

EMERGING
ECONOMIES
TRANSITION

Insolvency Systems in Asia

AN EFFICIENCY PERSPECTIVE

FINANCE AND INVESTMENT



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OECD Proceedings

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FOREWORD

An efficient and effective insolvency system is a critical component of every well-functioning market economy. The absence of such systems in many Asian countries was exposed by the 1997-1998 Asian financial crisis. Creditors subsequently avoided countries which did not previously afford them adequate protection; debtors could not be compelled to restructure debts in the absence of clear rules promoting financial discipline; and the reallocation of resources through corporate reorganization proved to be a very slow and inefficient process. Designing effective and efficient, formal and informal insolvency mechanisms, and building institutions capable of implementing them thus became a high priority for the crisis-hit countries.

Indeed, in the wake of the financial crisis, many governments in East Asia have undertaken profound changes to strengthen their insolvency mechanisms. However, these measures constitute only a first step in the reform process. Further reforms, particularly the development of a strong institutional infrastructure and well-trained insolvency professionals, are required in order to build a sound and enduring insolvency system.

These were among the principal conclusions of a conference on “Insolvency Systems in Asia: An Efficiency Perspective”, held on 29-30 November 1999 in Sydney, Australia. Under the auspices of the OECD Centre for Co-operation with Non-Members, this conference was jointly organized with the Australian Treasury, the Asia Pacific Economic Cooperation forum, the World Bank, and with the support of AusAID.

This publication contains a survey of the main findings and conclusions from the Sydney conference, followed by a comparative report and studies of the insolvency systems of one Asian OECD Member -- Korea -- and five non-Members: Indonesia, Malaysia, the Philippines, Singapore, and Thailand. All these reports were commissioned for the Sydney meeting.

These papers are intended to provide policy makers, members of the judiciary, private sector experts, academics and students with a greater insight into the

insolvency systems of the surveyed countries. They are also meant to show the way towards further necessary reforms.

The opinions expressed in this publication are those of the individual authors and do not necessarily represent those of the OECD, the governments of its Members or non-OECD Members. Stilpon Nestor, Head of the OECD Corporate Affairs Division, and Simon Wong, Counsel in this Division, have edited this volume. This book is published on the responsibility of the Secretary-General of the OECD.

Eric Burgeat
Director
Centre for Co-operation with Non-Members

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SYNTHESIS NOTE

Summary and Objectives

The OECD, the World Bank, Australian Treasury/AusAID, and APEC organized a meeting on *Insolvency Systems in Asia: An Efficiency Perspective*, which was held in Sydney, Australia, on November 29-30, 1999. Approximately 80 policy makers, members of the judiciary, private sector practitioners, insolvency experts, and academics from 14 Asian non-OECD Members, 9 OECD Member countries, and international organizations attended the meeting over the two days.

The primary purpose of the meeting was to bring together senior policy makers and experts from Asian non-Member and OECD Member countries to report on recent developments in insolvency reform and to discuss and recommend measures to strengthen insolvency systems. In addition, the meeting provided an opportunity to present and discuss the current effort by the World Bank to develop a set of principles and guidelines on building effective insolvency systems. The World Bank expects to release an initial exposure draft of the principles and guidelines in the first quarter of 2000. The participants were also advised about a proposal before the United Nations Commission on International Trade Law (UNCITRAL) to conduct work on the legislative aspects of domestic insolvency systems. Lastly, the meeting was intended to serve as a platform for launching a multi-disciplinary, multi-faceted dialogue forum to deepen dialogue and to co-ordinate future activities in the area of insolvency reform in the region.

In December 1998, the OECD commissioned country studies on the insolvency systems of Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand, as well as a comparative report analyzing the insolvency systems of the foregoing countries. These reports, along with the World Bank draft background paper on building effective insolvency systems and the presentations, served as the basis for the meeting and helped to stimulate lively debate in the general discussion segment of each session. During the conference, the panelists candidly discussed and analyzed insolvency from

multiple perspectives, focusing not only on legal and economic issues but also addressing political, social, and cultural concerns. In each session, the general discussion served to flesh out the underlying issues and enabled participants to share their countries' unique concerns and perspectives.

In the concluding session, the participants expressed a strong desire for a continuing dialogue on insolvency reform and urged the sponsoring organizations to remain active in this area.

Conclusions and Recommendations

A number of important issues pertaining to insolvency and related areas were discussed during the meeting. On the basis of these discussions and the recommendations provided by the experts, the following conclusions may be drawn:

An efficient and effective insolvency system is pivotal for long-term economic recovery and growth.

A well-developed insolvency system is a critical component of every well-functioning market economy. It facilitates smooth reallocation of resources into more productive uses for firms that cannot be returned to profitability through a restructuring, and provides firms suffering from temporary financial difficulties with valuable "breathing space" to redeploy resources in an orderly way, thereby maximizing going concern value and preserving jobs. The predictability and discipline fostered by an efficient and effective insolvency system also builds confidence among credit providers, resulting in reduced borrowing costs. In contrast, the absence of a well-functioning insolvency regime may precipitate capital flight, exacerbate production losses, and decimate enterprise value by giving debtors perverse incentives to engage in strategic behavior and to otherwise frustrate creditors. Some experts have concluded that deficiencies in the insolvency system were a primary factor that contributed to the financial crisis in certain countries.

The Asian financial crisis that began in 1997 shook the economies of many countries and caused tremendous social, political, and economic dislocations. It also exposed numerous weaknesses in the region's insolvency regimes. In response, governments in the region have exerted substantial efforts to implement reforms to expedite restructuring of financial institutions and businesses and to restore soundness to the economy. Since the inception of the financial crisis in 1997, governments in the affected countries have:

- Established asset management companies to deal with the non-performing loans of financial institutions;
- Created special agencies to accelerate restructuring of financial institutions and businesses;
- Introduced new legislation to modernize and improve the insolvency system and related areas; and
- Reformed existing insolvency institutions, including introducing or enhancing the utilization of rehabilitation procedures and creating special bankruptcy courts or divisions within the general court system.

Despite the sweeping changes undertaken by governments in the region, the conference participants expressed concern regarding three inter-related areas. First, many measures introduced since 1997 have been intended primarily to deal with the systemic crisis facing these economies. While these measures have helped certain economies to recover from the crisis, they serve only as a first step to a well-functioning insolvency system and policy makers should not be led into thinking that the reform effort is complete. In fact, the conference participants noted that, in many countries, the necessary basic insolvency rules still do not exist and the institutional infrastructure remains underdeveloped. Hence, additional reforms are still required to build a strong and enduring insolvency regime.

A related concern regards the pace and depth of corporate restructuring. While change is occurring very rapidly and governments have established special agencies (such as the Corporate Debt Restructuring Committee (CDRC) in Malaysia, Corporate Debt Restructuring Advisory Committee (CDRAC) in Thailand, and the Jakarta Initiative Task Force (JITF) in Indonesia) to facilitate out-of-court restructuring, progress has been slow and the restructurings undertaken so far have not been very successful. Participants noted certain debtors and creditors have engaged in “band-aid reconstruction” by only rescheduling debts without attempting real restructuring. In addition, certain participants question whether the newly created asset management companies promote or impede the required long-term restructuring.

Finally, the participants feared that the rapid recovery of certain affected economies could weaken the political resolve for a deeper, sustained insolvency reform effort and stressed that it is therefore essential for insolvency reform to remain at the top of the political agenda. To ensure that insolvency reform remains a priority, the conference participants urged international organizations such as the OECD, World Bank, APEC, and Asian Development Bank (ADB) to continue to be active in this area.

There is no "one-size fits all" solution.

It cannot be overemphasized that there can never be a “one-size fits all” insolvency system. An insolvency system will function well only if it accurately reflects the special characteristics of the country within which it operates. Insolvency systems will therefore embody different policy choices on procedural and substantive laws, including the allocation of risk among all participants, and should take into account the strengths and limitations of the institutional infrastructure, level of economic development, social traditions, and legal structures. For example, certain cultures may be more inclined to negotiate (rather than to litigate) to resolve disputes. In other countries, concern for social stability is heightened. In many Asian countries, stigma is attached to bankruptcy and debtors who declare bankruptcy suffer adverse social and reputational consequences. In addition, some jurisdictions may find it necessary to establish specialized bankruptcy courts to enhance predictability in judicial decision making. Lastly, the institutional infrastructure in many developing countries is weak and due to the intense competition for the limited pool of funds among various government organs, it may not be realistic to expect a significant increase in funding to strengthen the institutional infrastructure of the insolvency system. However, while an insolvency system must be designed to address such idiosyncrasies, weaknesses, and lack of resources, all insolvency regimes must contain certain fundamental features (as discussed below). In other words, a country’s special characteristics (particularly cultural concerns) should not be emphasized to such an extent that the effectiveness of the insolvency system is sacrificed.

The notion that there is no “one-size fits all” model lies at the heart of the World Bank effort to design a set of principles and guidelines on building effective insolvency systems. When completed, the World Bank principles and guidelines will serve as flexible core guidelines that will assist countries to benchmark their insolvency systems.

Notwithstanding the considerable flexibility in designing a well-functioning insolvency system, certain core features are essential to all insolvency regimes.

Despite the latitude in designing an insolvency system, all insolvency systems must contain certain core characteristics. First, all insolvency systems must strive to be *efficient*. A major component of efficiency is speed, which is critical when a company is teetering on the edge of bankruptcy as the loss of time resulting from procedural delays and strategic behavior can decimate going-concern value and destroy any possibility for a successful rehabilitation. Speed may be achieved through measures such as imposing time limits and

spelling out clearly the responsibilities of all parties. Yet care must be taken to ensure that the proceedings, whether liquidation or rehabilitation, are conducted on the basis of accurate information, meaning that sufficient amount of time must be given to independent third parties to prepare assessment reports. Thus, while speed is crucial, accuracy must not be compromised in the process.

Furthermore, the conference participants stressed that an efficient insolvency system should provide not only well-functioning formal mechanisms, but should also allow and facilitate out-of-court restructuring, which are often speedier and more cost-effective and which will ensure that scarce judicial resources are utilized sparingly and only when absolutely necessary.

Lastly, achieving efficiency also means that debtors must be provided with incentives to utilize the insolvency system at a relatively early stage of financial difficulty. Debtors should be given easy access to the insolvency system by requiring only a showing of financial difficulty and should be encouraged to use the system through both sticks (i.e., insolvent trading liability) and carrots (i.e., possibility of retaining management control). The governments of Thailand and Malaysia, in response to systemic distress, have also sought to encourage companies to utilize the insolvency system by waiving various fees and taxes in order to reduce restructuring-related costs.

