr Frome, a partner at Lovells, discusses efficient and effective techniques for accomplishing a negotiated solution to a financial problem without having to implicate the institutional framework established within a particular jurisdiction.

The article written by Helen Kryshtalowycz and Wm. Smith Greig, managing partner and senior associate respectively in the Kiev office of Squire, Sanders & Dempsey L.L.P., looks at the legal reform process within the context of the recently revised Ukrainian bankruptcy law. Bankruptcy laws, like the economies they serve, are not static and need to be amended and altered to serve the commercial reality of a particular country. In their article, Ms Kryshtalowycz and Mr Greig examine the changes to the Ukrainian bankruptcy law. The article also considers the legal, commercial, and political circumstances in Ukraine that facilitated the major overhaul of its bankruptcy law.

The article written by Adrian Cohen, a partner at Clifford Chance L.L.P., with John MacLennan, an assistant in the firm, provides insight into how insolvency was avoided for a leading Latvian financial institution, First Latvian Commercial Bank (formerly Rigas Komercbanka), and how the bank was subsequently restructured. It examines the roles of and the vital cooperation between all of the parties involved in the restructuring, including the Government of Latvia, the Latvian Central Bank, shareholders, commercial lenders, depositors, the EBRD, and their professional advisers. It notes the vital legal reforms that underpinned the restructuring and the novel solutions and structures designed to meet the requirements of Latvian law and the interests of all stakeholders. Mr Cohen acted jointly for the EBRD and for the commercial-lender syndicates led by Fuji Bank Limited and Landesbank Schleswig-Holstein Girozentrale.

The focus section concludes with an article by Gordon Johnson, senior counsel, The World Bank, discussing the initiative of The World Bank to develop principles and guidelines on effective insolvency systems. The article details the efforts of The World Bank, and its working groups, to promote consideration of insolvency issues through the presentation of papers and ideas at conferences throughout the world.
Bankruptcy laws: what is fair?

Current world conditions have demonstrated the interdependency of credit markets and bankruptcy laws. Market economies need a system of fair, predictable and consistently enforced laws and procedures to deal with financial failure. There are, however, no “right” and “wrong” answers to the question “What is a fair statutory scheme of bankruptcy laws and procedures”? The following article highlights a number of bankruptcy policy considerations for ascertaining fairness with respect to the treatment of secured creditors.
To non-insolvency specialists, bankruptcy law is not easily understood. Bankruptcy itself seems contrary to the notions of fair play and substantial justice. Specifically, bankruptcy laws often obliterate contractual bargains that were time-consuming to negotiate and implement. Plain and simple, bankruptcy means that creditors will not receive the benefit of their bargains and, in most cases, will lose money. To most, “bankruptcy fairness” is an oxymoron. How then can the fundamental fairness of bankruptcy laws be determined?

The short answer can be found within basic economic policy. In the abstract, bankruptcy laws are an amalgam of economic-based provisions designed to maximise values and fairness-based provisions that allocate those values. Put simply, economic policy dictates that a debtor, unable to pay its debts, either allocate the assets to creditors in a fair and proportionate manner or, if the enterprise value exceeds the asset value, restructure and reorganise its liabilities to a serviceable level.

Certainly, if people obtained goods and services only in exchange for cash or with comparable equivalents, as in a traditional barter system, there would be no debt and, therefore, no need for a bankruptcy system. In a communist regime, with only state-owned businesses and no market economy, there would also be little need for a bankruptcy system. However, market economies, by emphasising borrowing and credit, create the economic need for a bankruptcy system.

Once bankruptcy is put into an economic perspective and the “moral” dilemma of creating new bargains with the entity or representative of the entity that breached the original bargains is overcome, certain precepts should be considered. That is not to say that economic models are the only means for considering bankruptcy precepts and policies. Economic analysis focused on the debtor/creditor relationship alone is fraught with problems. Community interests must also be considered. Moreover, there are inherent difficulties associated with economic modelling for bankruptcy, as expressed by Professor Elizabeth Warren of Harvard Law School:

To model improved systems that operate only in perfect markets, or to ignore the high costs of collection outside the bankruptcy system when critiquing the high costs of collection in bankruptcy, is to design an airplane that carries no payload, flies only in a gravity-free environment, and consumes no fuel. The exercise may be great fun, but it yields little that is useful for those who need to build planes that fly. It is important to separate debates about bankruptcy fancy from debates about bankruptcy policy.

Development of universal, international precepts and policies for bankruptcy laws is the current subject of The World Bank Insolvency Initiative. The World Bank, along with other international financial institutions (including the EBRD), is committed to identifying principles and guidelines for sound insolvency systems and related debtor-creditor rights. Moreover, the legal department of the International Monetary Fund (IMF) has recently published a book on many of the general objectives and features of insolvency procedures.

Unlike the IMF and certain other international development banks, the EBRD is extensively involved in project financing to promote and foster the transition of 26 countries in central and eastern Europe and the Commonwealth of Independent States (CIS) to market-orientated economies. The EBRD’s focus often translates into providing secured financing to private sector borrowers in the transition countries. By focusing on the application of a provision of the Russian Bankruptcy Law that strips secured creditors of their security in a bankruptcy proceeding, this article explores a number of bankruptcy policy considerations for secured lenders.

3 Legal Department, International Monetary Fund, “Orderly and Effective Insolvency Procedures: Key Issues” (1999) (hereinafter referred to as “Insolvency Procedures”).

An economic view of secured lending

Before venturing down the twisted road of bankruptcy policies for secured creditors, it is important to examine at least one important economic view of secured credit in market economics. In a market economy, a business often needs capital to expand production, develop products, provide requested services and otherwise meet the needs and expectations of its customers and constituency. Loans can rationally supply this capital to finance development, expansion or production if the expected revenues cover the cost of all inputs plus debt service. In theory, secured financing can lower the cost of debt service, thereby facilitating the financing of projects that otherwise could never get off the ground or expand. Secured lending may accomplish this by increasing the likelihood that a creditor will be able to recover its principal, through a transfer of property rights from the debtor to the creditor. This transfer of property rights gives the creditor access to assets which it may then use to discharge some or all of the debtor’s liability. This reduces risk, and hence the interest compensation the creditor requires for lending. Often, this reduction in risk is large enough to make available credit that would otherwise be non-existent.

Put differently, the freedom of the secured party to liquidate collateral upon default may liberalise interest rates or repayment terms. Efficient and effective remedies to recover collateral should reduce the risk
to the secured lender and invariably the cost of lending, thus reducing the interest rate charged. A junior lienholder or trade creditor knows or should know the priority of its position and the relative value of the collateral, and it should adjust the interest rate charged to reflect the appropriate risk factors.

The secured creditor certainly benefits from security and ease in recovering collateral after default. Obtaining a security interest is therefore one of the most basic and reliable ways for lenders to protect their own financial position. With the strongest possible legal rights, secured creditors are best able to recover their money when debtors become financially distressed. As a corollary, the debtor should benefit from secured credit in the form of wider credit availability as well as cheaper and better credit terms. In a microeconomic sense, therefore, the increased availability of debt financing and cheaper credit for longer terms should inevitably benefit the economy as a whole.

**Treatment of secured creditors in bankruptcy**

If the economic view of the efficacy of secured lending is accepted (any economic view is subject to debate), then the issue of the treatment of secured creditors in bankruptcy arises. In a bankruptcy system that obliterates the bargain of the secured creditor, the economic efficiencies of secured lending and the concomitant reduced cost of lending never materialise. On the other hand, strong policy arguments can be advanced that a secured creditor should share some equitable fashion the losses with other creditors and, in a reorganisation scenario, the costs of restructuring. Unfortunately, there is no universal, international bankruptcy policy that can respond adequately to the competing issues of enforcement and equitable sharing. The following issues often arise with respect to secured credit in a bankruptcy proceeding:
- protection of collateral;
- compensation for depreciation;
- payment or accrual of interest;
- compensation for use of collateral;
- lifting of the stay for execution;
- the extent of any surcharge on the collateral; and
- priming of the security interest by other creditors.

Not all of these issues are addressed by bankruptcy legislation in each jurisdiction. Moreover, some jurisdictions limit or reduce the actual property rights granted to secured lenders under non-bankruptcy law.

Bankruptcy laws must balance the goal of maximising the value of the debtor’s assets with the need to protect the interests of secured creditors. Put simply, one of the most difficult tasks in formulating bankruptcy laws is striking the balance between the important public policy of value maximisation and the public policy of maintaining the integrity of the debtor’s previous transactions with its creditors. Western laws traditionally protect the secured creditor’s interest in specific collateral through requirements of adequate protection, stay relief to enforce security interests on pledged assets, compensation for depreciation, interest accrual for the oversecured creditors and various other protections. Indeed, the IMF states that “[a]s a general principle, an insolvency law should...[protect] the value of [the secured lender’s] security — and, as a consequence, the availability of credit is not eroded.”

The World Bank also recognises the issue:

An area of particular difficulty and contention is the extent to which the secured creditor should be allowed to assert its priority and enforce its security against the interests of the general body of creditors. The contest is between the individual interest of a particular creditor who has bargained for security and given value in reliance on it ... and the interest of unsecured creditors in the avoidance of precipitate action, such as the withdrawal of assets essential to the running of the business, which would damage or prevent the reorganisation of the enterprise to the benefit of all creditors.

To address the issue, The World Bank notes the following approaches:

One approach is to recognise the secured creditor’s rights but to restrict its remedies for a given period... Another approach might be to provide for arrangements under which secured creditors could be compelled to accept a change of status or a diminution of priority in the interests of the general body of creditors. The issue is part of a wider debate on the extent to which bankruptcy law should have a redistributinal role which goes beyond the avoidance of suspect transactions and the conferment of super-priority for certain types of debt.
As identified by The World Bank, bankruptcy laws are infinitely diverse. Bankruptcy tests the strengths and limits of property rights established by non-bankruptcy law. Although flexibility, transparency, and consistency are key components of effective bankruptcy laws, examination of at least a few of the underlying bankruptcy policies provides some insight into the fundamental fairness of a specific law. It is, therefore, a useful exercise to examine the specific and unusual treatment of secured creditors adopted by Russia where the security of a creditor is stripped by the bankruptcy. The Russian provision highlights and tests some of the esoteric bankruptcy policies.

TREATMENT OF THE SECURED CREDITOR UNDER RUSSIAN FEDERATION INSOLVENCY LAWS (THE STRIPPING OF SECURITY)

Once a borrower is declared bankrupt in the Russian Federation, secured creditors lose pledge rights in rem against specific assets of the debtor. In return, secured creditors receive a preferential right to recover ahead of general unsecured creditors but behind personal injury tort claims (capped at 10 years of periodic payments or until the claimant reaches 70 years of age) and wage claimants. Additionally, in the case of bankrupt banks, individual depositors are given priority over secured lenders. Moreover, all secured creditors participate in the distribution of bankruptcy proceeds on a pro rata basis, without regard as to whether the secured creditor had held primary or subsequent security interests in the specific property of the debtor. The amount of the third priority party’s secured claim entitlement is generally thought to be limited to the value of the property originally subject to the creditors’ pledge. Any excess claim amount would be treated as a fifth priority general unsecured claim (claims of the government are fourth priority). Finally, a secured creditor can vote the aggregate amount of its claim for various purposes (e.g., choice of the administrator in a bankruptcy proceeding and acceptance of settlement proposals) and, if the aggregate claim is large enough, participate on the creditors’ committee.

The major obstacle for secured creditors is the stay on execution or enforcement, effective immediately on the acceptance of the bankruptcy petition. Since security interests are stripped under the distribution scheme, there is no explicit provision for the lifting of the stay and no need to have such a provision. The provision relating to under-secured or partially secured claims is somewhat ambiguous. Because the secured creditor’s security is stripped upon the bankruptcy filing, there are no explicit provisions relating to after-acquired property. Finally, the Russian bankruptcy laws provide for the accrual of post-petition interest in a manner provided by Article 395 of the Civil Code of the Russian Federation. The contractual rates of interest (both default and non-default rates) do not accrue.

The Russian bankruptcy system adopts the second approach identified by The World Bank (quite different from the approach utilised by Western bankruptcy laws) by protecting the value of the secured claim through the provision giving secured claims priority over general unsecured claims.

The disregard for the property interest in the collateral itself does not necessarily mean that the Russian law is unfair to secured lenders. That is, if applied consistently within the language of the law, the Russian system may result in the same or greater recovery for a secured creditor than results from many Western systems.

The loss of the property interest (pledged collateral) results in a reduced recovery for a secured creditor only if the payment of the priority administrative, wage, and tort claims reduces the amount distributable to secured creditors to less than the fair market value of the collateral. For example, assume that a secured creditor, owed US$ 1,500, has a security interest encumbering all of the debtor’s real property valued at US$ 1,000. Assume further that the value of all of the
debtor’s property (inclusive of the encumbered real property) is US$ 1,200. Finally, assume that the priority administrative, wage, and tort claims are US$ 100. The Russian system would strip the creditor’s security and distribute the proceeds from the sale of all of the debtor’s property in the following order: (i) priority administrative, wage, and tort claims would receive the first US$ 100; (ii) the secured creditor would receive the next US$ 1,000 (i.e., the value of the secured claim); and, assuming no government claims, (iii) the last US$ 100 would be distributed to unsecured creditors on a pro rata basis (including the secured creditor’s deficiency claim). Under the adequate protection scenarios provided by most Western bankruptcy laws, the secured creditor would receive US$ 1,000 upon the sale of the encumbered real property and a deficiency claim of US$ 500 that would be shared on a pro rata basis with the general unsecured creditors. Based on the assumed facts, the secured creditor may receive approximately the same treatment, albeit in a different manner, under both systems of bankruptcy laws. The result changes dramatically if: (i) the secured creditor has an “enterprise mortgage” encumbering all of the debtor’s property; (ii) the priority claims are greater than US$ 500; or (iii) junior secured creditors are added to the mix.

Do the differences make the treatment of secured claims under Russian laws unfair? Hardly! The answer is completely dependent on the application of a controlling bankruptcy policy. There is, however, no one correct policy and hence no deemed inherent unfairness to secured lenders.

**Normative bankruptcy theories**

To the extent possible, bankruptcy laws should be viewed in conjunction with normative bankruptcy principles. Unfortunately, there are no undisputed normative bankruptcy principles. There are, however, some theories worth noting.

**Traditional public policies behind bankruptcy law**

Bankruptcy law can be evaluated from the vantage point of three general public policies. Simply stated, they are: (i) allowing the unfortunate but honest debtor a fresh start free of the obligations and responsibilities consequent upon business misfortunes (the “Fresh Start Policy”); (ii) fostering the equitable distribution of a troubled debtor’s assets through the equal sharing of losses by creditors of equal rank (the “Equity Policy”); and (iii) the restructuring and rehabilitation of a business to preserve jobs, pay creditors, produce a return for owners, and obtain the fruits of the enterprise (the “Rescue Policy”). With respect to the transition economies, (i.e., those countries that are shifting from communism to market economies), the Rescue Policy encompasses a transfer of assets to individuals or businesses that can more efficiently and effectively utilise those assets.

The application of these policies yields fair, practical, and predictable results. Take, for example, the debtor who lost a high-paying job and was not able to cut back on expenses before drowning in debt. The effect of the Fresh Start Policy of bankruptcy law is to insulate all (not just part) of the debtor’s future income from creditors, provided that the debtor is honest in handling its affairs and turns over all non-exempt property for distribution to the debtor’s creditors. Bankruptcy law allows creditors to scrutinise the debtor’s affairs and, assuming no misbehavior, it provides the debtor with a fresh start – free from past debts.

The Equity Policy and the Rescue Policy are also easily understood. For example, a debtor having US$ 10,000 in assets and ten creditors each owed US$ 2,000 are subject to either or both the Equity Policy and/or the Rescue Policy. Specifically, it would be unjust for the debtor to satisfy five of the ten creditors and leave five to bear the full brunt of insolvency while the others are preferred. The Equity Policy provides that the debtor breach all ten of its obligations and have all ten creditors share the pain. Put differently, even though we are all taught to keep our promises, bankruptcy is a scenario in which honorable conduct consists not only of breaching obligations, but breaching all similar obligations so that the burdens are shared equitably. In this context, the Equity Policy provides that many wrongs do make a right.13
Structured bargaining

Bargaining concerns what people do with rights. In markets, people exchange property rights. They bargain over the price and the bundle of rights to be transferred from one to another. For example, in a lending transaction, a borrower will bargain for immediately available cash at as low a cost as possible and the lender will negotiate for security (property of the borrower that may be liquidated to satisfy the indebtedness). This bargaining presupposes a set of legal rules, and the bargaining occurs within the legal framework. Even bargaining that does not directly use the law nevertheless occurs within its shadow.

Lenders need certainty in both the laws and the implementation of the laws. Defining the risks and making them predictable permits lenders to price loans and make financing assumptions. Certainty, on the other hand, not only raises the cost of capital but also limits the availability of capital. For secured lenders, certainty of the law and its implementation through the established systems may not be sufficient to lower interest rates and transaction costs. Reduced interest rates and secured lending transaction costs require efficient laws and legal systems in addition to predictability and certainty.15

Bankruptcy law can be viewed as creating a baseline. It enables the affected parties in distressed situations to negotiate out-of-court restructurings because each party can assess whether the consensual treatment of its position is better than bankruptcy. Indeed, in an environment with clear bankruptcy rules and procedures that are uniformly and transparently enforced, the bulk of debtor/creditor financial issues should be resolved through bargaining and consensus, not through litigation in the courts.

The bankruptcy laws and their enforcement must also be predictable. Individual countries can and do make different choices as to how insolvency laws will allocate risk among creditors and equity holders. The choices could be based on a hypothetical creditors’ bargain (described below), the interests of the community (also described below), the successful implementation of a system in another country, or on some other basis. Regardless of the choice, the rules should be clearly stated and consistently applied in a system that is transparent and open.16

Once the rules are known and consistently applied, creditors can make business decisions on the extension of credit in any particular country. Risks can be evaluated when the environment is stable and ascertainable. In this context, the treatment of secured claims under Russian bankruptcy law may be fair as long as the rules (and their application) can be determined in advance of the loan. One objective problem with the Russian system is that the risk of administrative and priority claims may not be ascertained with any certainty. As third priority creditors, secured creditors would have the discomfort of not knowing the amount of claims that may precede them in priority.

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14 This view is contrary to the explicit language of Article 114, point 3 (creditors in each priority ranking share pro rata the amount of their claims if liquidation proceeds are insufficient to pay them off in full). Notably, however, Article 114 conflicts with the priority ranking rule set forth in Article 342, point 1 of the Civil Code (laying down “first in time, first in right” priority rule).
15 See generally, Model Law on Secured Transactions (EBRD, 1994), which defines a set of 10 core principles for secured transactions.
16 In his article in the focus section of this issue, “The Role of the Judicial System: How to Achieve Consistency in Bankruptcy Cases,” United States Bankruptcy Judge Steven A. Felsenthal addresses the institutional framework necessary to achieve effective, efficient, fair, and consistent results from the application of the law.
The creditors’ bargain

In 1979, Professors Thomas Jackson and Anthony Kronman created a new law-and-economic analysis of US Bankruptcy laws. Soon thereafter, the “creditors’ bargain” model was developed by Professor Jackson. The model, in simplest terms, was utilised to analyse almost any bankruptcy issue by asking one theoretical question: What would creditors have agreed to if they had been asked in advance of insolvency? Professor Jackson argued that normative bankruptcy principles should be viewed as resolving a limited common-pool problem caused by the execution and enforcement of individual creditor remedies when the debtor has insufficient assets to satisfy all claims. A collection of assets can be more valuable when held together than it would be if the assets were immediately divided and distributed. A compulsory, collective proceeding, like bankruptcy, provides a mechanism to maximise the value of the assets of the common pool. The creditors’ bargain, in sum, asks what the creditors would agree to in advance to maximise returns from a limited pool of assets if they knew that individual creditors’ rights could not be enforced and that they would be forced into a collective proceeding like bankruptcy.

Notwithstanding the collective norm embodied in the creditors’ bargain, Professors Thomas Jackson and Douglas Baird argue that bankruptcy law should not alter the pre-bankruptcy entitlements among creditors. Most likely, the treatment of secured lenders under the Russian bankruptcy laws (i.e., the loss of the security interest on specifically pledged collateral) would shock Jackson and Baird (and most Western lawyers and bankers for that matter). Baird and Jackson would contend that the retention and foreclosure of collateral does not impair the value-maximisation goal in any meaningful manner. Moreover, they would argue that a bankruptcy rule that avoids a non-bankruptcy law entitlement, otherwise valid against unsecured creditors, provides a perverse incentive to general creditors to file a bankruptcy petition.

On the other hand, it could be argued that the Russian bankruptcy system adequately addresses the creditors’ bargain and common pool issues. Specifically, the stripping of security interests permits the efficient liquidation of assets and may thereby maximise the common pool for all creditors. Moreover, the security interest stripping may enhance the prospect of a successful reorganisation of the debtor. Replacing the secured creditors’ security interests with a priority over general unsecured claims (at least with respect to the value of the collateral) represents the type of bargain creditors may have reached in advance of an insolvency.

There is, perhaps, another way to view the role of bankruptcy law in the non-bankruptcy relationship of creditors. Specifically, there are two major characteristics governing the non-bankruptcy relationship between secured and unsecured creditors that deserves enforcement in bankruptcy. First, secured creditors are entitled to the value of the pledged assets to the full extent of the security interest. This entitlement, of course, does not allow the secured creditor to receive more than the value of the security. Secondly, unsecured creditors are entitled to the value of the pledged assets in excess of what is necessary to compensate the secured party. Enforcing this “bargain” under non-bankruptcy law is next to impossible. Absent a collective proceeding like bankruptcy, unsecured creditors are generally not entitled to notice of forced sales. Even if so notified, they would be in the awkward position of either bidding at the execution sale or losing the equity. It is therefore appropriate for bankruptcy policy to enforce the foregoing bargain on creditors in a collective proceeding.

The human and cultural predicament

Most people assume that bankruptcy is all about money. It is not. How a society treats individual and corporate debtors depends, in part, on what a particular culture believes underlies the financial failure. Cultural beliefs about human nature and property rights influence how any particular society wants to treat creditors and bankrupt debtors. The culture helps explain why in certain societies some creditors and/or debtors are considered more deserving than others. These beliefs justify the redistributive effects that consideration of cultural values imposes on other interests.

Bankruptcy laws are generally viewed from either a creditor’s perspective or a debtor’s perspective. These dual perspectives, however, fail to provide a complete picture. The interests of the community must also be considered. Bankruptcy touches on many community interests, and those interests should be considered in evaluating the underlying fairness of any bankruptcy law. For example, the closure and liquidation of a factory would cause people in the community to lose jobs, surrounding businesses to lose customers, the tax base of the community to diminish, and so on. If bankruptcy causes a business to relocate, there would be a similar negative ripple effect in the community losing the business and, perhaps, a positive ripple effect in the community gaining the business. What motivates and justifies the interests of the debtor and its creditors may be far different from the interests of the community.

In the United States, chapter 11 (the reorganisation chapter of the United States’ Bankruptcy Code) has been the subject of immense criticism, which may result from the failure of chapter 11 to take into account the interests of the community. For example, A.H. Robbins used chapter 11 in an attempt to eliminate its Dalkon Shield liability; Manville did the same for present and future asbestos claims; Continental Airlines, Wilson Foods, and Buildisco used chapter 11 to extricate themselves from agreements with the unions; and LTV tried chapter 11 to escape pension liabilities. During the time these cases were pending, chapter 11
was used as a basis for restructuring the debts of companies whose balance sheets were re-created during the leveraged buy-out craze of the 1980s. Public bondholders often received little or nothing while Wall Street investment banks received windfalls. Clearly the social issues involved in the cases impacted communities, not just debtors and creditors. The failure of chapter 11 to address the community issues justifies criticism.

In addition to collateral, secured lenders have a further advantage over most other creditors. Secured lenders repeatedly play the game of financial risk, consistently assuming the creditor position. Other creditors (workers and tort claimants) are generally not in the game of financial risk. In Russia, the scheme of distribution set forth in the Law on Bankruptcy suggests that the policy of the law is to limit freedom of bankruptcy and insolvency through a web of economics-based laws is certainly a Herculean task in and of itself. The addition of cultural and human factors makes it that much more difficult to formulate “fair” bankruptcy laws. Nonetheless, fair bankruptcy laws are a necessity for a smoothly performing market economy. Of course, beauty is in the eye of the bondholder (or secured debt holder). Accordingly, the final determination of fairness may ultimately depend on the perception of third-party lenders and investors regardless of the policies served and/or community needs met.

Bankruptcy addresses failures. A given society’s mechanism for addressing these failures becomes the prism for viewing a society’s most weighty problems. Notions of community, therefore, must be included when considering the fairness of bankruptcy laws.