Regardless of the underlying policy choices, regimes that foster *predictability* will instill greater confidence among credit providers. One expert remarked that creditors are more concerned with the predictability of their priority position rather than their particular ranking. Regardless of where a creditor ranks in terms of priority, an insolvency system that is predictable will enable such creditor to respond through a pricing adjustment. Predictability may be fostered through the adoption of clearly written rules and regulations, the creation of bankruptcy courts or specialized insolvency judges within the general court system to ensure consistent application of the law, and accountability-enhancing measures such as requiring judges to publish their decisions.

There was widespread agreement among the conference participants that the insolvency system should provide for both *liquidation* and *rehabilitation*. Liquidation proceedings will focus on an orderly winding-up of an enterprise while rehabilitation will provide the necessary “breathing space” to allow the company to reorganize and restructure. In times of systemic distress, the availability of rehabilitation procedures is especially crucial because many corporate failures resulted from sharply deteriorated macro-economic conditions rather than from poor management. In response to the systemic crisis in Thailand, the government recently amended the insolvency law to introduce rehabilitation proceedings. To protect the insolvency system from

abuse, the insolvency law must provide for the possibility of conversion from rehabilitation to liquidation (and vice versa) and must not require the proceeding to start from the beginning upon conversion. This could be achieved through, inter alia, a single (unitary) procedure, such as the one adopted in Germany, rather than separate procedures for rehabilitation and liquidation.

While policy choices may lead to a presumption toward rehabilitation, particularly during periods of systemic distress, ***preservation of a troubled enterprise at all cost is not the answer***. The markets must be allowed to work, which means that certain distressed companies must be allowed to fail. Otherwise, moral hazard will arise and lending decisions will be distorted on the implicit understanding that governments will always rescue companies that fail.

Regardless of the policy choices made, the insolvency law must delicately ***balance creditor and debtor rights***. Due to a heightened concern for social stability, certain insolvency regimes are strongly biased toward debtors, which has enabled debtors in financial difficulty to invoke the protections of the insolvency system simply to delay and frustrate creditors. In the long term, such insolvency systems may end up increasing the incidence of bankruptcies because creditors will be reluctant to extend long-term credit or any credit at all. On the other hand, regimes that strongly favor creditors may frequently cause premature dismemberment of enterprises that, given assistance and some time, can be returned to profitability.

The meeting participants also agreed that a ***moratorium***, or stay of proceedings against the debtor, should be provided for in all insolvency systems. A moratorium is important because it helps to preserve the value of the distressed enterprise's assets and business and provides the necessary breathing space to enable a company to restructure its operations. Some participants argued that a moratorium should be automatically invoked upon the submission of an insolvency petition while other participants felt that a moratorium should only be granted upon application to a court. In all instances, the conference participants believed that some form of compensation (i.e., payment of interest) should be provided to secured creditors who are prevented from pursuing their claims due to the moratorium and measures should also be taken to ensure that the underlying assets are protected. In addition, creditors who prove significant hardships as a result of a moratorium should be exempted from the stay. Such treatment is necessary and fair because the breathing space provided to the distressed debtor should not result in jeopardizing the creditor's business. Lastly, the moratorium should not prevent criminal and other public interest proceedings, such as environmental enforcement actions, from moving forward.

Given their intimate knowledge of the affairs of the company, most conference participants would permit the *existing management* of a company undergoing restructuring to continue running the business, albeit under the supervision of an administrator. Existing management (particularly in family-controlled companies), however, should play no role in the distressed company if they are likely to engage in strategic behavior and if the proper incentives to turn the company around are not present. In any event, the administration process should be monitored closely by creditors. However, the extent of *creditor involvement* in insolvency proceedings is a matter of proper balance. On the one hand, creditors are important because they are familiar with the debtor's business and, therefore, can accurately monitor the business operations and provide an informed opinion on the firm's prospects for continued survival. In addition, creditors are needed to monitor the administrator. On the other hand, extensive monitoring may be costly and the costs incurred may outweigh the benefits received, particularly for creditors with small claims and unsecured creditors who, under all scenarios, are unlikely to receive anything at all. Hence, a proper yet simple governance structure for creditors should be put in place to achieve these objectives.

The Asian financial crisis revealed serious shortcomings in the *institutional infrastructure* of the crisis countries, which remained underdeveloped partly due to decades of rapid economic growth when governments saw little need to strengthen the insolvency system. The conference participants argued that while a well-developed insolvency law is important for the proper functioning of the insolvency system, it is equally important that reform efforts also focus on developing a strong institutional infrastructure to implement and interpret the laws and to ensure that the system functions smoothly. The meeting participants also noted that until proper institutions are developed, formal insolvency mechanisms will only play a secondary role in most countries.

At the heart of the institutional framework is the court system. Courts should be structured to ensure their integrity and independence from political and other external pressures. To ensure that judges and administrators develop the requisite expertise in insolvency, standards to measure competence, performance, and quality of service should be introduced. These standards should be complemented by a merit-based hiring policy and continuing training and education. Transparency and accountability of the court system may be enhanced by formulating uniform operating procedures and clearly delineating the roles and responsibilities of court officials and other participants.

Unfortunately, many insolvency systems are plagued by corruption, with judges particularly vulnerable to undue influence due to their prominent position. To address this problem, the conference participants recommended the following remedies:

- Enact a self-executing law, to the extent possible, to leave a modest, clearly defined role to judges;
- Impose bright line rules to leave little discretion to judges;
- Require opinions to be published to enhance transparency and accountability; and/or
- Institute an independent body to establish, monitor, and enforce ethical standards in the judiciary.

Lastly, an insolvency system should be sufficiently *flexible* to enable creative but fair solutions to be designed. One expert stated that “the more flexible the procedure, the greater likelihood of successfully saving a viable business and maximizing the return to creditors and shareholders.”

Formal and informal mechanisms should complement and support one another

Notwithstanding the importance of an effective formal insolvency regime, it is also essential to reserve a central role for out-of-court arrangements and governments should encourage and assist in the development of strong *informal* insolvency mechanisms. Effective formal mechanisms are important to prod debtors and creditors to enter into good faith out-of-court negotiations while well-developed informal mechanisms are needed simply because courts will never have adequate capacity to deal with *all* insolvencies. During the meeting, participants stressed that the insolvency system should not be too “court-centered” and that most restructurings should occur out of court, leaving courts to intervene only when there is a genuine dispute. It is, however, important to emphasize that the development of informal mechanisms must not come at the expense of developing strong formal regimes. In certain countries, the informal and formal mechanisms compete with each other, leading to the underdevelopment of formal procedures.

Since 1997, in addition to reforming the formal insolvency system, governments in the crisis-affected countries have made serious attempts to promote viable out-of-court arrangements. The Indonesian, Korean, Thai, and Malaysian governments have established special facilitating agencies to encourage and accelerate out-of-court restructuring. The role of these institutions is to act as a special out-of-court mediator in workout situations. The facilitating agencies have been effective in helping to build a consensus among creditors and debtors as to what constitutes “best practices” for informal

restructuring. In addition, these institutions have helped to reduce the pressure on the court system in the crisis countries. Yet, the overall effectiveness of the facilitating agencies have been limited because they lack enforcement power to coerce debtors or creditors to cooperate and to punish parties that breach their contractual agreements. In addition, despite the disproportionate impact of a systemic crisis on small and medium-sized enterprises (SMEs), the facilitating institutions (with exception of the Corporate Debt Restructuring Advisory Committee in Thailand) mediate in only large restructurings. Lastly, the effectiveness of these agencies is hampered by the continuing problems in the formal regime. One participant commented that “unless the courts reach correct decisions in the cases that are before them, the utility of the facilitating agencies will be limited because there is no apparent ‘downside’ for a failed restructuring effort.”

Insolvency reform must be accompanied by a broader set of reforms in related areas

Comprehensive insolvency reform must also encompass broader reforms in related areas. Measures recommended by the meeting participants included strengthening accounting and auditing standards, improving the corporate governance structure of corporations and financial institutions, and developing effective regulatory oversight. The OECD-commissioned country studies showed that deficiencies in some of these areas contributed significantly to the recent financial crisis in the region. Effective reforms in these areas will strengthen the financial system and the increased transparency will enable regulators and creditors to detect problems at an early stage. Early detection of difficulties is important as the value of a company erodes rapidly when problems become apparent. In addition, the existence of such an early detection system may help to avert a recurrence of systemic distress in the affected countries by warning policy makers of impending problems well ahead of time.

Accurate and comprehensive company-specific financial information is crucial for the conduct of commerce. At both ends of the commercial spectrum (i.e., when lenders are contemplating extending a loan and when a company is facing insolvency), reliable financial information is essential for informed decision-making. For example, lenders require accurate and comprehensive information on the borrower’s operations in order to make informed lending decisions. When a company is insolvent, the same information is also required to determine whether rehabilitation or liquidation is the best course of action. The availability of accurate and comprehensive financial information helps to reduce the information asymmetry between debtors and creditors and generates confidence among all negotiating parties.

The recent regional financial crisis revealed serious deficiencies in the accounting and auditing standards of many Asian countries. In some countries, the accounting and auditing standards are woefully inadequate and as a result, the audited financial statements provide little reliable information. In other countries, internationally recognized accounting and auditing standards have been introduced but the adoption rate among corporations and accounting/auditing firms is low. Making matter worse is the fact that the regulatory bodies have neglected to ensure compliance with these standards.

Numerous instances of “fudged accounts” have been discovered in the course of workouts and other insolvency proceedings. In one high-profile workout, independent investigation revealed that the actual debt of the distressed company was US\$23 billion higher than the amount reported in the financial statements. Not surprisingly, this revelation threatened to thwart the entire restructuring effort. A few weeks later, it was also discovered that this company utilized a previously undisclosed offshore company to secretly transfer up to US\$7 billion to other companies in the group.

During periods of systemic distress, the government can facilitate formal and informal restructuring by permitting special accounting treatments to be used. For example, the Bank of Thailand has modified the accounting rules to allow financial institutions to reclassify non-performing loans (NPLs) as performing once a restructuring agreement has been signed. To enable debt for equity swaps to be a more viable option in workouts, the Thai government now permits equity participation by banks above the regulatory ceiling for a period of up to three years.