**Conclusion**

Bankruptcy is a defining characteristic of a market economy. It establishes the limits and priority of credit extension and entrepreneurial venture capital and allocates risk. Empirical evidence has shown that social progress takes a toll in the form of bankruptcies and insolvencies. Dealing with bankruptcy and insolvency through a web of economics-based laws is certainly a Herculean task in and of itself. The addition of cultural and human factors makes it that much more difficult to formulate “fair” bankruptcy laws. Nonetheless, fair bankruptcy laws are a necessity for a smoothly performing market economy. Of course, beauty is in the eye of the bondholder (or secured debt holder). Accordingly, the final determination of fairness may ultimately depend on the perception of third-party lenders and investors regardless of the policies served and/or community needs met.

For its part, the EBRD will continue to support and participate in multilateral efforts to establish global principles and guidelines for building effective insolvency systems. While policy issues are clearly the province of national governments, governments of transition countries must recognise the issues and make a deliberate choice of which policies to promote. In addition, through its role as a prominent investor, the EBRD will continue to reinforce the need to have systems in the EBRD’s countries of operations that apply “fair” laws in a consistent, predictable, and uncorrupted manner. Finally, through systematic monitoring of progress in bankruptcy/insolvency law in its countries of operations, the EBRD will evaluate and publicise the legal reform efforts of transition countries as they grapple with choosing and implementing “fair” bankruptcy systems.

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EBRD legal indicator survey: assessing insolvency laws after ten years of transition

The EBRD’s Legal Indicator Survey suggests that the choice of insolvency system is less important than the progress and effort put into effectively implementing a chosen system.

The design of effective insolvency procedures involves not only specific expertise but also extensive implementation efforts. Insolvency reform often received less attention during the initial phases of a country’s economic transition. Ideally, insolvency legislation should enhance the protection of all parties’ rights in a transparent and equal way. Insolvency procedures maximise and protect the value of the insolvent entity for the benefit of all parties involved and the economy in general. The key question to be answered with respect to all insolvency regimes is how to distribute the costs and risks between market participants.

The first part of this article outlines some of the major issues that should be addressed when assessing the utility of a legal framework for insolvency within a transition economy. The second part of this article analyses the EBRD’s survey results in light of the goals and objectives discussed in the first part.

### Key issues for an effective and efficient insolvency system

#### Commencement and duration of an insolvency procedure

**Commencement of insolvency procedure**
A clear definition of insolvency is essential, given the importance of any trigger mechanism that puts a legal entity into insolvency. If the trigger is pulled too early, that action may have detrimental effects for the debtor which is trying to save its business; if the trigger is pulled too late, creditor rights may be impaired because the debtor’s assets may be depleted. For example, in its 1992 “Bankruptcy Act”, Hungary chose an automatic trigger. This meant that any entity that had debts more than 90 days overdue was required to file for bankruptcy. This provision created a flood of debtor bankruptcy filings in 1992, and, together with the lack of an efficient reorganisation procedure, resulted in the removal of this automatic trigger in the 1993 amendment to the “Bankruptcy Act.”

Most west European insolvency systems have a trigger that relies on a combination of “cash” criteria and “accounting” criteria, or on one of the two. Under the cash criteria, an entity is insolvent if it is unable to pay its debts in a timely fashion (for most market economies, this means 90 days overdue). Under the accounting criteria, an entity is insolvent if its liabilities exceed its assets. Given the relatively low standard of accounting practices in many transition economies, some combination of the two tests may be the best approach.

It is vital for transition economies to remove all impediments to the filing of an insolvency petition by all parties. The decision on whether a party or combination of parties – the debtor, the creditor, or the court – can file an insolvency petition also results in different insolvency procedures. In situations in which insolvency law provides for the possibility of both a reorganisation and liquidation, both debtor and creditor should be allowed to file a petition. In cases where only a debtor can file a petition, insolvency law should provide incentives for the debtor to avoid delay in the filing of its petition. In cases where the court can initiate an insolvency procedure, the court must be capable administratively of implementing this task.
Duration
A speedy insolvency procedure will increase efficiency and reduce costs. In practice, delay can harm both debtors and creditors and clog the court system. The interests of creditors can only be assured if the insolvency proceedings take place in a timely fashion in order to preserve the value of the debtor’s assets. A timely insolvency procedure can also, depending on the insolvency system chosen, provide the debtor with a clean balance sheet and a “fresh start”. This in turn can enhance the risk-taking necessary for private sector development. Therefore, strict time limits should be included in an insolvency law for filing petitions, drafting and voting of reorganisation plans, valuation of assets, and sale of assets.

The problems with slow insolvency proceedings can be seen in the Slovak Republic. It is not unusual to wait one year for a hearing after a petition is filed, and each debtor is required to go through a “reorganisation” phase irrespective of the state of its financial conditions. An insolvency case in the Slovak Republic can take several years to resolve.¹

Alternatives to liquidation
A workable insolvency law should have an alternative to straightforward liquidation – i.e., a form of reorganisation. The insolvency law should cover, among other things, the following reorganisation issues: (i) commencement of a reorganisation procedure; (ii) identity of parties who can commence a reorganisation procedure; (iii) extent of the “stay” during negotiation of reorganisation plan; (iv) management role during negotiations; (v) route to transfer to liquidation at any time; (vi) time limits; (vii) voting on reorganisation plan; and (viii) implementation of reorganisation plan.

Special attention should be given to the level of creditor support needed to approve a reorganisation plan. The reorganisation options in industrialised economies’ insolvency systems normally require two-thirds or a majority of creditors to approve a reorganisation plan. Some jurisdictions have a dual majority requirement, counting votes by number and claim amount. The dual requirement protects large claims from being subjected to a plan favoured by only small claimholders, while it protects large groups of small claimholders from the wishes of holders of large claims. Romania’s earlier insolvency law required a 100 per cent approval, but this was changed in the June 1995 “Bankruptcy Law”. This law allows creditors representing two-thirds of outstanding claims to approve the reorganisation plan. The new law also requires a simple majority of creditors in each class to approve the plan. The bankruptcy laws that came into effect in 1996 in Latvia and the Czech Republic both require only a simple majority of creditors to approve a reorganisation plan. The requirement of qualified majority approval of a plan, such as in Romania, provides additional protection for creditors.

Management and activity of enterprises during an insolvency procedure

Company management during insolvency
During insolvency, the management of an entity in distress can stay in place, be removed, or be put under “quarantine”. The majority of insolvency systems in industrialised economies provide for removal of current management. The court in turn appoints a trustee or administrator. The trustee administers the entity in distress, and the debtor is required to reveal all assets and liabilities.

Restricting company activity during insolvency
Most industrialised economies’ insolvency systems introduce a “stay” on all financial transactions once the insolvency procedure has started. This can cover a wide variety of activities but in most cases includes a prohibition on the issuance of new debt, the payment of outstanding claims, and the sale of assets.² The stay should be applicable to the debtor and all types of creditors, i.e., both secured and unsecured. The secured creditors should be included in the stay since their incentive will be to sell their collateral as soon as possible, even though this may not be beneficial for the insolvency procedure. However, the trustee should make sure that the collateral of the secured creditor is protected. A number of insolvency systems in transition economies exclude the payment of taxes, and salaries from the operation of the stay. However, these exceptions should be kept to a minimum, and exceptions should only be made for those assets that are irrelevant to the sale of an entity as a going concern.

Extent of power of the trustee or administrator
A trustee or administrator is an independent person whose role is to supervise or manage the insolvency proceedings. Given the importance of the role of the administrator, it is advisable that sufficient training and professional standards be established for administrators.

¹ In this article the term “insolvency” represents both liquidation and reorganisation proceedings. This article will focus only on insolvency issues pertaining to enterprises, not financial institutions.
² In contrast, the Czech Republic’s 1998 amendment to its “Bankruptcy Law” does not provide a clear definition of insolvency or a clear indication of when a debtor is required to file a petition. This has given rise to an inadequate use of the law.
³ US Foreign Commercial Service and the US Department of State, Slovak Republic Country and Commercial Guide 1999 (July 1998), http://www.mac.doc.gov/eebic/COUNTRYR/SLOVAK/CCG/index.htm. (“A bankruptcy law exists but is not very effective. A number of bankruptcy cases have been filed, but few have been resolved. The law discriminates against foreign creditors and operates on the principle of one vote per creditor, regardless of the size of claim. Requirements for debtor-initiated bankruptcies are unrealistic.”)
⁴ The “Croatian Bankruptcy Law” enacted in 1994 provides for the court to issue a resolution commencing the bankruptcy with the following results: the trustee takes over all managerial powers; employees are given 30 days’ notice of dismissal; a stay is issued on proceedings and execution; and all claims against the debtor mature.
these professions (possibly through a licensing regime). Romania faced the dilemma when drafting its insolvency law of to whether to give the bulk of the insolvency work to administrators or judges. Romania opted to give the work to judges; its reluctance to empower administrators related to the newness of the profession and the need for them to have extensive financial qualifications as well as integrity. It is preferable for the court to appoint the administrator and for the insolvency law to provide for conditions under which the administrator can be dismissed. The insolvency law should provide a transparent and easily understood method of remuneration for the administrator.

**Priority among creditors**

In order to attract foreign direct investment and implement an efficient and effective liquidation, priority between creditors should be respected. Secured creditors should be compensated according to the value of their secured claim. The 1994 Bulgarian “Bankruptcy Law” provides this clear priority for secured creditors. Poland’s insolvency legislation, by contrast, does not provide secured creditors with the highest priority. Administrative costs, such as payment of liquidation specialists, must be paid before the secured creditors are compensated. Super-priority claims, such as taxes or payments to employees, should be kept at the lowest level possible, as such priority can undermine the investment climate by decreasing lenders’ confidence in security.

If a reorganisation is the outcome of the insolvency system, the priority between creditors and the relationship towards the shareholders depends completely on the outcome of the reorganisation plan. Special attention should be given to the role and rights of minority shareholders. Often they are not heard or cannot take part in the voting on a reorganisation plan – a frequent complaint in Russia, for example. A possible solution could be to appoint one representative for all minority shareholders who would participate in the reorganisation procedures.

**Obstacles to implementation**

**Efficient court capacity**

It is a common misconception that court involvement is by definition slow and cumbersome. Very often, liquidation via the court is slow, as it can take time to identify and verify competing claims and because competing claimants often bring litigation to challenge the actions of the liquidators. However, reorganisation via the court is not by definition slow. What is most important is the court’s capacity to handle the often-complex commercial issues involved in insolvency cases. The adequacy of legal infrastructure is a significant factor that influences the length of time for insolvency proceedings. To address the issue of judicial capacity to handle insolvency cases, a special focus should be given to the training of all court personnel, not only the judges but also clerks and other court administrators. The insolvency law should provide ample room for the exercise of discretion by judges in order to develop a more workable insolvency court system.

Implementing an insolvency system depends not only on the court, but also on the professionals involved in the insolvency process. Professional standards, licensing and training should be developed and further refined for liquidators, trustees/administrators, accountants, valuation specialists, and lawyers specialising in insolvency cases. For example, Estonia has established a certification examination for potential administrators after they have attended a two-week training course. Croatia has recently proposed bankruptcy amendments that will require trustees to have at least ten years of experience in finance and pass a professional examination.

**Implementation of insolvency reform: success, failure or still in progress? Perceptions in transition countries**

Since 1997, the EBRD’s Office of the General Counsel has conducted a survey concerning the extensiveness and effective-ness of commercial laws in its countries of operations, including a series of questions on insolvency law. The insolvency survey attempts to quantify the perceptions held by lawyers and insolvency experts as to whether a country’s insolvency laws are comprehensive and whether they work in practice. Much of the material that forms the basis of this article is not readily verifiable and reflects the subjective assessment of survey respondents. Similarly, the information and views provided by respondents were not always consistent. Where there were large discrepancies among respondents, recourse to the EBRD’s in-house knowledge of the conditions in the country in question was used to arbitrate. Accordingly, while the purpose of the survey was to reflect the perception of lawyers on insolvency law in the region, care must be taken in reading and interpreting the results.

Countries in central and eastern Europe as well as the CIS have had to grapple with the various issues discussed in Part I when drafting new insolvency legislation.

Insolvency reform has occurred at a faster pace in the EBRD’s countries of operations than commercial law reform efforts elsewhere. One of the first studies of insolvency reform was undertaken in 1995 by the international accounting firm Deloitte Touche Tomatsu (D&T), which surveyed the insolvency laws of 13 countries in central and eastern Europe. At that time, D&T noted that there was no active creditor class in the region that could be relied upon to commence proceedings. As of 1995, D&T identified three major factors limiting the ability of creditors to initiate insolvency proceedings:

- vague definitions of insolvency or the “grounds” for filing a petition;
- lack of any obligation on the part of management or the debtor to initiate a proceeding when insolvent or penalties for failure to file a petition; and
- wide court discretion concerning whether to commence an insolvency proceeding based on the information contained in a petition.
As early as 1995, D&T had identified a lack of proper infrastructure for the implementation of insolvency laws as a major impediment to appropriate enforcement. The D&T Report recommended improving and developing the role of the judiciary and of the insolvency professions (lawyers and court appointed liquidators), as well as the development of detailed procedural rules to be used in insolvency proceedings.\(^8\)

The D&T Report noted that “without substantial improvement in the infrastructure, e.g., the Courts, judges and trustees, even the best laws will not be applied successfully in practice … Further, much greater attention (and resources) should be given to the development of related professions such as lawyers, accountants, investment bankers, appraisers and auctioneers.”\(^9\) Thus, the gap between extensive laws and effective implementation was apparent in 1995.

As a result, in 1996 commentators continued to note that the use of bankruptcy procedures was still relatively infrequent in central and eastern Europe and the CIS.\(^11\)

When the EBRD commenced its insolvency survey in 1997, it noted that efforts had already been made to refine legal frameworks that had been put in place during the early 1990s.\(^12\) The EBRD noted that many countries (more than one-third of those surveyed) had recently adopted new insolvency legislation or amended laws enacted in the early 1990s.\(^13\) The EBRD noted that many countries had adopted fairly extensive legislation; and (ii) there remains a gap between the extensiveness of this legislation and the effectiveness of its implementation. In some part, the gap may be due to the fact that much of the legislation that is currently in place is relatively new and, in some instances, replaces problematic legislation. It may take several more years for the true measure of the effectiveness of the second wave of legislation to be measured in a consistent fashion. Although many commentators focus on ten years of transition, starting from 1989 when measuring the success or failure of legal reform, this may not be the most appropriate benchmark when assessing insolvency reform in the EBRD’s countries of operations. Rather, many of the major reform efforts have occurred since 1995, and the development of an effective insolvency culture and legal practice is still taking shape.

A more recent trend has been for jurisdictions to enact special legislation to deal with insolvent banks. Russia, for example, enacted a new law in 1999 to deal with insolvent financial institutions, partly as a reaction to the bank failures that occurred in 1998. Additionally, organisations such as The World Bank and the EBRD have launched major technical assistance projects in many countries in order to facilitate the development of effective insolvency mechanisms.

\(^8\) In Hungary over 5,000 reorganisation cases were filed in 1992 and 1993; 90 per cent of these cases were completed by the end of 1993. Of the completed cases, a reorganisation agreement was reached in 72 per cent of the cases. No agreement was reached and hence straight liquidation resulted in 30 per cent of the cases, and 43 per cent of the cases were completed administratively (i.e., rejected on technical grounds or rendered irrelevant as the debtor had paid its debts).
\(^11\) Richard D. Coates and Arlene Mirsky, Esq. (Deloitte Touche Tomatsu International), “Restructuring and Bankruptcy in Central and Eastern Europe”, D&T Report (1995). The countries surveyed were Albania, Bulgaria, Czech Republic, Estonia, FYR Macedonia, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. The D&T Report summarised: (i) the efficiency of bankruptcy proceedings in the region; (ii) the infrastructure for implementation of bankruptcy laws; and (iii) incentives in the insolvency structure faced by potential parties to insolvency proceedings.
\(^12\) D&T Report, p.5.
\(^13\) D&T Report, pp.11-14. D&T noted that several countries had as early as 1995 developed innovative programmes to train liquidators. Estonia was cited as requiring prospective trustees to take a two-week training course and a certification exam. In Hungary the Ministry of Finance licensed liquidators based on certain professional and financial criteria. Ibid, p.13.
\(^14\) D&T Report, p.19.
\(^15\) Michael Kim, “When Non-use is Useful, Bankruptcy Law in Postcommunist Central Europe”, 90 Fordham Law Review, pp.1043 and 1047 (December 1996); Bufford supra note 6 (“there are insufficient incentives in the market place or the legal system to force unprofitable businesses into bankruptcy either voluntarily or involuntarily”).
\(^17\) In 1997, the Bank noted that Armenia, Azerbaijan, Croatia, the Czech Republic, Estonia, Latvia, Lithuania and Moldova had all recently enacted new insolvency legislation.
\(^18\) For discussion of “rescue” procedures in four of the countries surveyed (Poland, Bulgaria, the Slovak Republic and Hungary), see Harry Rajak, “Rescue versus Liquidation in Central and Eastern Europe”, 33 Texas International Law Journal, p.157 (Winter 1998).
**EBRD legal indicators: extensiveness and effectiveness of insolvency law**

**Categories**

- **Comprehensive**
  Insolvency law is perceived as comprehensive, highly effective, and clear with respect to issues such as the legal definition of insolvency, the role of the courts and trustee during liquidation, and the priorities of creditors. Insolvency law is also perceived as effective in the majority of cases. For example, respondents believe that liquidation proceedings are often concluded in a timely fashion, and that legal personnel (judges and liquidators) fulfill their duties effectively. Reorganisation proceedings are also perceived as effective in helping creditors and debtors reach a settlement at least some of the time.

- **Adequate**
  Insolvency law is perceived as adequate and reasonably effective. Countries in this category are perceived as having adequate or satisfactory laws for dealing with liquidation with respect to issues such as the legal definition of insolvency, the role of the courts and trustee during liquidation, and the priorities of creditors. Insolvency law is also perceived as being effectively implemented in almost all instances. None of the countries surveyed were perceived as falling into this category.

- **Barely adequate**
  Insolvency law is perceived as barely adequate and with minimal effectiveness. The law may be perceived as unclear on an essential component, such as the priorities of creditors or the legal definition of insolvency or the powers of the trustee or liquidator. Additionally, the legislation is perceived as ineffective when implemented. Proceedings are perceived as lengthy, and court involvement may adversely affect the duration of proceedings. Reorganisation proceedings may not be utilised frequently or are perceived as ineffective in promoting settlement between creditors and debtors.

- **Inadequate**
  Insolvency law is perceived as inadequate and ineffective. Legislation enacted in the early 1990s may be in need of substantial amendment or revision. The existing legislation is perceived as lacking in several areas, including the definition of insolvency, the role of the trustee and the courts in liquidation, the priorities of creditors and also the nature of reorganisation proceedings. The law is also seen as ineffective due to lengthy delays in completing insolvency proceedings, serious lack of skilled judicial personnel or trustees, and uncertainty about how courts and trustees will fulfill their duties.

- **Detrimental**
  Insolvency law is perceived as wholly ineffective and may discourage use of insolvency mechanisms by creditors. Countries are perceived as having rudimentary insolvency laws.
legislation or laws that are rendered ineffective by virtue of a fundamental lack of enforcement or implementation. Respondents may perceive the law as creating disincentives for creditors to file petitions and to use liquidation as an exit mechanism even when they have a large outstanding debt.

Analysis of results

There have been very few major changes in the insolvency classification that countries received for 1998 and 1999. In a few instances, small shifts either upward or downward were likely due to changes in perceptions of the effectiveness of the insolvency regimes. It is interesting to note that for countries with barely adequate insolvency laws or worse, the majority had effectiveness ratings that were lower than their extensiveness ratings. A few countries in the adequate category also had lower effectiveness ratings.

Bulgaria, Croatia, Estonia, FYR Macedonia and Hungary all received high ratings for their insolvency laws. FYR Macedonia may seem a surprise candidate for this grouping. Nonetheless, it enacted new insolvency legislation in 1998. However, both FYR Macedonia and Bulgaria had significant gaps between the perceived extensiveness of this new legislation and its effective implementation. As implementation problems become more widely recognised (through use), it is likely that these countries’ insolvency laws will be perceived as less robust.

The majority of countries included in the survey fell into the barely adequate category. Their laws are perceived as substantively adequate but in need of revision in at least one of the major areas discussed in the first part of this article. This classification is consistent with the general trend for most countries towards revising and updating their insolvency practices. Most countries have either revised laws that were enacted in the early 1990s or have adopted new legislation that is meant to achieve many of the objectives discussed earlier.

At the same time, respondents do not perceive these laws as effectively enforced. Delays, lack of properly trained personnel or inactive liquidators are some of the factors behind ineffectual implementation. The Czech Republic’s law has consistently fallen into the barely adequate category, for example, although it amended its insolvency legislation in 1998. The new amendments do not clarify when a debtor is legally insolvent and required to file a petition. Hence, respondents may not have perceived the recent changes to Czech law as having any tangible impact on the effectiveness of the insolvency process.

Kyrgyzstan had a very high extensiveness score in 1999. This may reflect optimism about the new legislation, which came into force at the end of 1997. However, the gap between extensiveness and effectiveness was quite significant – hence Kyrgyzstan fell into the barely adequate category. This may be due in part to the length of proceedings and the need for the judiciary to acquire more familiarity with insolvency law and practice.

The Slovak Republic has also received a similar rating for the past two years. As some commentators have speculated, the fast pace of initial legislative reform in this country has led to the need to revise existing legislation, which has caused a delay in the adoption of a new insolvency law. The EU has recently criticised the Slovak Republic for its ineffective enforcement mechanisms.

Poland moved into the barely adequate category this year. Poland’s lower rating, relative to other pre-accession countries like Hungary and Slovenia, may reflect the uncertainty over whether secured creditors receive the highest priority in a liquidation proceeding. Survey respondents (many of whom represent lenders) may perceive this uncertainty as a significant impediment to an effective insolvency regime in Poland. Moldova’s score also rose significantly between 1998 and 1999, possibly in response to proposed modifications to its existing insolvency law.

14 One surprise in the survey was Latvia’s lower score in a year when it had amended its legislation to strengthen the power of trustees. At the time of the survey, respondents may not have yet fully understood the changes made in the law at the end of 1998. Failure to publicise the changes fully or provide sufficient trustee training could explain why respondents had not perceived the effect of this change.

15 Bulgaria, for example, has also received high marks for its insolvency legislation from the EU (with respect to its potential for accession). See Dick Leonard, “Bulgaria Aims for EU”, Europe (1 December 1999). Hungary too has consistently received high ratings for its insolvency legislation. In 1995, D&T gave Hungary the highest score (in a survey of 13 countries’ insolvency legislation), D&T Report, p.8.


17 One factor formerly suggested as a reason for slow court actions – incompetence of the judicial corps to deal with a wide body of new laws – is rapidly being addressed. Increasingly, judges must pass difficult examinations on current laws, and the judicial corps is becoming more professional and more independent over time. Still, actual court procedures sometimes tend to follow whimsy or Soviet practice.

18 Bankruptcy proceedings are very lengthy and possibilities for financial restructuring of potentially viable enterprises are lacking. The revamping of the bankruptcy process, which has been set in motion by the Government (with assistance from The World Bank) will be a key element in a decentralised approach towards enterprise restructuring, Regular Report from the Commission on Progress towards Accession: Slovakia (13 October 1999), http://europa.eu.int/comm/enlargement/slovakia/rep_10_99/index.htm.
Countries classified as inadequate have been consistently perceived as having ineffectual insolvency processes and outdated legislation. For example, up until the adoption of its new law at the end of last year,19 Ukraine had requirements that made it difficult for creditors to commence insolvency proceedings. The new law includes more comprehensive procedures for reorganisation and also introduces the concept of a liquidator.

Azerbaijan, by contrast, has relatively new legislation enacted in 1998, but still falls into the inadequate category. Azerbaijan received a high rating for the extensiveness of its legislation. However, respondents noted that the implementation of the law was highly ineffective. Azerbaijan had by far the widest gap between its ratings for extensiveness and effectiveness, which points to an inefficient use and enforcement of its insolvency laws.

Other countries perceived as inadequate include Uzbekistan and Belarus (whose score actually increased in 1999). In 1998, Belarus amended its original 1991 insolvency legislation, and, while the law has been applied only a few times (many insolvent companies continue to operate), these amendments could explain the increase in the score.20 Survey respondents also could be reacting to a new insolvency law that the Belarus Government introduced in late November 1998, even though this law is not scheduled to enter into force until early 2000.

Georgia and Armenia now also fall into this category after a decrease in the perception of their insolvency systems. These declines are due to significant decreases in the perception of the effectiveness rather than the substance of their insolvency laws. For example, while Georgia’s insolvency law became effective in January 1997 and cases have been brought under this law, none of these cases have yet been concluded. Time delays such as these, perhaps caused by the judiciary’s lack of understanding of their powers under the law, are a key factor in lowering Georgia’s score.