In addition, the combination of weak corporate governance structures in financial institutions, inadequate supervision by regulators, and industrial policies also contributed to the regional financial crisis. In certain crisis countries, weak corporate governance structures enabled financial institutions to operate without regard to the best interest of shareholders, leading to poor credit risk evaluation, non-arm’s length lending, weak monitoring of borrowers, and lackadaisical efforts to recover loans upon default. In addition, lax regulatory supervision enabled the controlling shareholders of banks to divert funds to such shareholders’ non-financial enterprises in violation of the law. Moreover, these problems were exacerbated by the pursuit of an industrial policy by certain countries, which often led to imprudent lending based on political factors rather than market needs. Weak corporate governance at the corporate level was also an important factor in the crisis, as companies were geared towards serving the interests of a few core ‘inside’ shareholders, spreading the risks to minority shareholders but keeping the control to the former. A high level of leverage was a standard way to achieve such objectives.

Future Work

In the concluding session, a consensus emerged among the conference participants on the need for continuing dialogue in the area of insolvency reform. The participants stressed that it is imperative that the momentum for reform is maintained and that the sponsoring organizations continue to be active in this area. In addition, all future endeavors should attempt to integrate the work completed by other international organizations, such as the IMF, ADB, and UNCITRAL.

One suggestion that garnered widespread support is to produce, after completion of the World Bank principles and guidelines on building effective insolvency systems, an agenda for reform from a regional perspective. Furthermore, the importance of evaluating current reform efforts, and discussing other related developments was stressed. These subjects will be discussed at a follow-up conference in Indonesia, in February 2001. The participants agreed that it is essential to maintain the present composition of participants (consisting of senior policy makers, members of the judiciary, academics, bankers, lawyers, accountants, and other insolvency practitioners and experts) in any future work. Moreover, it will also be beneficial to include more representatives of the corporate world (i.e., the debtor community) in all future work.

ASIAN INSOLVENCY REGIMES FROM A COMPARATIVE PERSPECTIVE: PROBLEMS AND ISSUES FOR REFORM

by

Il Chong Nam* and Soogeun Oh**

1. Introduction

Although the efficiency of insolvency proceedings has long been a subject of debate and reform efforts in many countries around the world, the proceedings in the crisis-hit East Asian countries have received particular attention in recent years. A large number of firms in the region became insolvent in the wake of the crisis, but the insolvency proceedings that were in place did not appear to be effective. Further, deficiencies in the insolvency proceedings were singled out by some experts as one of the main factors that contributed to the crisis in some countries. Indeed, in Korea, a string of large corporate failures, starting from the bankruptcy of Hanbo and Kia, was a main culprit for the economic crisis. In Indonesia and Thailand too, the bankruptcy of a large number of firms was a key component of the recent economic crisis.

In many respects, an effective insolvency mechanism is one of the most sophisticated institutional arrangements for an economy to establish. It not only involves the decision of whether to liquidate or restructure firms, which entails the processing of a huge amount of complex information under enormous uncertainty, but also the division of the economic value of a large and complex firm to numerous stakeholders with diverse interests. Also required, to a large degree, is that these decisions be made by stakeholders on a voluntary basis. Consequently, stakeholders must overcome intrinsic information asymmetry and free-rider problems in order to coordinate their actions in a non-cooperative way.

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In this context, it is not surprising that countries with a short history of capitalism are unlikely to have well-developed insolvency mechanisms. This is due primarily to the lack of sufficient experience or requisite human resources. In fact, the economic system of many developing countries is still based more on informal relationships than legal contracts or institutional mechanisms. The East Asian countries hit by the recent crisis seem to be no exception in this regard.¹

Further, the crisis-hit countries in East Asia seem to exhibit fundamental weakness in their overall infrastructures as related to their financial markets, with the weakness systematically linked to inefficiency in their bankruptcy mechanisms. Indeed, there is ample evidence that in those afflicted countries in East Asia, the weak corporate governance structure of financial institutions and inadequate prudential supervision went hand in hand with the poor state of insolvency mechanisms. Financial institutions in those countries neither performed satisfactorily in accurately evaluating credit risks at the lending stage and monitoring their clients, nor acted decisively once bankruptcy occurred. Consequently, the failures in the financial sector translated into the failures in insolvency mechanisms.

Banks in Indonesia and Korea are good examples. The state-owned banks of Indonesia had weak commercial orientations and were subject to politically motivated lending decisions. In addition, the banks owned and controlled by private shareholders were mostly controlled by families that dominated the conglomerates. Weak prudential supervision led to large-scale diversions of funds from these banks by dominant shareholders. In the case of Korea, prior to the crisis, the purchase of shares of banks was allowed subject to a ceiling, but the control of the banks was firmly in the hands of the government instead of a governance structure that represented the interests of the shareholders of the banks. As a consequence, banks were forced to serve as a means to support industrial policies that depend upon the employment of the chaebol system. Prudential regulation did not have much chance of becoming effective as the government itself interfered heavily with the management of banks².

It is difficult to expect that banks will act properly as a profit seeker in facing bankrupt borrowers in such a situation. In both countries, the inability and/or reluctance of the financial institutions to act decisively in recovering their loans when client firms failed aggravated a situation already worsened by the sclerotic insolvency proceedings.³

The above argument in turn leads to the question of the root cause of the weak corporate governance of financial institutions and inadequate prudential regulation. Of course, many of the problems can be attributed to corruption or to the shortage of qualified professionals as well as a host of other factors that

generally define the quality of the institutional infrastructure of an economic system. However, there is a possibility that the industrial policies or, more generally, the development strategies of the past and current governments may have played a key role. When a government interferes with the financial market to finance its pet project, it has to tamper with the corporate governance of lending institutions. Further, if a pet project turns out to be a financial disaster, the government naturally becomes liable for cleaning up the mess from the unfortunate investment as it was behind the investment decision in the first place. There is also the question of how the government properly controls the businessmen who run the government-sponsored projects in order to minimize the adverse effect of wrong incentives that they can have.

The above discussions suggest that we need to look beyond the narrowly defined court-supervised insolvency proceedings to a broader set of institutional arrangements or policy environments in order to understand the factors that collectively determine the efficiency of economic activities concerning financially-troubled firms. While this paper is concerned primarily with the comparison of the insolvency mechanisms of six Asian countries -- Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand -- it also attempts to address the broader range of issues discussed above. The issues that we address in this paper can be summarized as follows.⁴

- What are the main features of the insolvency proceedings in place in East Asian countries?
- What are their properties in terms of efficiency and fairness? In particular, what aspects of the insolvency proceedings of each country give distorted incentives to some key stakeholders that could result in inefficient or unfair outcomes?
- What are the key factors that affect insolvency proceedings and their outcomes? In particular, how well or how poorly does the financial market function, and how does its performance affect insolvency proceedings?
- What are the sources of the systemic risks and what are some possible solutions?
- What is the general nature of the government in its role in economic affairs and how does the nature of the government or its policies affect insolvency proceedings?

This paper is organized as follows. The next section offers an overview of the key issues concerning insolvency mechanisms. Section 3 offers a comparative analysis of insolvency mechanisms of the six Asian countries mentioned above. Section 4 draws conclusions. Finally, the appendix contains a summary of the insolvency mechanisms in the six countries. This summary is based primarily upon their respective country reports.

2. Main Issues in Law and Economics of Insolvency

2.1 *The Role of Insolvency Mechanisms*

Firms often fail to pay their debts for a variety of reasons. The need for the state to intervene and provide solutions when corporate failure occurs has long been recognized. However, the pivotal role of firms in modern economies and the prevalence of limited liability companies necessitate insolvency mechanisms as distinct from debt collection mechanisms. In principle, an insolvency mechanism can be superior to a debt collection mechanism because it can lead to an increase in the economic value of a bankrupt firm that can be distributed to creditors and debtors by limiting creditors' ability to collect their claims individually.

It is crucial to study insolvency mechanisms from the perspective of economic efficiency rather than fairness, just as it is crucial to regard the failure of a firm to pay its debts as a state rather than an action. There exist several forms of efficiency that the study of insolvency mechanisms should take into account. Ex-post efficiency implies that an insolvent firm is to be liquidated if and only if its liquidation value is greater than its going-concern value. An important prerequisite to this principle is that the value of an insolvent firm should be maximized regardless of the modality of resolution. In other words, the liquidation processes should maximize the proceeds from the sales of the assets of the firm when liquidated, and by the same token, the reorganization plans also must be drawn and implemented to maximize the value of the firm from the forward looking prospective. An important implication of the concept of ex-post efficiency is that the decision regarding the fate of an insolvent firm should be independent of both the ability of the firm to eventually pay its debt and the relative magnitude of the firm's value and the size of debt. This implication, although obvious to most experts, has been overlooked by practitioners and institutional arrangements in many developing countries.

In reality, however, things are not that simple. The decision-making process on the fate of an insolvent firm and the division of the firm value could affect ex-post efficiency. When a bargaining process, such as the US Chapter 11-style

proceedings, is used, ex-post efficiency could be affected by the incentives of some stakeholders to hold out in order to extract concessions from the other stakeholders who are more adversely affected by protracted bargaining. In addition to small creditors, shareholders or managers who expect very little because the firm is in very poor shape typically seem to have strong incentives to hold out.

Division of the economic value of the firm among creditors, shareholders (managers) and other stakeholders does not affect ex post efficiency *per se* as it involves only the distribution of wealth. However, it significantly affects the behavior of creditors and debtors in the lending stage, and thereby the conditions for lending. More generally, how the value of an insolvent firm is divided among various stakeholders in the bankruptcy state, together with what may happen to the firm itself, determines ex-ante efficiency in several ways.⁵

First, once insolvency occurs, the fate of the firm in question determines the degree of risk-sharing by lenders and equity investors. A loan contract that stipulates payments independent of the performance of a debtor firm cannot be executed in insolvency states and will be replaced by the outcome of an insolvency mechanism that governs the parties involved, once insolvency occurs. Of course, what a creditor receives from a bankrupt debtor firm through an insolvency mechanism generally differs from the terms of the original contract and usually depends upon the performance of the firm. Consequently, insolvency proceedings affect the supply of credit in financial markets, and thereby the equilibrium prices for credit.⁶

Second, insolvency mechanisms affect the behavior of creditors and debtors, particularly in the world of limited liability. The screening activities of lenders at the lending stage, as well as monitoring after the loan are affected by what would happen in the bankruptcy state. The rationale for the actions of shareholders and managers is based upon the projected outcomes of bankruptcy. They have incentives to take on an “all-or-nothing” gamble strategy when they expect very bad payoffs in bankruptcy states compared to non-bankruptcy states. Managers may also try to take actions that would make them more indispensable in the bankruptcy state.