### Variations of the adequacy of insolvency laws in transition countries across regions

**General trends and perceptions**

Based on an analysis of survey responses for the past three years, some of the general trends include the following:

**Survey respondents are often unsure of priorities during liquidation**

Nearly all jurisdictions now recognise the right of secured creditors to have first priority for payment of their debts during liquidation or to have the property securing their debt removed from the debtor’s estate. Notable exceptions to this trend include Poland, and Russia, where secured creditors fall behind employees with unpaid wage claims and persons with personal injury claims. In Russia the cost of bankruptcy administration also comes before secured claims. However, most jurisdictions have realised the importance of giving secured creditors priority, thus encouraging secured lending and lowering the cost of credit.

Survey respondents, however, were often uncertain about whether secured creditors took first priority and also what the other rankings were. In some instances, this is because the civil code provisions on secured lending may conflict with insolvency laws. For example, the Albanian “Law on Bankruptcy” is unclear on the issue of priorities among creditors, while the Albanian Civil Code fails to give secured creditors a priority position, beyond purchase-money charges.

In other circumstances, ambiguities exist in the insolvency law itself. Romania’s insolvency legislation, for example, had stated that debts of shareholders are last in priority whereas secured creditors receive highest priority. The status of shareholders who had made secured loans to a company, however, was uncertain. Amendments have now been made to the law to protect the rights of shareholders who are also secured lenders.

**Lack of clarity in insolvency legislation concerning the role of the liquidator**

For most jurisdictions surveyed, respondents often provided conflicting responses when asked about the authority of the liquidator and his or her powers. This is based in part on the fact that various laws provide more or less specific provisions about the liquidator.
Moreover, some of a liquidator’s powers develop through custom and practice and cannot be discerned from a simple reading of an insolvency law. Recent legislative changes, however, have attempted to address this problem by specifying and enumerating a liquidator’s or trustee’s powers. Latvia amended its insolvency law in 1998 to include a further enumeration of powers for the insolvency trustee and the courts.21

Implementation problems

If bankruptcy trigger procedures are unclear, debtors and creditors alike are uncertain as to whether to commence insolvency proceedings, but amendments designed to speed up the insolvency process can themselves create confusion. This was the case with the amendments to the Czech Republic bankruptcy legislation proposed by the Government in April 1998. Similarly, Georgia has been cited for poorly defined trigger conditions. The Georgian law was modified in 1997 so that an unpaid obligation rather than liabilities having to exceed the debtor’s assets can trigger bankruptcy. However, the use of this balance sheet test can sometimes be difficult to implement with an insolvent company due to uncertainties in accounting methodology in transition companies.

Developments since the survey

The survey results that are summarised above reflect perceptions concerning insolvency legislation as of July 1999. Recognising the problems in their insolvency systems, some countries have begun to address the deficiencies in their system during the past few months.

In the Czech Republic, there has been growing concern about insolvency legislation. The EU and The World Bank have both criticised the Czech Republic for inadequate insolvency legislation.22 Czech legislation is perceived as lengthy and in some instances a disincentive for creditors to pursue insolvency proceedings. The lengthy nature of proceedings may be perceived as providing an opportunity for management to strip assets.

In November 1999, the Czech Parliament was considering its 11th amendment to the existing insolvency law. Based on this amendment, creditors would be able to seize and liquidate a debtor’s assets. The new changes were due to come into effect in early 2000. It is unclear, however, whether judges will be required to freeze an entity’s assets immediately to protect them for creditors.23 Other changes included a shortening of the deadline to ten days for a company to be declared insolvent.24 Additionally, in January 2000, a new bill was introduced to protect employees of insolvent entities.25 Employees would be eligible to receive unpaid wages for up to three months from the Czech Government in the event that an insolvency petition is filed against an employer. Interestingly, there have been challenges made to the role of Czech liquidators.

As noted above, the EU also characterised the Slovak Republic laws as ineffective. In response, the Slovak Government has begun the process of revising its law and views for insolvency reform as one of its priorities for 2000.26 Slovak legislative reform is aimed at strengthening debtors’ rights and also facilitating debtor-initiated restructuring. However, a lack of qualified commercial judges and insolvency administrators who can implement and enforce any revised legislation could diminish the benefits of the new legislation.27

Other accession countries have also publicised their efforts to improve insolvency procedures. Lithuania’s Government, in a Priority Action Plan for accession to the EU, noted that proper enforcement of its insolvency legislation was one of its main objectives.28 Romania also has accelerated the timetable for reform of its insolvency procedures.29

Conclusion

Insolvency procedures force debtors and creditors to negotiate. They can also help alleviate premature closures of companies facing financial difficulties, induce debtors to service their debts more consistently, and lead to appropriate downsizing and sale of assets. While there is no such thing as a single, ideal model, internationally accepted standards for effective and efficient insolvency systems – when those standards emerge – will be an important tool for transition countries looking to develop or refine their insolvency system. The EBRD’s Legal Indicator Survey suggests that the choice of insolvency system is less important than the progress and effort put into effectively implementing a chosen system.
As noted above, D&T identified in 1995 the lack of proper incentives for debtors and creditors to utilise insolvency mechanisms and a lack of infrastructure as problem areas in central and eastern Europe. Since the D&T Report, there has been a significant level of legislative reform in the EBRD’s countries of operations. The results of the EBRD survey lead to the conclusion that these reforms have not yet had the intended results. While the laws may have been improved, implementation continues to be weak and inconsistent in many countries.

This suggests that in addition to the need for more time to absorb the most recent changes and for more attention and resources towards implementation, additional time is needed for the public and for the legal community to develop strong insolvency procedures and practice.

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Foreign direct investment (FDI) and domestic bank credit to the private sector are highest in countries with effective insolvency laws

As part of the most recent analysis of the EBRD legal indicator survey, a regression analysis was conducted to determine the impact of insolvency law on the volume of bank credit to the private sector and on the flows of FDI into a sample of transition economies. This analysis is patterned, to some extent, on the methodology pioneered by economists La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997) and the subsequent literature on the relationship between legal factors and external debt and equity finance. Virtually all the literature on the determinants of FDI stresses the importance of property rights and investor protection (as embodied in legal rules) as well as adequate judicial enforcement of those rules.

We tested the significance of insolvency law for the volume of bank credit to the private sector and for flows of FDI into the transition economies. Alongside the legal measures, market size, growth and geographical distance to western Europe are employed as explanatory variables. Market size and economic growth are borrowed from the methodology of La Porta, et al (1997); geographical distance is added to capture additional factors, presumed to affect banking activity and FDI – notably asymmetric information between domestic and foreign investors.

In general, the regressions revealed strong evidence that the country scores for legal effectiveness act as significant determinants of the ratio of private sector credit to GDP in the EBRD’s countries of operations. A similarly strong positive correlation exists between the country scores for insolvency effectiveness and flows of FDI. This result seems to confirm the view that legal effectiveness has a stronger impact on FDI inflows than legal extensiveness. In contrast, the regressions revealed no correlation between the extensiveness of insolvency laws and the ratio of private sector credit to GDP or the flow of FDI. The correlations can be seen from the scatter graphs above.

As noted in the text, a large number of countries have enacted adequate bankruptcy legislation and legal frameworks. Implementation and enforcement, however, remain the perceived problems, and thus effectiveness ratings on the whole were much lower than extensiveness ratings. However, the regression analyses indicate that it is the effectiveness of insolvency laws that seems to be a determining factor with respect to the relationship between insolvency laws and the levels of FDI and bank credit in the private sector in the various countries surveyed. As a result, those countries that focus on improving the implementation of their insolvency laws, through additional institution building and training, can expect to see a payoff through increased FDI and additional private sector bank credit.

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2 Our measures of bankruptcy legal extensiveness and effectiveness cover the main components of the creditor rights index in La Porta et al, ibid.
3 Spatial considerations are often considered in the international trade literature. Proximity to western Europe might be beneficial for the central European transition countries due to lower transport costs, shared history of capitalist institutions, similar cultural past, lower perceived risk on the part of Western investors, etc. Thus, the smaller the distance, the higher private debt and FDI are expected to be. This conjecture is borne out by the regression results. The distance coefficient is found to be significant and has a negative sign.
4 Bankruptcy effectiveness and distance of capital city to Vienna are both found highly significant at 1 per cent level for the ratio of private sector credit to GDP, while average GDP growth appears significant at 5 per cent. In the FDI regression specification only effectiveness and growth are found highly significant – both at 1 per cent level. Somewhat surprisingly, distance and market size appear irrelevant for FDI flows. Market size is found insignificant in the private credit regressions too.
The role of the judicial system: how to achieve consistency in bankruptcy cases

Bankruptcy laws must not only be fair but must appear fair to the public at large. The perception of the public of the fairness of any law is often based on direct or indirect experience with the judicial system. Bankruptcy increases the exposure of the public to the judicial system because of the number of parties impacted by the financial failure of a business. This article explores the requisites for the creation of an effective and fair judicial system.

Thomas L. Friedman, the New York Times columnist, writes in his popular book The Lexus and the Olive Tree that in today’s global market, a state’s economic “operating system” cannot function effectively and competitively without “software” that includes a strong and independent judicial system, with defined procedures for settling disputes, under the rule of law. The judicial system must assure that “domestic and foreign investors could always count on a reasonably level playing field, with relatively little corruption, plenty of legal safeguards for any foreigner who wants to make an investment and take out his profits at any time, and a rule of law that enables markets and contracts to work and protects and encourages innovation.”

But with innovation comes failure. Accordingly, the state’s operating system must include “a system of bankruptcy laws and courts that actually encourages people who fail in a business venture to declare bankruptcy and then try again, perhaps fail again, declare bankruptcy again, and try again, before succeeding … without having to carry the stigma of their initial bankruptcies for the rest of their lives.”

In the global strategy of the financial industry, “the quality of justice” is one of the most significant determinative factors for gauging the legitimacy and efficacy of the insolvency system. Lenders insist that the insolvency system be premised on “a court system that would ensure the efficiency, neutrality and competence of commercial courts.” Vendors, suppliers, and bankers require an insolvency court system that operates with speed and decisiveness. That system “depend[s] on powerful courts embracing jurisdictions that minimised procedural maneuvering.”

This paper explores how the judicial system achieves that goal through consistency of process under the rule of law, given the assumption that the state’s insolvency laws assign dispute resolution in insolvency cases to the state’s judicial system.

The rule of law in insolvency proceedings

To be accepted as legitimate by its users specifically and the marketplace generally, the judicial system that serves as the institutional mechanism for dispute resolution in insolvency proceedings must be premised on the rule of law, operating within a defined court structure, and applying a coherent body of insolvency law. The concept of the rule of law operates on both the theoretical and practical levels. On the theoretical level, a coherent judicial system presumes that the body politic shares a value system of government by law and not by people. The rule of law elevates courts from the rule of individuals to the rule of an institution acting on behalf of society generally under a structured system of laws.

On the practical level, the rule of law structures an orderly and uniform procedure, with notice and an opportunity to be heard in a transparent, public court presided over by an impartial judge. While insolvency laws must be structured to fit a state’s business environment, legal culture, and particular needs, the judicial system must assure an effective “operating system” for debt and equity restructuring.

As envisioned by Professor Paul W. Kahn in his book The Reign of Law, in the political value system, courts stand for the rule of law. Regardless of the men and women who sit as judges, they function as a court, acting as an institution under the rule of law. By acting as an institution under the rule of law, the court appears as something other than its individual judges pursuing their own course of political action. The court renders decisions as an institution not as individuals on behalf of the body politic. In this elevated sphere, judges act under law, not on behalf of a state’s head of government or sovereign or church or financial power. This value system fosters the development of a judicial system operating with equality, impartiality, and universality, which, in turn, assures stability of the law and predictability and fairness of the process.
With a concept of the rule of law, the court does not make exceptions in its decision-making process for particular individuals because of who they are or because of the power they exercise. Rather, the court demands equality between the ruler and the ruled. The concept of the rule of law creates in the community the belief in an ordered and stable system. This value system separates the court from the political power of the legislative and executive branches of government and from the economic and market powers of the litigants.

The structure and operation of insolvency courts

On a practical level, the court system must have a hierarchical structure, with a chain of command that will assure binding judicial decisions and an error-correcting and law-developing appellate system binding on all lower courts and parties. At the trial level, the insolvency courts must have a broad grant of jurisdiction. A fragmented grant of jurisdiction results in expensive litigation over the court’s authority and delay in the resolution of cases. As Professors Bruce G. Carruthers and Terence C. Halliday observe in their book Rescuing Business, delay generated by jurisdictional disputes results in the dwindling of remaining assets of the insolvent entity and forestalls rapid and effective reorganisation, thereby impairing prospects for corporate turnarounds. The cost of litigation over jurisdictional issues adversely impacts the time value of money while threatening the decline in value of the estate, the dissipation of resources, creditor logjam and deadlock, and a lack of focus on the negotiations of new agreements. Establishing a “forum of clearly defined, true insolvency court jurisdiction – one operating as a court of identifiable stature equipped with adequate personnel and expertise to give ‘one-stop’ service to [the state’s] bankruptcy needs” provides an effective court system responsive to the economic affairs of the litigants. The court system must therefore be structured to avoid the cost and delay of litigation over jurisdiction.

Appointment of qualified judges

Within the broad grant of jurisdiction, judges must be selected free of political influence and partisanship, patronage and conflicts of interest as well as localism. The insolvency court must be structured to attract highly qualified attorneys to accept appointments to the bench. The judges must be insulated from political control by long-term appointments and must be secure in their positions by appropriate salary levels and other benefits that guarantee a first-rate court. As one commentator noted, commercial players have “a right to have issues adjudicated by a full-fledged court and not some subordinate functionary”. Only with such a court will the community have confidence in the bankruptcy judiciary.

The judicial system should have clear criteria and minimum standards for the qualifications and selection of judges, for the processing of judicial appointment and for governing judicial conduct. Sound selection and appointment of judges are the keystone of an independent and efficient judiciary. At a minimum, “personal qualifications and experience should prevail over political considerations”. Once appointed, judges must be held to the highest ethical standards. To protect their independence and integrity, they should be immune from suit when acting in their official capacity. The judicial system must have its own mechanism of enforcing the strictest code of ethical conduct for judges. Written standards and guidelines must be developed to assist judges in avoiding conflicts of interest, undue influence, favoritism or bias, and lapses in judicial ethics.

Recommendations of The World Bank and specialised administration

The World Bank has prepared a draft background paper entitled “Building Effective Insolvency Systems: Toward Principles and Guidelines” which discusses the institutional framework for insolvency proceedings. It suggests that standards be adopted to measure the competence, performance, and service of insolvency courts. The courts should be reinforced with qualification, training, and continuing education criteria and programs for the judiciary. General standards for performance would include access to the courts, court efficiency, equality, fairness, and integrity in court decisions and treatment among the parties, court accountability, and the maintenance of public trust and confidence in the judicial system. The judges must adopt ethical standards to avoid financial or personal conflicts of interest that might impair or appear to impair their ability to render impartial decisions.

The courts should also be separated from the administration of the bankruptcy estate. This will leave the court with the judicial function of adjudicating disputes and managing litigation. With a segregated judicial role, the judge may be “an impartial arbiter who receives evidence in accordance with procedure and evidentiary rule ... and who receives no evidence or communication

2 Friedman, p.299.
3 Friedman, pp.299-300.
5 Carruthers and Halliday, p.471.
7 Kahn, pp.18-22, 105, 108 and 128.
8 Carruthers and Halliday, pp.474 and 476-478.
9 Johnson, p.35.
except on the record and in the presence of both parties. The administrator-judge does not and cannot fulfill this image. Under the rule of law, professional persons, business persons, and bankers tend to favor an independent court engaged only in adjudication, which includes case management.13

Some have advocated independent, specialised insolvency courts or specialised insolvency judges within courts of general jurisdiction because of the specific nature of and issues that arise in insolvency proceedings.14 Specialised courts would learn the financial and business arrangements and the standards and practices common in commerce and finance, without the need to be continually educated in these matters. But whether specialised or general, the courts must have adequate resources and facilities and staff sufficient to support the court’s work and enhance the court’s image. Set and setting must be recognised as crucial to the legitimacy of the judicial process. Courts must adopt operating rules and procedures for handling and administering cases. Efficient and reliable standardised procedures for dealing with cases interject a degree of uniformity and predictability among courts and from one case to the next. Affected parties must have maximum and convenient access to court hearings and case records.

Need for transparency

The court’s proceedings must be performed in full public view and must accord with defined procedural rules giving all interested persons an opportunity to be heard on notice. Facts must be developed based on established rules of evidence, and the court must render its decision based on those facts.15 In that world, the court must render its decision by applying the law to the facts the court derives from the evidence. The court must articulate its decision by means of a written or oral statement on the official public record. In that statement, the court must express its perception of the law and the application of the law to the facts to resolve the matter before the court. In doing so, the court should define the matter being decided and explain procedurally how it became ripe for decision. The statement or opinion of the court should then find the facts of the case, declare the law being applied, and explain how the court applies the facts to the law. The court must then determine the remedy or relief to be afforded and explain the basis for that relief.

The court must be structured to operate autonomously, independent of external control or influence over court decisions and objectives. The court itself should establish its own internal operating procedures and should create its own administrative arm to handle the bureaucracy of running a judicial institution. To the extent possible, courts should have uniform operating rules and practice regulations. The procedural rules would augment, not supplant, the insolvency laws. The procedural rules should be designed to secure the just, speedy and inexpensive determination of actions pending before the court.

The court must organise its external operations and activities to avoid compromising the integrity and independence of the court. This is because “the diverse communities interacting with the court, or affected by its decisions, should have a reasonable expectation that the system will be fair and independent.”16

With regard to court operations, the court should assure the transparency and accessibility of the court, court decisions and records, hearings and trials, public information and debtor financial data. Transparency means an established framework visible to the public for processing cases through to conclusion. The court must assure the accountability of all participants in the process. The judge should have the power to appoint qualified persons to examine the affairs of the debtor or to act as an expert for the court.

Although affected by local traditions and local legal culture, the court system must nevertheless be transparent and available for public review. “The issue of public understanding of bankruptcy, and a population’s appreciation of what a bankruptcy system, courts included, can and cannot do, is of paramount importance in an emerging market economy.”17 To assure consistency and legitimacy, the court must limit its actions to within the prescribed law. The rule of law, as a value system, compels the court to limit its remedial power. If the matter cannot be addressed within the confines of the applicable law, the rule of law suggests that the parties have to look elsewhere for resolution or guidance.18

Need for appellate review

Once the court has issued its decision, the judicial system must provide for an effective and prompt procedure for appellate review of that decision. The jurisdiction of the appellate court must be unambiguously defined. The system should be a hierarchical one. The decision of the appellate court must be binding on the bankruptcy court. Carruthers and Halliday observe that the structure of the appellate system will have “powerful symbolic overtones.”19 The dignity and efficacy of the bankruptcy court turns on the integrity of the appellate review. The appellate court must ensure that the insolvency court has correctly applied the law, has a sufficient evidentiary basis for its findings of facts, and has articulated a rational basis for the exercise of its discretion. The appellate court performs both error-correcting and law-developing functions. “[T]he law should not provide too
many surprises and be so unpredictable that long-term investors cannot cope with the uncertainties. Uniformity and consistency require that the law-developing function of the appellate court have a binding effect on the bankruptcy court.

Nonetheless, the appellate court should defer to the fact finding of the insolvency court, provided the bankruptcy court has not abused its discretion and has articulated a rational basis for its findings. Except for errors of law, a decision to overrule an insolvency court should rest on carefully articulated reasons over and above a belief that the appellate court would have decided the matter differently. Thus, an appellate court should develop a standard of not overruling an insolvency court’s fact findings without completely reviewing the record before the bankruptcy court. That process enhances judicial consistency. Once an appellate court has articulated a rule of law or a legal standard, that court should be circumspect in developing a different standard. The appellate court should itself maintain legal consistency by developing and articulating circumstances in which it would overrule its prior decisions.

At most, the review system should be limited to an appeal to an intermediate appellate court with discretionary review by the state’s highest court. Any additional layers of review add unnecessary expense and delay. Without a mechanism for prompt appellate relief, the appeal process can stymie reorganisation, frustrate business opportunities, and adversely impact the time value of money to bankers, trade and service creditors, and the debtor. As Carruthers and Halliday observe, speed and decisiveness depend on powerful courts with embracing jurisdictions that minimise procedural maneuvering through appeals.

### The law and its application

The final component concerns the insolvency law itself and how the court applies the law. The state should enact a comprehensive insolvency code that applies uniformly throughout the state. Multiple statutes by district or locale should be avoided. Judicial consistency and predictability cannot be obtained where courts apply different statutory provisions for different regions of a country.

As with any code of law, the legislature will enact mandatory and discretionary provisions: rules of command and standards. Rules of command provide for a certain result. For example, a claim against a bankruptcy estate shall be barred if not filed by a certain date is a rule of command. Courts must enforce the statute’s commands. Rules of command assure that particular situations will be uniformly and consistently handled in a fixed manner. But statutory rules of command suppress potentially relevant circumstances of a dispute. As the late Justice Oliver Wendell Holmes of the United States Supreme Court once observed, “general propositions do not decide concrete cases.” Every future contingency cannot be anticipated. While consistency should be a goal, it cannot be an obsession because “over-emphasis on certainty may lead us to ... intolerable rigidity”.

On the other hand, a statutory standard gives the judge discretion by enabling him to find, weigh, and compare facts. For example, the court may permit a creditor to foreclose on its security interest in the debtor’s property. The statutory standard allows the judge to examine whether cause exists to permit the foreclosure on a pragmatic basis. The judge may weigh the facts and the particular circumstances of the case in light of precedent from prior cases, the interests of the community, and the persons affected by the decision. The judge may also consider the norms, mores, and customs of the particular marketplace. He may also draw on his life experience and weigh historical considerations. Standards permit the judge to test a result by its consequences.

A rule of command thus affixes certainty to a particular set of circumstances. On the other hand, a standard recognises the importance of restructuring a business in a fluid market. With fluidity comes the need for the pragmatic exercise of discretion. But the law itself must ultimately confine the judge’s exercise of discretion.

The law will also, inevitably, contain gaps. Not every situation that may arise in a business relationship can be anticipated by the legislature. The judge may be called upon to fill the gap or determine whether the court has the power to fill the gap.

While a comprehensive statutory scheme must necessarily vest the court with discretion, discretion tends to diminish certainty. The commercial market looks to the courts for consistency and coherency, for predictability and uniformity. But the travails of debtor-creditor relations in complex and changing markets must, of necessity, result in an insolvency law that defers certain matters to the court’s discretion, to be exercised pursuant to articulated standards. For the exercise of discretion, a well-structured judicial system operating under the concept of the rule of law and applying a comprehensive insolvency law should establish legal protections by formally rationalising the law with defined procedural and disciplined decision-making techniques.
The desire for consistency must also recognise that judges themselves are different. Different judges do not decide the same cases the same way. Therefore the role of the judicial system in achieving consistency must recognise that insolvency laws vest judges with discretion and in the exercise of discretion, different judges will adjudicate differently.

Nonetheless, hierarchical judicial systems, with insolvency courts grounded in the rule of law, temper the exercise of discretion, confining the adjudication of insolvency disputes to insolvency law. The court’s institutional approach to decision-making and the articulation of decisions provides a structure that assures uniformity of process which itself fosters a rational and more predictable exercise of discretion.

Consequently, the process by which the court reads and applies the insolvency laws produces uniformity, even when the code vests discretion in judges who may make different decisions differently albeit in similar situations. When the statute commands a certain action or result, the judge’s role is to enforce that command. But when the statute provides a standard for the exercise of the court’s discretion or when the statute leaves a gap for the court to fill, judicial consistency and predictability compel the court to employ certain canons or methods of construing the statute. When applying the bankruptcy laws, the court has a duty to consider them in their entirety.24 The court must consider the particular statutory language relevant for the pending case, but must do so in light of the design of the statute as a whole. The court must consider the statute’s object and its policy. The court must give meaning to all terms of the statute and avoid readings that create internal inconsistencies or contradictions. When the court finds the statutory scheme coherent and consistent, the court generally should not inquire beyond the statute’s language.

Public policy considerations and insolvency laws

Insolvency laws are generally designed to foster the equitable distribution of a troubled company’s assets through the equal sharing of loss by creditors of equal rank. Additionally, insolvency laws generally provide for the restructuring of a business to preserve jobs, pay creditors, produce a return to owners, and obtain for the economy the fruits of its enterprise.25 The legislature may articulate that kind of a policy statement in the preamble to the code. But when the legislature does not articulate the policy, the court should do so when considering a statutory standard or filling a statutory gap. By doing so, the court disciplines the process by explaining how its application of the statute furthers the statute’s object and its policy. The court further achieves uniformity of process by circumscribing the exercise of its powers.