2.2 *Three Fundamental Ex-Post Decisions*

Any insolvency mechanism should address three fundamental issues when insolvency occurs: (1) what to do with the firm itself, i.e., whether to liquidate or restructure, (2) procedures for restructuring or liquidation and (3) division of the economic value of the firm among various stakeholders upon liquidation or during restructuring.

The choice between liquidation and restructuring is critical, because the value of the firm that stakeholders can divide among themselves is generally different in the two alternative cases. In principle, it is desirable to liquidate the firm when its liquidation value is greater than the going-concern value and vice versa. How to restructure or liquidate an insolvent firm is important because it is desirable to maximize the value of the firm in either case. In fact, the actual modality of restructuring or liquidation critically affects the value of an insolvent firm, and hence provides a basis for the choice between liquidation and restructuring.

Division of the pie is relatively simple when the firm in question is to be liquidated. Proceeds from auctioning of assets are distributed to the stakeholders according to a pre-fixed rule. It appears that the absolute priority rule enjoys wide support in this case, although one can argue that imposition of this rule in liquidation would give shareholders (managers) wrong incentives.⁷ If the firm in question is to be restructured, division of economic values is achieved basically through debt-equity swaps. When a firm cannot pay all of its debt, there has to be a debt reduction in order for the firm to survive as a going concern.

Creditors generally receive shares of the firm in return for forgoing part of the loans. Sometimes, in a trivial case, a simple deferment of payments to creditors is sufficient. However, the deferral of payments usually entails losses to some creditors even when the firm pays the principal and interest fully, according to the terms specified in the original contract. This is because the position of the creditor, including his or her position toward the terms of lending, keeps changing. Consequently, the simple deferral of payments generally entails certain losses. Any modification to the original terms of the contract which results in a reduction in the present value of the loans, such as a reduction in interest rates, or the prolongation of the payment schedule too far into the future, should be interpreted as foregoing part of the loan.

There are conflicting views on the principles governing the conditions of debt-equity swaps. The absolute priority rule is certainly appealing, as it preserves the order of priority given by the original contracts. However, it is likely to induce shareholders (managers) to behave in ways that would dissipate the value of the firm. Many countries give some breaks to original shareholders during reorganization by giving shares of the firm to creditors in return for haircuts that are substantially smaller than the shares dictated by the absolute priority rule, although the degree of deviation differs from country to country.

2.3 *Decision-Making Process*

The ultimate question concerning insolvency mechanisms is how to achieve efficient outcomes. The most popular mechanisms are structured bargaining games supervised by the court and informal bargaining games, such as the "London Approach" or the "Workouts" used in Korea. We summarize the nature of these two mechanisms as well as two other mechanisms that have been proposed or used. We start by considering a simple mechanism that gives to a single authority the power to make fundamental decisions on insolvent firms. This mechanism provides a benchmark against which properties of the other mechanisms can be compared.

2.3.1 *Regime 1: Decision by a Single Authority*

Suppose that the government has the best information about the economic environment surrounding an insolvent firm and that its objective is maintaining economic efficiency. In such an ideal world, it would be best to give the government the power to make the three fundamental decisions mentioned previously.

The government would proceed with the following steps. First, it determines the optimal strategy for restructuring and liquidating the firm in question with the objective of maximizing the firm's value. The maximized values of the firm correspond to the going-concern value and the liquidation value, respectively. Second, the government then decides between liquidation and reorganization based upon the result of the valuation in the first step. Third, the government implements the optimal restructuring plan or liquidation process. Lastly, the government divides the value of the firm between various stakeholders according to a given rule. The division rule is determined by the government as a solution to the maximization problem for the overall (ex-ante and ex-post) efficiency.

The insolvency mechanism described above is efficient in the given setting. Further, it is likely to be more efficient in terms of cost than the other insolvency mechanisms that involve bargaining by stakeholders, since it is immune to haggling and time-consuming negotiations. Time is crucial in insolvency proceedings as the value of an insolvent firm can deteriorate rapidly, especially when reorganization is deemed desirable.

One of the major weaknesses of this mechanism is the unrealistic assumption about the government. Few would agree that the government has better information than the other players. Furthermore, even the assumption that the objective of the government is to maximize economic efficiency cannot be taken for granted. In reality, the government is not a single agent with a well-

defined objective function of its own. Rather, it is closer to a loose collection of politicians and bureaucrats who pursue their own objectives. It is also an error to presume that the government knows the best way to liquidate or reorganize an insolvent firm. Consequently, there is no guarantee that giving the government the power to make fundamental decisions in insolvency mechanisms will lead to an efficient outcome.

Valuation is the most problematic issue here. Valuation is crucial in insolvency mechanisms because it provides the basis for choosing between liquidation and reorganization, as well as the conditions for debt equity swaps. Thus, valuation determines the fate of the firm itself as well as the distribution of wealth among stakeholders. In normal situations, the valuation of an asset is determined in the market as a result of the profit-seeking activities of investors who bet on the asset with their money. However, in the above setting, valuation depends on a third party (in this case, the government) that does not have any earthly interest in the firm. As a consequence, there is no guarantee that the third party's valuation coincides with the true value of the firm. Further, it is impossible to convince every stakeholder that the outcome of the valuation reflects the true value.

Nonetheless, this mechanism may be appealing to developing countries that are not equipped with well-developed legal infrastructures with respect to insolvency proceedings.⁸ In particular, when a large number of firms become insolvent simultaneously, a bargaining process similar to the one envisaged in the US Chapter 11 is likely to entail too much cost for the economy to bear.

2.3.2 *Regime 2: Formal Bargaining in Earnest*

Another way of making a decision on an insolvent firm and the division of its value is negotiation or bargaining by creditors and shareholders (managers), subject to some rules and restrictions.⁹ This type of conflict resolution typically consists of the procedures concerning protection of the firm's assets from debt collection attempts by individual creditors; classification of creditors according to some priority ordering; the drawing up of plans for reorganization; voting mechanisms; a prescription for probable outcomes in each contingency resulting from voting; and the authority of the mediator, which is usually a court.¹⁰

Three fundamental decisions regarding an insolvent firm are made as an outcome of bargaining games that are played by the creditors and shareholders (managers) of the firm according to the rules set out by the formal insolvency proceedings. Players try to maximize their respective objectives in a non-cooperative way, taking into account that the others are doing the same.

A notable feature of this type of bargaining is the possibility that some players may threaten to veto a plan in order to extract concessions from the other players. If the players advancing such threats have the ability to veto a plan, and if they have more to gain once the plan is vetoed, their threats are clearly credible. In such a case, their share of the firm value needs to be increased in the final proposals for voting in order to ensure that the reorganization plan is approved. In situations where players are expected to lose as a result of vetoing a plan, the credibility of their threats is not well established, although this may not prevent the veto power from being exercised. Whether the insolvency mechanism should allow the stakeholders to hold out in such a situation is also an important issue that must be addressed by an efficient insolvency mechanism.

Formal bargaining proceedings have some advantages compared to Regime 1 in that decisions are not made by a third party but by stakeholders. Thus, it appears that the implicit valuation behind a liquidation/reorganization decision under Regime 2 is more likely to reflect the true value of the firm than is the case under Regime 1. There is no guarantee, however, that the decisions will always be more efficient or fairer under Regime 2 than under Regime 1 because of the heterogeneity among stakeholders in information and attitudes towards risks.

Thus, it is possible for firms to end up liquidated even if the going-concern value is greater than the liquidation value, or vice versa. Furthermore, it may be very difficult to design a bargaining process that guarantees that the division of assets will satisfy the optimal division rule most of the time, even if a society agrees on an optimal division rule.¹¹ In addition, formal bargaining games tend to take too much time, resulting in the dissipation of a firm's value. This dissipation can at times be substantial in both absolute amounts and in relation to the asset value or potential economic value of the firm. Negotiation among a large number of creditors and shareholders who do not have the same information and financial positions simply cannot be done without substantial costs. The possibility of haggling and strategic maneuvers described above makes it even more time consuming and costly.

In spite of these deficiencies, formal bargaining proceedings have evolved to play a central role in dealing with insolvent firms in many advanced countries. They also provide a backdrop for informal bargaining mechanisms in which stakeholders bargain over a set of packages that are Pareto superior to what they would receive under formal bargaining proceedings. In less developed countries, formal bargaining proceedings either do not exist, or even where they do exist they often play only a secondary role.

2.3.3 *Regime 3: Informal Bargaining*

Creditors and shareholders of a firm can always agree to bypass the formal bargaining proceedings in place and instead try to find resolution outside of the formal bargaining process. Informal bargaining is, however, constrained by formal bargaining in the sense that no stakeholder would agree to a proposal that would give him a payoff worse than what he or she would expect to receive in formal bargaining proceedings. Thus, agreements made through informal bargaining are superior to those made through formal bargaining, if they are made. The surplus that participants could create by going into informal bargaining would depend on the degree of inefficiency in formal bargaining proceedings.

The Pareto superiority of informal bargaining is particularly meaningful when the firm is likely to be restructured. Division of the firm value in such a case takes the form of debt equity swaps. Informal bargaining has been used in many countries, sometimes playing a more important role than formal insolvency proceedings.¹² However, informal bargaining shares most of the deficiencies of formal bargaining listed above, although to a lesser degree.

2.3.4 *Regime 4: Recent Proposals that do not Depend on Bargaining*

Recently, some economists have proposed insolvency mechanisms designed to bypass the problems inherent in the bargaining approaches. These proposals commonly separate the decision concerning the firm itself from the decision on division of the firm's value. Typically, debt-equity swaps take place according to some given rule which does not require bargaining by stakeholders, but more accurately reflects the valuation of stakeholders more accurately. After the debt-equity swaps, the firm becomes financially healthy, and former creditors become shareholders. The future of this born-again firm is determined by new decision-makers. If the going-concern value is smaller than the liquidation value, the new decision-makers will liquidate the firm. If the going-concern value is greater, the new decision-makers will try to explore the best modality of restructuring in order to maximize the value of the firm.