While bankruptcy or insolvency laws typically vest the courts with powers of equity, the courts cannot view themselves as roving commissions to do equity. Rather the courts must fashion relief within the strictures of the bankruptcy laws themselves. If the law provides remedies, the court should not create its own, even if the court believes its remedy would be more equitable under the circumstances. If the law does not prohibit a particular act, the court should not create its own prohibition, even if the court believes that the circumstances warrant a prohibition on equitable grounds.

Adherence to precedent

The court structure for decision-making described above further enhances the consistency and uniformity of process. By rendering an oral or written statement of the reasons for a decision, the court addresses the legal standards. When a superior court in a hierarchical judicial system has adjudicated or defined the elements of a standard or the manner in which to apply a standard to a particular fact pattern, the insolvency courts must follow that decision. Should the court believe the decision was not well-founded, the court may critique the decision in its statement but nevertheless must follow the decision. The superior court may then review its prior ruling on an appeal.

When the court or another court of equal rank has ruled on an issue, the court should tend to follow that prior precedent or articulate the reasons why the prior precedent should not be followed. The court should extract from a set of precedents the underlying principle to be applied to the factual situation before the court. The court should tend to follow that underlying principle. But where circumstances have changed, the court should determine the path or direction along which the principle is to move and develop, and then articulate why that principle applied to the prior case but why it should or should not apply to the case before the court. The court must do this by utilising the canons of construction of the statute and constraining itself within the confines of the statute. This exercise assures that the law develops in a reasoned and articulated fashion, subject to scrutiny and analysis by the parties particularly and by the public at large. Thus, while the standards of an insolvency code may be applied with results that vary among insolvency courts of equal rank, the law itself will develop in a reasoned fashion which itself breeds legitimacy to the process.

Use of ADR procedures

While the judicial system must be structured to facilitate the timely adjudication of disputes, judicial decision-making should likewise encourage consensual resolution of disputes where possible. Without compromising their independence, impartiality and objectivity, courts may preside over settlement conferences with all the interested parties present. With their understanding of the record of a case and their judicial experience, courts may often suggest compromises that would enhance
the restructuring of commercial relations or the resolution of disputes in a timely and effective manner. The procedural rules of the court should encourage settlements. Judges must, however, conduct settlement conferences with all parties present.

The World Bank has suggested the use of alternative dispute resolution procedures. Mediation and arbitration should be available when appropriate. But those techniques should not be used to delay or avoid the judicial decision-making process. The court must structure and manage its cases to focus the parties on a timely decision either by settlement or trial. If forced to focus on a trial of their dispute, the parties will likely realise the benefit of a consensual business resolution without adjudication. But if the parties suspect the court will delay the process or realise that they themselves may delay the process by invoking alternative dispute resolution procedures, then mediation or arbitration may frustrate the timely and effective resolution of a case. The marketplace will not wait. Litigation and dispute resolution in a bankruptcy reorganisation differs from retrospective contractual or tort litigation; it is litigation in a fluid, dynamic, elastic market.

Yet mediation may, at times, be the best mechanism for resolution of the case. The mediator should usually be independent from the court, but there may be extraordinary occasions when the prestige, experience and, indeed, the power of a bankruptcy judge should be employed to mediate a case. In those situations, the judge assigned to mediate the case should not be from the local court presiding over the case. That separation preserves both the integrity of the mediation process and the impartiality of the presiding judge.

A judge may have the stature and experience to assist the parties in striking a balance in which the parties can preserve their vital interests. The judge may focus the parties on the tensions between their legal positions and the pragmatic realities of their business relationships. Often judges come to pragmatic resolutions after listening to the parties articulate their disputes. A judge may realise that some cases just get bigger and more complex until the parties cannot extricate themselves from the problem and the courts cannot effectively adjudicate a final resolution. In mediation, the judge may focus the parties on resolutions without jeopardising the impartiality of the decision-making process should settlement fail.

The judge would act as a catalyst, making suggestions when parties reached an impasse in their negotiations. Whether taken or not, the parties cannot ignore the participation of a judge. Even if the parties do not accept the judge’s suggestions, they must respond to the suggestions and inevitably must find their own alternatives to satisfy their obligations to the judge. When the judicial system commits the resources of a judge to mediation, the parties must accept that this process will differ from engaging a private mediator.

Conclusion

Returning to the Friedman analogy, a state’s economic operating system in the global marketplace can only function effectively and competitively with software that includes a judicial system with defined procedures for settling disputes under the rule of law. For insolvency proceedings, parties in interest require a judicial system that produces coherent, consistent, uniform, and predictable results. But the fluidity and uncertainties of the market in turn require that the insolvency courts be accorded a measure of discretion. Since the exercise of discretion diminishes consistency, the judicial system must operate by defined and predictable procedures in public proceedings and with articulated explanations of the court’s decisions.

In sum, the judicial system must be premised on a community value system based on the rule of law. The rule of law structures an orderly and uniform procedure for the court, with notice and opportunity to be heard in a transparent, accessible and public court presided over by an impartial judge. The insolvency law should vest the insolvency court with broad jurisdiction, but the court must confine itself to that jurisdiction. The judicial system should have a hierarchical appellate structure with the appellate court decisions binding on the insolvency courts. The bankruptcy courts must read and apply the insolvency laws pursuant to defined canons, enforcing statutory commands and articulating the basis for the exercise of discretion granted under statutory standards.

The judicial system will thereby assure consistency when commanded by the law and a uniform, transparent process for the exercise of discretion, with articulated judicial reasons for court actions and a public record for analysing those actions. The judicial system charged with resolving disputes in the insolvency process must enable markets and contracts to work and evolve with protections for all parties affected, and yet do so in emerging and global economies.

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Multi-creditor restructurings in transition countries: lessons from developed jurisdictions

A consensual out-of-court restructuring or “work-out” is a non-judicial process through which a financially distressed business and its significant creditors reach an agreement for adjusting the obligations of the business enterprise. This article identifies and describes the factors that result in successful out-of-court restructurings involving multiple creditors.
The choice for creditors

When a company or group faces financial difficulty, creditors can choose to follow one of two paths. Either they can adopt the “each man for himself approach” and try to remove or reduce their exposure by pressing for total or partial repayment or, if this is not possible, seeking security for their debt. The alternative, “the coordinated approach”, is where creditors seek to work with each other to devise a collective response which is in their mutual self-interest.

The obvious problem with the “each man for himself approach” is that if other creditors pursue the same policy (with equal enthusiasm and dexterity), the debtor will rapidly be driven into formal insolvency, thus producing the very result that the concerned creditor was seeking to avoid.

Over time, financial institution creditors (who have to factor the possibility of debtor default into their usual business planning) have learned that, generally speaking, they achieve better returns as creditors if formal insolvency can be avoided. They have also learned that a collective and coordinated approach by the main creditors can often assist the debtor to find a “solvent” solution to its difficulties to the benefit of all concerned.

Background to coordinated approach

In the United Kingdom, the coordinated approach to restructurings had its origins in the late 1970s, when the Bank of England began encouraging UK banking institutions to produce a collective response when dealing with a major UK corporation in financial difficulty. In those days the most typical problems were issues of liquidity where additional short-term funding was needed. In the 1990s, however, there was a spate of cases in which banks had to overcome massively insolvent balance sheets caused by the collapse of the UK and US property markets. The Bank of England lent its support to such initiatives by offering to act as an “honest broker” to help resolve any disputes or difficulties between the participating creditors and by lending moral encouragement for the coordinated approach. The UK methodology for multi-creditor rescues culminated in the “publication” and use in the early 1990s of what is now known as the “London Approach”.

While the London Approach has the relatively unique feature of central bank involvement and endorsement, the principles behind the London Approach are of general application and have been reflected in codes of practice produced in a number of the “tiger” economies (e.g., Thailand, Hong Kong, Indonesia and Malaysia).

The involvement of an official body such as the central bank or monetary authority, although very helpful in persuading creditors to adopt a collective approach, is not a sine qua non to coordinated approaches to restructurings. Nor is it the case that the principles behind typical methodology of the coordinated approach are only suited to common law jurisdictions.

The rescue culture

The so-called “rescue culture” currently “in vogue” in a number of jurisdictions reflects the general recognition by financial institution creditors that the formal or court-supervised insolvency process, unless “pre-packaged”, is very often disadvantageous for creditors, not least because its result is unpredictable. It usually produces lower returns than can be achieved through a solvent restructuring or a managed work-out. Coordinated multi-creditor approaches to restructurings are not therefore the product of philanthropic or charitable tendencies on the creditors’ behalf, nor should the current ascendancy of the “rescue culture” be taken as signifying a willingness on the part of financial institution creditors to rescue companies or businesses from insolvency at any cost.

Where investigation reveals that saving a company reduces the likely return for creditors compared with an insolvency, creditors are always likely to choose the formal or court-supervised insolvency option. In such cases attention switches from saving the corporate entity to the most efficient and cost-effective way of business or asset realisation. Sometimes this can best be achieved through a formal and preferably a “controlled” or “pre-packaged” insolvency and sometimes by a sale through a managed work-out. The general experience remains however that rescue is better for creditors than insolvency.

Creditor stability

The initial objective of all attempted restructurings is creditor and business stability. Rescue or restructuring is very difficult unless at least the creditor position is stabilised. Other forms of instability also can be highly prejudicial to efforts at restructuring (e.g., political or general economic instability). Sometimes creditor stability proves unachievable (usually because management has left things too late), and the downward spiral to financial collapse becomes irreversible. In most cases, however, a “standstill” by the major creditors of the distressed debtor gives time both for the position of the debtor to be properly analysed and for rescue proposals to be formulated and presented to the participating creditors.

The initial stabilisation process is traditionally achieved by a standstill agreement. Typically, in a standstill agreement the participating creditors agree between themselves and with the debtor group:

- not to press for repayment of their debts or issue or pursue proceedings against the debtor during either a defined period or until a majority of their number decide otherwise (“the standstill period”);

1 Under English insolvency law, “pressure” can justify preferential treatment, whereas in many civil code countries abnormal pressure can count against the creditor.
Focus on insolvency law

between themselves to is still benefit in the creditors agreeing

agreement between creditors and the debtor group may itself trigger technical insolvency.

not to try to improve their individual positions by obtaining or enforcing security; and

to allow continued utilisation of existing credit lines and facilities either at the limits which previously existed or at least at the exposure levels at the date the standstill commenced (the “standstill date”).

In return for the support from the participating creditors, the debtor group will generally agree not to take any action which would disadvantage the participating creditors, either individually or collectively during the standstill period (e.g., by offering security to non-participating creditors, transferring assets from companies that participating creditors have recourse against, or otherwise running down its business or assets so that the prospects of repayment for creditors are diminished). In some cases the participating creditors will demand that security be given for their collective benefit at this stage in return for their support.

The standstill agreement serves to reassure the directors of the debtor group that it is appropriate for them to continue their business and to incur credit and that for the time being there is a reasonable prospect of a successful rescue. This is because under the corporate governance laws of several countries, including the English Insolvency Act of 1986, directors can incur personal liability if the business continues and credit is incurred beyond the point at which insolvent liquidation becomes unavoidable.2

In some jurisdictions, a formal standstill agreement between creditors and the debtor group may itself trigger technical insolvency. Even in these jurisdictions, however, there is still benefit in the creditors agreeing between themselves to “standstill” relative to the debtor and for the debtor to agree in favour of the participating creditors not to take any steps or carry out an action that might prejudice the position of the participating creditors while a review of the business is carried out.

Fairness between creditors

Attempts to persuade creditors to participate in a coordinated approach will often flounder if either the debtor or participating creditors (particularly those seeking to promote the rescue) are perceived to have taken actions which unfairly prejudice one or more of the creditors. A recent example of the difficulties that can arise is the Holtzman case in Germany, where it was reported that one of the major bank creditors took considerable exception to the fact that the debtor group had drawn down substantial additional amounts under its facilities immediately before calling for a standstill and seeking support from its financial creditors. Not surprisingly the bank took the view that the company should have called for support before increasing its borrowings from that bank and was very disinclined either to be sympathetic to the management of the debtor or to participate in the attempted rescue operation.

As one of the main objectives of the standstill is to preserve the status quo and the relative position of creditors inter se, actions that have clearly advantaged or disadvantaged particular creditors shortly before the rescue process is initiated are likely to be a major hindrance to any coordinated approach. On the other hand, it is very rare that creditors (except where the only lendings are through syndicated facilities) are in exactly the same position as each other, and usually certain creditors are far more exposed to the debtor than others. The coordinated approach can cope with disparity of self-interest in the rescue, but “unfair” treatment is a major obstacle. This issue of “fairness” is not one of legal definition but is something that can nevertheless be easily appreciated in practice.