Debt-equity swaps critically depend on two factors: valuation of the firm and priority ordering of the claims among various stakeholders. Since it is generally impossible to assign an objective value to a firm, valuation is conducted basically in one of the following two ways. The first is to use the estimate of a third party.¹³ This method is close to Regime 1 in spirit, with similar strengths and weaknesses. The successful valuation under this scheme requires procuring an able and impartial third party and giving the party a proper incentive to produce best estimates. A mechanism of this kind also needs to include an

appeals process in order to deal with cases where stakeholders do not agree with an estimate given by the third party.

The second way is to use the incentive of stakeholders to maximize their wealth. In the Bebchuck scheme, all debts are cancelled and converted into equities according to an option scheme based upon the absolute priority rule. All the equities are given to the most senior creditors, while junior creditors are given options to buy the equities from senior creditors at a price that equals the sum of all debts that were held by creditors who are senior to them. The amount paid by those creditors who exercise their options is used to buy the matching number of shares from some creditors at prices that are par with their original debt amounts. Old shareholders are the most junior stakeholders in priority and are given only the option to purchase the shares from the most junior creditors at a price that equals the sum of all debts. Finally, creditors and shareholders can trade equities and the options before options are exercised and debt equity swaps take place.

This procedure needs no bargaining. Valuation of the firm is determined by the actions of various stakeholders who decide on whether to exercise their options based upon the relative magnitude of their estimates of the value of the firm and the sum of all debts that have priority to its claim. Thus, there should not be any dispute as to the condition of debt equity swaps as long as stakeholders do not face liquidity constraints. Liquidity constraints could be alleviated to some extent by the trading of equities and options. However, creditors and shareholders are, to some degree, subject to liquidity constraints due to the imperfection of the financial market. In particular, the imperfections of the financial market make it difficult for junior creditors and shareholders who wish to exercise their options but face a shortage of cash to borrow from the financial market. Consequently, the Bebchuck scheme is biased in favor of senior creditors and against junior creditors and old shareholders.

It should be noted that this bias does not cause any new problem to the ex post economic efficiency. Further, if the financial market is reasonably efficient, interest rates of various types of loans with differing seniority will adjust to reflect the conditions for debt equity swaps *à la Bebchuck* in bankruptcy states. The Bebchuck scheme also has an advantage over the bargaining approaches described above in that it does not require too many judges or a high degree of expertise from the judges handling bankruptcy cases.

Although the original Bebchuck scheme assumes the absolute priority rule can be modified to give room to shareholders as an incentive not to behave in a value destroying manner. This scheme will work well in countries in which the financial market is fully developed. However, in countries with underdeveloped financial markets, this scheme could lead to concentration of

ownership of bankrupt firms in the hands of a few banks. In countries where most banks fall into bankruptcy themselves and become nationalized, the Bechuck scheme may lead to nationalization of most bankrupt firms.

2.4 *Problems with Creditors, Corporate Governance, and Prudential Regulation*

Creditors are the most important players in the resolution of corporate insolvency. The ex post efficiency of an insolvency mechanism critically depends on the ability of creditors to maximize their share in the division of the firm's value.¹⁴ Ex ante efficiency in the financial market at the lending stage clearly requires well-managed, profit-oriented financial institutions that are also subject to effective prudential regulation.

There is plenty of evidence that shows that financial intermediaries in many developing countries, including all of the East-Asian countries hit by the recent economic crisis, have not been managed with strong commercial orientation and that prudential regulation was virtually non-existent or weak at best prior to the crisis. It is not surprising that in such a situation the lenders did not take actions to retrieve their loans as much as possible once their client firms become insolvent, and that they continued to lend at rates that did not correctly reflect the risks involved.

Apart from the corporate governance issues with financial institutions, the efficiency of insolvency mechanisms will also be significantly affected by the corporate governance of debtor firms. It is well known that most East-Asian countries suffer from irregularities concerning the corporate governance structures of their firms. Some of the consequences due to the failure in corporate governance have been delayed reporting of financial difficulties, delayed proceedings due to the lack of reliable information about the firm, massive asset stripping as a result of both, and holding out by dominant shareholders resulting in further asset stripping. In addition, cross-loan guarantees and cross-shareholdings among multiple firms under the same control, which have been observed in some Asian countries such as Korea and are a result of failures in the corporate governance of firms, can seriously undermine the efficiency of insolvency mechanisms.

The final issue regarding the corporate governance of a bankrupt firm concerns the optimal transition of the control of the firm from the hands of the old managers or shareholders to new managers. While there exist good reasons to let the old management remain, there also exist reasons to replace them with a fresh, new management team. There is no answer that single-handedly provides an optimal solution to this problem in all circumstances. However, it seems safe

to say that the old management should not automatically maintain control of the firm, and that creditors who are expected to become major shareholders within a short period of time should be allowed to participate in selecting a new management. In fact, separating the bankrupt firms from the influence of their dominant shareholders appears crucial for an efficient outcome in most of the Asian countries that were directly affected by the recent economic crisis.

2.5 *Government Policies*

There are at least two reasons why the government wants to play a role in bankruptcy mechanisms even in a country that is equipped with a relatively well-established court system. First is the possibility of a systemic crisis. It may be too costly to let the court handle most of the cases when a large number of firms fall into financial trouble simultaneously. Further, in countries where the financial markets are not well developed, the bankruptcy of even a couple of large firms could cause serious financial difficulties for major financial institutions and a severe credit crunch, which in turn could precipitate the collapse of the other firms and financial institutions. Governments should try to stop this vicious cycle and contain the bankruptcies of firms to isolated cases.

Most Asian countries, except Japan and Singapore, appear to fall in the category of countries in which financial markets are underdeveloped compared to the real sector. Further, most of the Asian countries have seen an influx of capital from the international financial market. A sudden reversal of foreign capital flows could trigger a financial crisis that may well send even the largest firms and financial institutions into deep financial trouble. These two factors combined -- the underdevelopment of financial markets and heavy reliance on foreign capital -- could trigger a systemic bankruptcy relatively easily, compared to more mature economies. Concerns over such systemic crises are believed to lie at the heart of the governments' initiatives in various forms of informal proceedings. However, it should be clearly understood that the effects of the insolvency proceedings in which the government plays a role are not limited to the macro performance of an economy. Government interventions affect the efficiency and fairness at a micro level, and in effect determine the incentive structures faced by various economic agents, including firms and financial institutions, their shareholders and managers, and even ordinary taxpayers and savers.

Second, there is a possibility that the government is linked to the insolvency of large firms in a more systematic way. The industrial policy or development strategy of a country can be a crucial factor in determining the state of insolvency proceedings as well as the state of the financial market in some countries. Many countries which embarked on industrialization relatively late had, or still have, political systems that give more discretion to the

administrative branch of the government than most advanced countries that have longer histories of democracy and capitalism. In some of these countries, past or present governments have pursued rapid industrialization through a hybrid economic system. Such a policy often entails heavy intervention by the government in the financial market because the government needs money to support target industries or target firms.¹⁵

Often, some of the projects that were financially supported by the government turn out to be money losing businesses and end up bankrupt. The government has two strong incentives to intervene in the way the bankruptcies of such firms are handled. First, when the government intervenes heavily, all the major problems of the financial market become the business of the government. This is especially so when a large number of financial institutions become financially troubled as a result of a bad lending decision for which the government is ultimately responsible. Second, the government sometimes wants to continue to promote the industrial policies for the industries in which the bankrupt firms operate.

Thus, there is a possibility that insolvency cases are handled by the government as a part of a development strategy or industrial policy in combination with financial market policies that are designed to support industrial policy. This kind of policy mix has far-reaching implications not only with respect to insolvency mechanisms, the performance of financial markets, and the insolvency of the financial institutions themselves, but also affects a wide range of economic issues including the corporate governance of firms and financial institutions, competition policies and fiscal policies.

3. A Comparative Analysis of Insolvency Mechanisms in Asia

Generally speaking, Singapore is far ahead of the other five countries in the overall quality of legal infrastructures governing economic activities, including insolvency mechanisms as well as the other institutional arrangements concerning financial markets. Malaysia is also equipped with reasonably well-functioning infrastructures concerning the bankruptcy of firms and its financial markets. In the other four countries, neither the financial markets nor the insolvency mechanisms worked properly before the onset of the crisis. Many reform measures have been introduced since 1997 regarding financial markets in general, and insolvency mechanisms in particular. It is too early to evaluate the effectiveness of the reform measures with any precision at this point.

In this section, we present the key aspects insolvency mechanisms and financial systems of these countries and attempt to compare them. Our focus is centered on the efficiency of the institutional arrangements concerning the bankruptcy of

firms and the root cause of the persistence of inefficient systems in some countries. This section consists of four parts. Subsection 3.1 contains an analysis of characteristics of the financial markets and corporate governance structures in the six countries, attempting to characterize the key players in games involving bankrupt firms: financial institutions, shareholders and managers of debtor firms, and the government in these countries.

Subsection 3.2 deals with formal insolvency proceedings. This part summarizes the salient features of formal insolvency mechanisms of the six countries and also attempts to give a comparative analysis of them. Subsection 3.3 reviews informal proceedings such as the “Jakarta Initiative” and “Corporate Restructuring Agreements” of Korea.

3.1 *Creditors, Debtors, and the Government*

3.1.1 *Financial Markets*

The profit-oriented management of financial institutions and adequate prudential supervision by regulatory authorities are the two most crucial elements in insolvency mechanisms. A full-blown analysis of the financial markets in the six Asian countries is beyond the scope of this paper. However, scattered pieces of information, casual observation, as well as the country reports suggest that, prior to the crisis, Indonesia, Korea, the Philippines, and Thailand generally failed in inducing efficient corporate governance structures in financial institutions and in putting effective prudential supervision in place, while Singapore and possibly Malaysia fared significantly better.¹⁶

The role of the government as a corporate governance agent in the banking industry was strong in Indonesia and Korea and relatively weak in Singapore, Malaysia, and the Philippines. In Korea, the government allowed private investors to purchase up to 8 per cent of the shares of a bank, but prohibited private shareholders from taking control of the management of banks. The government interfered heavily with the key decisions concerning the governance of banks, such as the selection and dismissal of top managers. It also affected major management decisions through its influence on top managers. In Indonesia, state banks were run by management vulnerable to meddling by politicians. Thus, the banks’ lending decisions were generally not profit-oriented. In the other four countries, the proportion of state banks was not a significant factor.