Basis of standstill arrangements

Typically, standstill arrangements between participating creditors reflect their relative positions and exposures as at the standstill date. The relative limits or exposures of each participating creditor on the standstill date are used to determine issues such as risk sharing, voting and distribution of recoveries. The emphasis of standstill arrangements is therefore both to preserve and to reflect those relative positions.

New money

If during the standstill period (or at any other time during the restructuring process) it becomes apparent that the debtor needs additional funding (i.e., in excess of the exposure/limits available at the standstill date), this additional lending or exposure is supposed to be accorded a priority of return in any pay-back or (if the support operation is terminated or collapses) in any insolvency. This priority of return can be achieved either through the granting of security for the “new money” lending and/or through arrangements between the participating creditors themselves under which they agree to apply amounts they receive from the debtor (including any amounts received by way of dividend in any liquidation) first in repayment of the new money lending. Occasionally, the participating creditors will commit to underwrite the additional new money exposure but are increasingly reluctant to commit beyond the amount of any prospective receipt in an insolvency.

The issue of “new money” is complex, particularly when one has to consider contingent exposures that are “marked to market” (e.g., Forex, swaps, derivatives, etc.). Originally the “new money” concept only applied to traditional loans but nowadays, where financings take a number of exotic forms and institutions tend to mark their exposures to market where they can, changes in market position between the standstill date and the date of pay-back are often treated as if they were new money loans. Difficulties arise because not all contingent exposures can be marked to market and it is therefore debatable whether it is “fair” to treat fluctuations in some contingent exposures as “new money” but not others.
Another modern day feature is the proliferation of negative pledges which can make it problematic to provide security in support of new money lending. A “cat and mouse” game can continue between those seeking to provide creditors with cover for their exposure and the drafters of negative pledge clauses. Usually the problem can be ameliorated by using arrangements such as transferring assets into new special-purpose vehicle companies or by the creditors “acquiring” assets either in the traditional sense or through repurchase structures (although the dividing line between a true repurchase and a security arrangement is sometimes a fine one).

Steering committees and coordinators

To assist with the coordinated approach it is usual for the participating creditors to appoint a representative steering committee to facilitate dialogue with the debtor group and to help manage the restructuring process. The steering committee (or the creditors themselves) will also often appoint a coordinator who will take much of the administrative burden of the process and who acts as the chairman of the steering committee.

Creditors are usually reluctant to allow steering committees/coordinators to speak on their behalf or to commit them to any particular course of action. Equally, steering committees and coordinators will not wish to assume a representative position for fear of incurring liability to the participating creditors, the debtors or third parties. Coordinators are best described as facilitators and the steering committee as a sounding board for the likely reaction of the participating creditors to proposals that the debtor may be thinking of making to the creditors group.

The advantages of channelling communications between the debtor group and the participating creditors through a steering committee/coordinator are considerable, but the process can be time-consuming for the creditor representatives who sit on the steering committee or act as coordinators. The assistance of professionals can reduce this burden, but the input of creditors is always necessary when commercial choices are required.

The steering committee/coordinate is often delegated authority to instruct outside professionals such as accountants and lawyers, and it is common for them to seek indemnities from the participating creditors for costs incurred if these cannot be recovered from the debtor. As a result, the participating creditors will expect to receive the benefit of advice or information provided by the retained accountants or lawyers. One major advantage of the steering committee structure is that it helps to ensure that all participating creditors receive the same information and advice. While the practice of having single shared advisers to the creditor group as a whole works well in most cases, individual creditors sometimes also need separate advice as to their positions compared to other creditors. Costs of such advice have to be borne separately by the creditor concerned and are not shared with the other creditors.

Importantly, each of the creditors will be expected to make its own credit assessment and decisions regarding any information, advice or proposals relating to the restructuring process and coordinators and cannot rely on the steering committee coordinator in that regard. It is therefore important for any coordinator/steering committee to ensure that disclosure of relevant information is made on a timely basis to all participating creditors and that they do not assume responsibility by a course of conduct.

General and open-ended indemnities from the participating creditors in favour of the coordinators and/or the steering committee are becoming increasingly problematic. However, as reward for their efforts, the coordinators and steering committee members usually receive special fees which are time-based and/or contain incentives for success.
Legal and accounting due diligence

The other main objective of the standstill is to enable the creditors to obtain and verify information concerning the debtor group. Typically, the legal due diligence aspects will involve obtaining accurate corporate information identifying and categorising assets, identification and review of main contracts and analysis of potential counter claims or set-offs against receivables and the likely impact of any insolvency or security enforcement on leases, contracts, licences or other assets. Certain assets, e.g., land, intellectual property rights, investments in joint ventures, technical or other terminable licences and franchises, will require particular investigation.

The legal due diligence exercise also often includes a general analysis of the validity of recourse which individual lenders have against particular debtor companies and considers issues such as fraudulent and preferential transactions (as well as other transfers for less than reasonably equivalent value), and the validity and priority of any security.

The accounting due diligence exercise is usually carried out in parallel and seeks to verify financial information produced by management, assess systems and management capabilities, conduct critical reviews of budgets and forecast, estimate realisable values of assets, verify liabilities, evaluate cash flow requirements, earnings, and CAPEX requirements, review management, and generally report on the viability of the business and any business plan.

The reasonable costs of both the legal and accounting due diligence will be for the debtors’ account, and it is customary for some of the accounting due diligence (except any security review or cash flow estimates) to be made available to management.

The insolvency model

From the information obtained during the due diligence phase, the accountants are then able to produce an insolvency model based on certain stated legal and accounting assumptions (e.g., as to validity of security, operation of set-off, etc.). Such models seek to include all relevant claims (e.g., inter-company, subrogated and third-party claims) which would be counted in any insolvency of the relevant debtor company. Insolvency models can either be used simply to identify where assets will go in the event of an insolvency (applying usual insolvency principles) or can be more sophisticated and seek to predict likely returns to creditors in any insolvency using assumed realisation values and a contemporaneous liquidation and asset realisation model of all companies in the debtor group at the same time. Insolvency models consider each debtor company separately and then aggregate the results for each company in the debtor group on a creditor by creditor basis so that the net expected return to each creditor can be determined. This provides a benchmark against which the creditor can evaluate any debtor proposals for the restructuring.

In the case of larger groups, the insolvency models can be extremely complex and have to take account of insolvency regimes in different jurisdictions. The output from the insolvency models is not only used to identify the claims of lenders against each company and to estimate the likely return from lenders, but can also be used to calculate the comparative percentage return to creditors compared to other creditors and the amount of indebtedness which appears to be covered as opposed to uncovered. These calculations can in turn be used when considering such issues as whether to agree to convert debt to equity or (in extreme cases) to permit debt write-offs.

Exits

Once independently verified information has been obtained, it then becomes possible for the participating creditors to evaluate the restructuring proposals suggested by the debtor. Where the problem is merely one of short- or medium-term liquidity difficulties, the creditors may be satisfied that the business case supports additional funding or a rescheduled repayment arrangement. In this event the restructuring will be embodied in a new financing agreement that reflects the terms of the rescheduling. Typically, rescheduling facility agreements are carefully tailored to the particular business.

It is also customary for the participating creditors to obtain security at this stage if they have not already done so. This security is usually taken for their collective benefit by a trustee or agent and charges all the assets and undertakings of the debtor in all relevant jurisdictions.

If the evidence suggests that the business cannot sustain the existing level of debt, the participating creditors will compare the likely consequences of a formal insolvency and a solvent restructuring. Provided they are satisfied that the restructuring should produce better returns, they may then consider issues such as debt-to-equity conversion or other methods of removing some of the debt from the debtors’ balance sheet. Inevitably, there is some tension between the wishes of management to remove as much debt as possible and the creditors’ desire to convert as little debt as possible. The common objective should, however, be to restore the solvency of the debtor, help create a profitable business capable of supporting the restructured levels of debt, and produce acceptable returns for the shareholders which may by this stage include former creditors (due to debt-to-equity conversion).

Having agreed on the commercial terms of the restructuring, it is then necessary to consider the methodology for implementing both the restructuring of the balance sheet and the rescheduling of the residual debt. In many cases, both can be achieved by agreement between the relevant parties. However, when publicly traded debt or equity
is concerned, it is often necessary to resort to court-approved arrangements or compromises to affect the balance sheet restructuring.

In virtually all cases, the rescheduling and the taking of security for the rescheduled indebtedness necessitates an agreement between the creditors (“intercreditor agreement”) regulating issues such as the relative priority of creditors’ claims, the arrangements made between creditors during the rescheduling period, the holding of the security by the trustee or agent, and the sharing of any realisation proceeds. Once again, the benchmark for these agreements will be the perceived position of various participating creditors as at the standstill date. In addition to a priority agreement covering the sharing of proceeds of security, there will also often be loss-sharing or risk-sharing arrangements between these participating creditors which again reflect their perceived relative positions as at the standstill date.

In a number of cases the restructuring is assisted by a partial equity raising, the issue of new debt (e.g., a high yield bond) or with a partial or total takeover by a third party. It is also not uncommon for the lenders sometimes agree only to make a claim against separate security against other companies to senior creditors so that the senior creditors are paid off first.

Other ideas used to develop coordinated approaches where there are differences of position between the creditors include “shortfalling”, in which those who hold separate security against other companies agree to declare losses against the security given to the participating creditors as a group to the extent that they are unable to recover loss from their separate security. This is an approach that is often used in relation to finance leases.

**Tiering and turnover clauses**
The coordinated approach to restructurings is not confined to cases in which all creditors are unsecured or hold the same security. It is also suitable in cases where there are significant differences between the position of individual creditors not only in terms of exposure but also in the priority ranking of their exposures in any insolvency. In these cases the objective is to seek a solution that satisfies the aspirations of the different categories of creditors (it being recognised that sometimes those aspirations will differ but that the creditor group should not oppose attempts by others in lower rankings to benefit unless the aspirations are mutually exclusive). The fundamental principle remains that any arrangements should, when compared with a putative insolvency, preserve and reflect the relative positions of the participating creditors, including any advantages they may hold.

“Tiering” of claims is the technique used where either individual creditors or groups of creditors would hold different relative positions in terms of priority in any insolvency. The claims of the participating creditors are “tiered” in a priority agreement to respect those relative priorities (e.g., secured creditors are placed in a higher tier for payback than unsecured) and proceeds of realisation or repayment cascade down the tiers reaching the lowest tier of priority last.

A variant of this approach, used in the US, is “turnover”, whereby “junior” creditors agree to turn over any realisation proceeds to senior creditors so that the senior creditors are paid off first.

Other ideas used to develop coordinated approaches where there are differences of position between the creditors include “shortfalling”, in which those who hold separate security against other companies sometimes agree only to make a claim against the security given to the participating creditors as a group to the extent that they are unable to recover loss from their separate security. This is an approach that is often used in relation to finance leases.

**Documentation**
The decision to resort to a standstill arrangement will be motivated, in part, by a desire to avoid the consequences of embarking upon formal insolvency proceedings. Any such restructuring will therefore be dependent on effective contractual documentation. A non-exhaustive list of the typical documentation required would include:

- Letters recording appointment of co-ordinator/steering committee;
- Standstill agreement;
- New money agreement;
- New money security;
- Restructuring facility agreement;
- Restructuring security agreement;
- Inter-creditor agreement; and
- Equity-related agreements.

**Conclusion**
Although recourse to formal or court-supervised insolvency proceedings may be inevitable in some cases, the London Approach provides an effective framework for cooperation between creditors. The procedure is informal and flexible, allowing creditors to take an active role in restoring the company in difficulty. In addition, taking an agreed form of collective action prior to the commencement of any insolvency proceedings reduces the risk of an economically inefficient free-for-all raid on the assets of the debtor.

The late 1980s and early 1990s saw a number of successful and high-profile rescues of major UK-based groups, many of which had significant overseas operations. In many cases, the coordinated approach was successfully adapted in overseas jurisdictions to work in parallel with the restructuring in the UK. The “truth” which has emerged is that the principles of the coordinated approach to multi-creditor restructuring apply equally in other jurisdictions. There is now increasing international interest (including from the EBRD, IMF and The World Bank) in the possibility of developing a protocol or code of best practice that can be universally applied and can provide an internationally accepted framework for creditor cooperation as an alternative to resorting to formal or court-supervised insolvency procedures.