In all of the countries except Korea, ownership and control by private shareholders was allowed. In Indonesia, the Philippines, and Thailand, the

majority of private banks were owned and controlled by the same families with controlling interests in conglomerates. Such joint ownership and control of banks and firms by the same shareholders is not a prevalent feature in Malaysia and Singapore.

The corporate governance of non-bank financial companies is not much different from that of banks. Most of the non-bank financial companies are privately owned and controlled, as is the case with the banks in these countries. In Indonesia, the Philippines, and Thailand, most of the non-bank financial companies are owned and controlled by families that have controlling interests in conglomerates. In Korea too, private ownership and control of non-bank financial companies was allowed, unlike in the instance of banks. As in the cases of Indonesia, the Philippines, and Thailand, a majority of non-bank financial companies in Korea were dominated by *chaebol* families with controlling interests in conglomerates.

Prudential supervision was relatively effective in Singapore and Malaysia, but was ineffective in the other four countries. Although Thai banks and NBFIs were on the surface somewhat restricted in directly holding shares of listed non-financial business firms, they were still able to hold a controlling share in listed companies through their equity shares in holding companies, which are not subject to any investment restrictions. The investment records of Thai banks also revealed extensive investments in unlisted companies.¹⁷ In short, financial institutions faced conflicts of interest as creditors in these countries. There is evidence that lax regulation by the authorities, together with policies that gave strong tax incentives to offshore borrowing, led to a sharp increase in lending by Thai financial companies to the real estate and property sector, mainly financed with borrowing from abroad.

In Indonesia, lax regulation and continued government subsidies to financially troubled banks that gave distorted incentives to the banks are also well documented.¹⁸ In Korea, weak prudential supervision, coupled with the *chaebols'* domination of NBFIs, resulted in the collapse of many NBFIs that signaled the start of the economic crisis. In the Philippines too, weak prudential supervision and the ownership and control of banks by conglomerates resulted in many banks becoming the cash vaults of conglomerates.

The situation in Singapore and Malaysia appears to be much better compared to the other four countries. Prudential supervision seems to have resulted in reducing the possibility and the scope of conflicts of interest to tolerable levels. In Malaysia, only a few of the 37 commercial banks are controlled by conglomerates. In addition, prohibitions of loans to related parties and the stringent enforcement of this rule by the central bank have greatly reduced opportunities for business groups to avail themselves of easy loans through their

close ties with banks. In Singapore, the Banking Act limits the investments of banks in other non-financial businesses to a maximum of 20 per cent of their capital base. Banks are more severely limited in their ability to acquire large equity shares in a single firm even though it may be less than the stipulated 20 per cent. In order to acquire high levels of ownership positions, banks have to undergo a judicial review process by MAS (Monetary Authority of Singapore). In addition to enforcing legislation, MAS also performs regulatory supervision by directly intervening in matters of corporate governance. For example, it maintains the right to approve the appointment of directors on the boards of financial institutions. Features like these may also exist in laws or guidelines in the other countries too. However, the effectiveness of regulation appears to vary.

In short, the joint ownership and control of banks and debtor firms, combined with lax prudential supervision, generally led to inefficient management of lending institutions in Indonesia, Korea, Thailand, and the Philippines. In particular, large amounts of loans were made to the firms under the control of the same families. In Korea, where the private control of banks was prohibited, the lack of adequate governance structures and intervention by politicians in the management of banks led to massive amounts of loans to unprofitable projects.

Problems with the corporate governance of banks and NBFIs and lax prudential supervision not only led to improper lending decisions as stated above, but also resulted in inefficient outcomes once insolvency occurred. Banks and NBFIs in Indonesia, Korea, the Philippines, and Thailand have all tended to refuse to acknowledge the financial difficulties of their debtors and initiate insolvency proceedings to resolve the situation.

In Korea, banks often kept pumping money into large, ailing debtor firms, just to keep them afloat. These firms had already taken out excessive amounts of loans and were viewed as unable to pay back the existing debts. Banks in Indonesia and Thailand, which were owned and controlled by private shareholders, also shared the tendency to refuse to officially accept debt reduction when facing the insolvency of their debtors, even when it was obvious that the firm value was smaller than the amount of loans. In sum, many lending institutions that fell into deep financial trouble themselves as a result of reckless lending also frequently indulged in asset-stripping activities, as they found little incentive to reveal the problem of their debtors and engage in bankruptcy proceedings that could only bury them.¹⁹

Ineffective governance structures and inadequate prudential supervision in Indonesia, Korea, and Thailand ultimately resulted in massive amounts of non-performing loans. The proportion of non-performing loans held by commercial banks was estimated to be 22.7 per cent in Korea as of December 1997, and

58 per cent in Indonesia as of December 1998. In contrast, it was 7.3 per cent in Malaysia as of December 1998, up from 3.2 per cent in the same month in 1997. Thus, while Malaysian banks clearly suffered from the economic crisis that hit the region, they were in a much healthier condition than their counterparts in Indonesia and Korea. These findings are consistent with the state of corporate governance and prudential supervision in the three countries. Many banks and NBFIs were consequently closed down in Indonesia, Korea, and Thailand.

The following table summarizes the situation in Korea regarding bankruptcies of banks and NBFIs following the onset of the recent economic crisis.²⁰ It should be noted that the difficulties with some of the financial institutions are not over and that the list could grow longer, although overall, the financial sector has regained stability.

Table 1 Financial Institutions Suspended or Closed Recently in Korea
(as of June 1999)

	Total No. of Institutions (end-1997)	License Revoked	Suspended	Other Measures ¹⁾	Sub-total	Present No. of Operating Institutions
Banks	33	5	-	4	9	24
Merchant Banks	30	16	1	1	18	12
Securities Companies	37	3	3	-	6	32 ²⁾
Insurance Companies	50	4	-	1	5	45
Investment Trust Companies	6	1	1	-	2	3 ²⁾
Mutual Savings and Finance Companies	230	25	14	2	41	189
Credit Union	1 666	1	-	130	131	1 535
Leasing Companies	25	-	-	5	5	22 ³⁾
Total	2,077	55	19	143	217	1 860

Notes: 1) Including mergers by other companies. In the case of credit unions, bankruptcy is also included in this category.

2) Che-il Investment Trust changed into a Security Company (Jan. 1999).

3) Two new companies were established in 1998.

Source: Financial Supervisory Commission.

The final point we wish to make concerning the financial markets in Asia is that the markets are still underdeveloped in most countries. The markets for mergers and acquisitions are generally very thin. The market for various claims to insolvent firms is also very thin or nonexistent. Consequently, the trading of financially troubled firms or claims on them rarely takes place in the financial market. This market has been dominated by government businesses, such as Danaharta of Malaysia and KAMCO of Korea.

3.1.2 *Corporate Governance*

It is well known that the corporate landscape in Asia is dominated by conglomerates and that, except in Japan, Singapore, and in Hong Kong, China, conglomerates are tightly controlled by some families.²¹ Dominant families have been using schemes such as cross-shareholdings and cross-loan guarantees in acquiring and maintaining control of multiple firms in diverse industries. Self-dealing and the simple diversion of funds by dominant shareholders (managers) from the firms under their control were quite widespread in four of the six Asian countries, excluding Singapore and possibly Malaysia. It is true that these countries have laws and regulations designed to guarantee to minority shareholders certain rights to information and participation in decision-making.

However, when control is concentrated, rights of access to information and participation in decision-making may not be sufficient because dominant shareholders could override the opinions of minority shareholders by vote. Thus, the effectiveness of remedial measures available to minority shareholders is crucial when dominant shareholders or managers act against the interests of the firm or shareholders in general. Previous studies generally conclude that remedial measures are not effective in these countries²² and regulations concerning the accuracy of financial information provided by firms were not satisfactory either. Most of the above countries have introduced a wide range of reform measures to deal with corporate governance problems since the onset of the crisis. However, there is no evidence that the newly introduced reform measures are rigorously enforced.

It is hard to tell how the presence of such dominant families affects the behavior of a firm in reporting financial difficulties and in responding to bankruptcy situations in general. Nonetheless, it is reasonable to expect that a group of firms under the unified control of a dominant family, that are also interconnected by cross shareholdings and cross loan guarantees, is more likely to hide adverse financial information and resist entering into insolvency proceedings. The reason is that the dominant family has too much to lose by admitting difficulties or by agreeing to a reorganization plan that is acceptable to creditors. This is especially true when the firms as a group have excessive debts compared to their equities.

Cross-shareholdings and cross-loan guarantees could work in favor of dominant shareholders as they can give temporary assurance, however false these assurances turn out to be later, to creditors. However, the same strategies could send the whole group of firms into bankruptcy when only one or two firms performed poorly in their respective industries. This is devastating not only to shareholders and managers of most of the firms in a conglomerate, but also to creditors, as well as to the court and the government. An isolated incidence of

insolvency could quickly spread into the full-blown bankruptcy of a string of large firms with diverse stakeholders. In most developing countries, the bankruptcy of a major conglomerate is often more than enough to cause an economy-wide crisis.

As the legal infrastructures concerning corporate governance in these countries are not well-established, dominant shareholding families of Indonesia, Korea, the Philippines, and Thailand face the incentives described above, although the degree of the problem varies across countries. It should also be noted that the conflict of interest that arises at the lending stage due to the common ownership and control of firms and banks by the same dominant family extends into the monitoring and bankruptcy stages.

Dominant shareholding families in the four countries are likely to be an obstacle to the speedy and efficient resolution of insolvency problems. As majority shareholders of the firms under their control, the families usually have the ability to veto a reorganization plan legally in formal and informal bargaining proceedings.²³ Their threats to veto an efficient reorganization plan and to send the firms into liquidation unless they are guaranteed substantial shares of the firms could be credible under existing insolvency mechanisms. Thus, it is crucial for these countries to strike the right balance between protection of the rights of shareholders and protection of the rights of creditors of large firms. More fundamentally, these countries should try to overhaul financial systems that give distorted incentives to dominant families.

The corporate governance of firms that are in insolvency proceedings is another issue that has far reaching implications in most Asian countries. The country reports in this study generally indicate that debt equity swaps have been used in formal insolvency proceedings.²⁴ However, there are no reliable data on the extent of the use of debt equity swaps or the conditions of the swaps when they are used. Our tentative conclusion, based upon previous studies such as the ADB report, our country reports, as well as the results of our interviews with experts in the region, is that debt equity swaps generally do not involve significant changes in the corporate governance of debtor firms, even when they are used in formal reorganization cases.

This suggests that formal insolvency proceedings did not provide strong incentives to dominant shareholders to behave in ways that are compatible with economic efficiency. Although these studies indicate that debt equity swaps have been used in informal bargaining games, they do not give the details of the outcomes of these games, which are rarely revealed. However, scattered pieces of information concerning informal bargaining proceedings suggest that the corporate governance problems of the insolvent firms be serious.

First, old dominant shareholders are frequently given favorable treatment and are allowed to run the firms even in situations where it is clear that they are the source of the problems rather than a solution. Second, creditors sometimes do not act aggressively to install new management in the firms in which they hold large equities as a result of debt equity swaps.²⁵ Third, due to the concentrated ownership and control of firms as well as underdeveloped financial markets, it is not easy to find investors to whom creditors could sell the shares of the firms under their control after debt equity swaps take place, at least in the short run. As the creditors face the prospect of maintaining ownership of the firms for a longer term, they should try to take a systematic approach to the insolvent firms under their control. However, we have not yet noticed a significant improvement in this area.

3.1.3 *The Government*

In most East-Asian countries, the government intervened in the financial market in its pursuit of industrial policies. Korea presents the most extreme form of such industrial policies and offers a vivid example of the effect of industrial policies on the evolution of bankruptcy proceedings.

The Korean government took control of the banking sector in the early 1960s, directing banks as well as NBFIs to supply credit to the projects favored by the government. The most notable example of industrial policy in Korea is the government's promotion of heavy and chemical industries in the 1970s. At that time, the Korean government directed financial institutions to supply more than 50 per cent of the domestic credit to selected industries at a discount. Although the shares of most of the banks were sold to non-governmental institutions and individual investors in the early 1980s, banks remained under tight government control. More generally, the government continued to use the *chaebol* system by which financial resources are allocated to the group of firms controlled by *chaebol* families as a way to build and maintain modern industries that require large amounts of capital. The intervention by the government in the allocation of financial resources considered necessary in order to support the *chaebol* system.

It should also be noted that the *chaebol* system was generally incompatible with an advanced corporate governance system because it critically depended on the ability of the dominant families to move financial resources freely without due consideration of the ultimate owners of the financial resources, such as minority shareholders of the firms under their control or depositors of banks. Thus, regulations on corporate governance issues were weak and ineffective. The weak governance structures, together with the absence of a reliable mechanism to allocate financial resources based upon the profit incentives of investors, led

to the investment of huge amounts of funds in unprofitable projects. It is well known that many of the large firms that went bankrupt or fell into deep financial trouble over the past few years had been created by the allocation of financial resources directed by the government rather than the market, and that this in turn led to the collapse of many financial institutions.

The above arguments suggest that there is a possibility that the simultaneous collapse of a large number of firms in 1997 and 1998 may not have been due solely to an external shock, such as the rapid depreciation of the Korean won. It is possible that many of the firms finally collapsed because the financial institutions, which had fallen into deep financial trouble themselves as a result of the large scale bail-outs, finally became unable to support these ailing firms any longer. Thus, the systemic crisis could be rooted to domestic factors more heavily than external factors. Of course, the key external factors, such as the sudden reversal of foreign capital flows, can also be explained by the lack of reliable systems with respect to financial markets and corporate governance.

It is not surprising that insolvency proceedings have been heavily influenced by the government in Korea, considering the scope of industrial policies and the government's intervention in the financial market to support its industrial policy. Before the onset of the crisis, the majority of the large bankruptcy cases had been handled by the Korean government as a part of its industrial policy, and called "rationalization".²⁶ The main objective of the government in rationalization appears to have been restoring stability in the financial market and making the bankrupt firm solvent again. There was little discussion on the efficiency of the proceedings, such as a comparison of the going-concern value and the liquidation value, or an efficient division rule for the firm value. There was little room for creditors or shareholders (managers) of the bankrupt firms to negotiate either.

Although not in as extreme a manner as Korea, the other East-Asian countries have also depended on industrial policies. Indonesia and Malaysia attempted to build target industries through credit interventions by state-owned banks in the early 1980s, with disappointing results. Even after Malaysia gave up this kind of industrial policy, its government committed itself to a high-growth policy based on high investment, which eventually led, albeit indirectly, to the promotion of mega projects. Such a policy ultimately resulted in lower rates of return and an increase in non-performing loans. In addition, bail-outs had been widely conducted in Indonesia, Malaysia, and Thailand during the past financial crises, although Thailand did not actively promote the kind of industrial policies pursued by Indonesia, Malaysia, and Korea.

At least to the extent that industrial policy concerns interfered with the allocation of financial resources, the governments of these Asian countries

contributed to the determination of the insolvency proceedings that were in force. Ex ante intervention in the allocation of financial resources and ex-post intervention in the bankruptcy proceedings by the governments in the region, which often included large scale bail-outs, constituted a mechanism that gave distorted incentives to various economic agents in these countries. It is too early to tell whether these countries have begun to adopt alternative systems that are fundamentally different from the old system, and that depend more on market forces and contract-based institutional arrangements.

3.2 *Comparative Analysis of Formal Insolvency Mechanism*

In this subsection, we provide a comparative study on the strengths and weaknesses of the formal insolvency mechanisms of six East-Asian countries. In our study, we examine the insolvency mechanism of each country with a focus on its efficiency. To this end, five conceptual criteria are identified as important elements of the efficiency of the insolvency mechanism: 1) transparency, 2) expediency, 3) expertise and experience, 4) legal enforceability, and 5) ancillary institutional environment.

For transparency criteria, we analyze and compare the level of sophistication of the legal framework associated with insolvency proceedings, as well as the extent of discretion in actual rulings and practices by the court or the government. The expediency criterion refers largely to the procedural simplicity of the insolvency proceedings. To address the issues of expertise and enforceability, we first look into whether the mediator of the insolvency proceedings -- typically the court or the government -- is sufficiently equipped with the critical knowledge and experience required for making fundamental decisions. Two other aspects of expertise deal with the mediator's access to information in handling the insolvency proceedings, as well as the role and participation of creditors in the decision-making process. The enforceability criterion is largely concerned with the soundness of the judicial system, with particular emphasis on effective debt collection.

The last criterion, ancillary institutional environment, is not directly related to the efficiency of the insolvency mechanism. Nonetheless, we believe it is critically linked to the efficient functioning of the insolvency mechanism. No doubt, the existence of well-functioning financial markets facilitates the asset liquidation or debt collection process, which is the core ingredient of insolvency proceedings. Efficient financial markets are able to provide benchmark prices for debt equity swaps and the valuation of firms in question. These considerations are already reflected in the previous section. The ancillary institutional environment also addresses an incentive structure that is designed to prevent the moral hazard of managers and financial institutions. We examine

whether criminal or civil charges are pressed against managers of insolvent firms upon the investigation of their mischief or expropriations. Such charges will provide effective ex ante incentives for corporate managers and financial institutions to manage in the best interests of their respective shareholders.

3.2.1 Transparency

Transparency has been one of the most important principles of economic and legal reform in the crisis-hit countries in East Asia. Clearly, transparency is the prerequisite for the efficiency of the insolvency mechanism given the fact that the insolvency mechanism typically involves complex information processing and acute conflicts of interest among stakeholders. This is particularly so in the insolvency mechanism that is based on formal or informal bargaining procedures.

For insolvency mechanisms to be transparent, the minimum requirement is a set of fine statutory rules regarding the bankruptcy proceedings. Transparent and sophisticated rules of the bargaining game reduce uncertainty with respect to the outcome of bankruptcy proceedings, at least with respect to legal aspects, and hence, allow all the stakeholders of a bankrupt firm to play rationally. More importantly, transparency in the insolvency mechanism is crucial not only for ex post efficiency but also ex ante efficiency in that it can provide an incentive to managers of a firm to refrain from forbearance activities in the midst of financial troubles.

The crisis-hit countries, including Indonesia, Korea and Thailand, amended or overhauled their insolvency laws after the crisis. As a result, the degree of sophistication and transparency in the legal structure associated with their insolvency mechanisms has increased significantly. In 1998, Korea amended three insolvency laws, namely the Corporate Reorganization Act, the Composition Act, and the Bankruptcy Act, for the first time in any meaningful sense since their enactment in 1962. In Thailand, the Bankruptcy Act, which was legislated in 1940, was amended in 1998 and 1999 so that it now includes 97 articles. Indonesia was no exception with regard to amendments, as its 1905 Bankruptcy Act was substantially overhauled in 1998 with 289 articles.

In Malaysia, four formal insolvency mechanisms have been in place on the basis of the Companies Act 1965, the Judicature Act 1964, and the Bankruptcy Act 1967. Corporate workout programs, which are handled outside of the court, also have a legal base in the Pengurusan Danaharta Nasional Berhad Act legislated in 1998.

Singapore has perhaps the best developed legal infrastructure for insolvency mechanisms among the countries in our study. The Companies Act and the Bankruptcy Act (amended in 1995) constitute the legal base for dealing with corporate and personal bankruptcy cases, respectively. These two laws are equipped with sophisticated statutory rules regarding insolvency proceedings. In the Philippines, the Insolvency Law and Presidential Decree (PD) No. 902-A are the major pillars of the legal structure regarding insolvency proceedings. The suspension of payments in the course of corporate restructuring has its legal base in PD No. 902-A, which was rather quickly formulated under martial law in 1982. PD No. 902-A contains only a few provisions. As a result, statutory rules regarding bankruptcy proceedings are quite vague and leave large room for discretion, although precedents have provided some guidelines. In order to supplement the PD No. 902-A, “Rules of Procedure on Corporate Recovery” was drafted by the SEC, which has legal jurisdiction over the decision for suspension of payments, and put up for a public review in 1999.

Another element of transparency involves the consistency of court rulings and interpretation of related laws. In Indonesia, inconsistent court rulings related to insolvency proceedings can be easily found. Furthermore, past cases of court rulings are not well documented, nor posted in a public domain. These problems seem to have arisen largely as a result of unclear provisions in the Bankruptcy Law, particularly with respect to procedural matters. In actual practice, the procedural law used in bankruptcy trials refers to the Indonesian Civil Procedural Law. The definition of debt in the Bankruptcy Law has been interpreted in two different ways. On the one hand, the legal definition of “debts” has been interpreted to cover the broad definition envisaged in the law of obligations in the Indonesian Civil Code (ICC). On the other hand, the Supreme Court appears to have a totally different interpretation of debts as it narrowly defined them as the principal and interests. Consequently, only loans would qualify as debts under the Bankruptcy Law.

In some countries, the more serious problem is the court’s moral hazard or corruption. In Indonesia and the Philippines, the corruption in the judicial system is a major source of uncertainty and irregularities in the outcome of insolvency proceedings. The problem of moral hazard in the judicial system or with other authorities in charge of insolvency proceedings is common across most East Asian countries, with the exception of one or two countries. In these cases, the moral hazard stems largely from lack of expertise and knowledge of financial instruments and business practices.

3.2.2 *Expediency*

Expediency is key to the successful resolution of corporate failures. The value of an insolvent firm is likely to decay over time regardless of the modality of resolution. This is particularly so in cases of reorganization. It is not an easy task to compare the expediency of insolvency proceedings in an objective way. Concrete statistics for the settlement of cases are not easily available in some countries. Furthermore, given the fact that the new legislation has been in place only for a year or so, it would be premature at this juncture to assess the expediency aspect of insolvency proceedings for Indonesia, Korea and Thailand. This limitation needs to be taken into account in the comparative study.

In Indonesia, the amended Bankruptcy Act stipulates that the provisional arrangement plan shall be finalized within two months of the filing of the petition, and that the plan shall be implemented within 270 days of the finalization of the plan. In Korea, prior to the 1998 amendment of the insolvency laws, the time involved was usually about a year and a half from the filing of the petition to the approval of the reorganization plan. Since the amendment, the process appears to take about a year. According to the newly amended insolvency law of Thailand, the court is required to issue the commencement order within 3 weeks of the petition, approve the reorganization plan within 5 months of the commencement, and conclude the implementation of the plan within 5 years of the approval. In summary, the expediency of the insolvency proceedings seems to be improved, at least in terms of steps in and duration of procedures, in those three countries whose insolvency laws were amended after the crisis.

In Malaysia, the average time period from the commencement of the scheme of arrangement to the implementation of the arrangement plan is 8-12 months²⁷. Delays could arise from the fact that in many instances regulatory body approvals are required and these may take time. In the Philippines, as of November 1999, the average duration of the 30 pending cases for insolvency proceedings of the SEC exceeds 580 days. If those cases that were filed before 1999 are considered, the average duration is over 700 days.

In light of this, an efficient insolvency mechanism should be able to provide an expedient resolution both in terms of legal procedures and economic decision-making. Several factors can be identified as major determinants of the expediency of an insolvency mechanism. Transparent statutory rules are clearly one of such factors, as we have already analyzed in the previous section. The procedural simplicity of an insolvency mechanism is another important factor. For instance, the number of laws that govern the insolvency proceedings varies across countries. Furthermore, the number of steps within the insolvency

procedures is also different from country to country. Last but not least, expediency can be affected significantly by how the procedure is run.

(1) Procedural Simplicity

In order to address the issue of expediency, the legal framework associated with the insolvency proceedings needs to be examined at both the level of legal structure and individual laws. Table 4 summarizes the legal structure surrounding the insolvency proceedings in East Asian countries. As can be seen, Indonesia and Thailand seem to have the simplest legal structure for insolvency proceedings. All their proceedings are regulated by a single law, but the petitioner is supposed to choose between the liquidation and reorganization modality of the insolvency proceedings. Other countries in the study have separate laws governing the insolvency proceedings for each modality of the corporate resolution. For instance, Korea has three separate statutes for three different insolvency proceedings. Singapore is similar to the case of the US, in that the Companies Act includes three independent chapters and sections that respectively govern three different insolvency proceedings. The appointment of a receiver, however, has its legal base in common law.

Table 4 Legal Structure of the Insolvency Proceedings in EA Countries

Country	Procedure	Governance Law
Thailand	- Reorganization - Liquidation	- Bankruptcy Act
Indonesia	- Suspension of Payment (Reorganization) - Liquidation (Liquidation/Rehabilitation)	- Bankruptcy Act
Singapore	- Scheme of arrangement - Appointment of a Receiver - Liquidation - Judicial Management	- Sec. 210 of the Companies Act - Common Law - Part X of the Act - Part VIII A of the Act
Malaysia	- Liquidation of Corporate Entities - Scheme of Arrangement - Private & Court Approved Receiver	- Part X of the Companies Act - Sec. 176 of the Companies Act - Terms of a debenture
Korea	- Corporate Reorganization - Composition - Liquidation	- Corporate Reorganization Act - Composition Act - Bankruptcy Act
Philippines	- Suspension of Payment - Voluntary & Involuntary Insolvency	- PD 902-A - Insolvency Law

The fact that some countries have multiple laws governing insolvency proceedings is closely related to the historical evolution of their legal structures. In most cases, insolvency laws were enacted before their industrialization, and hence, focused largely on the personal bankruptcy of consumers or the self-employed. As a result, at the time of enactment the insolvency laws was more concerned with liquidation. However, in tandem with the rapid industrialization of these countries there has been a growing demand for distinct treatments of corporate and personal insolvencies. Consequently, new legislation or amendments address the issue of the reorganization of troubled firms. Such chronological development in legal demand has resulted in a system of multiple laws associated with insolvency proceedings.

The system of multiple laws seems to have some advantage and flexibility in that it allows managers of troubled firms and financial creditors to choose the modality of resolution at the initial stage of filing a petition for the court procedure. However, troubled firms can easily exploit such flexibility in order to buy time at the expense of creditors and other stakeholders. Furthermore, if the court dismisses the petition, then new insolvency proceedings for a different form of resolution commence again from the very beginning under the relevant laws, further delaying the resolution of a corporate failure.

In light of this, the system of multiple laws seems to be less favorable in terms of the expediency of insolvency proceedings. Several remedies can be suggested in this regard. First, the insolvency laws need to be structured to allow easy transfer of the cases from one procedure to another. Specifically, upon the dismissal of the petition by the court, the new insolvency proceedings need to incorporate the progress made in the previous proceedings, including for example, the results of due diligence and other considerations made by the court. Second, and more efficient, is to unify the multiple laws governing insolvency cases into a single law. Under the unified legal structure, the court can determine the choice of the modality of the resolution after careful reviews on the likelihood of rehabilitation. As the court's decision tree is internalized under the unified system, the insolvency proceedings can be shortened by preventing unnecessary duplication of common procedures, such as due diligence and the filing of claims.

Indeed, the recent trends in East-Asian countries are in favor of the unified structure, as can be seen in Indonesia and Thailand. Korea is no exception in this regard. Korea is currently working on amending the Corporate Reorganization Act and the Composition Act in such a way as to facilitate the transfer of cases across different insolvency proceedings. In addition, the Ministry of Justice recently launched a research project to explore the merits of a unified system for insolvency proceedings.

At the level of individual laws, the number of steps in the insolvency proceedings is an important indicator of the expediency of the insolvency mechanism. In Thailand, standstill is automatically applied upon the filing of the petition. This option can save time with regard to the deliberation on the desirability of a protection order. However, most countries are conservative in adopting such an option given the fact that it can restrict the creditors' rights.

Another issue related to expediency is whether the commencement of a formal procedure requires a formal court order or not. In Indonesia, once the bankruptcy petition has been appropriately filed at the Commercial Court and all legal requirements have been fulfilled, the bankruptcy proceedings should begin within 20 days from the date of the petition. In other countries, the court issues the commencement order only after a careful review of the legal requirements for the order, and this review process takes several weeks to several years.

Since the crisis, some East-Asian countries have substantially improved the expediency of the insolvency proceedings by introducing time limits for the interim steps of the formal procedures. Table 5 shows that in Indonesia, the newly legislated Bankruptcy Law introduced a time limit for each critical step in order to expedite the proceedings. In order to ensure the court's adherence to the pre-specified time limit, an automatic approval system was also adopted in which the failure to make any decision within the prescribed time limit automatically forwards the case to the next step. In the 1998 amendment of its insolvency laws, Korea also introduced provisions for time limits for critical steps of the proceedings, but the provisions are usually interpreted as a reference for the judge, not as mandates. The Thai Bankruptcy Act, amended in 1998 and 1999 respectively, provides time limits too.

(2) Quantum Requirement and Cram-down Option

The quantum requirement and the existence of a cram-down option are directly linked to the expediency of insolvency proceedings, but their mode and content vary across countries in our study. In all countries except for the Philippines, the insolvency proceedings for reorganization incorporate the quantum requirement, as summarized in Table 6. The general trend has been to ease the quantum requirement in order to improve the expediency of the insolvency proceedings. In the Philippines, the SEC handles most of the insolvency cases under the PD No. 902-A and is allowed to exercise discretion with regard to the design of a reorganization plan with no requirement for creditors' consent.

Table 5 Measures to Improve Expediency: Indonesia, Korea and Thailand

Country	Measure to Improve Expediency
Indonesia	<ul style="list-style-type: none"> <li data-bbox="331 279 1065 401">i. From the filing to provisional measures: Less than 30 days from the date of submission of the bankruptcy petition, because the petition itself must be decided within 30 days from registration with the Commercial Court. <li data-bbox="331 418 1065 618">ii. From the filing to the order of opening: Within nine days as of the date of registration of the bankruptcy petition with the Commercial Court, the Court must appoint a Panel of Judges and decide on the date of the first hearing, which may not be later than 20 days after the registration date. However, with the approval of the Commercial Court, the first hearing may be delayed for up to five more days. <li data-bbox="331 635 1065 722">iii. From the order for opening to the confirmation of the plan: Approximately 36 days, for the confirmation of provisional composition. <li data-bbox="331 739 1065 861">iv. From the confirmation of the plan to the closing of the proceedings: Approximately 225 days, for the completion of the permanent composition plan. Or, 270 days as of the date of the provisional composition as stipulated by the court.
Korea	<ul style="list-style-type: none"> <li data-bbox="331 928 1065 980">i. A provisional protection order shall be made within 14 days after the application date. <li data-bbox="331 998 1065 1119">ii. In reorganization procedures for small- and medium-sized enterprises, decision on the commencement of the procedure is require to be made within 3 months from the application date. <li data-bbox="331 1137 1065 1223">iii. The reorganization plan shall be submitted within 4 months after the last day for filing of claims and approved within 1 year after the commencement of the procedure. <li data-bbox="331 1241 1065 1328">iv. In composition procedures, the court shall decide the commencement of the procedure within 3 months from the application date.
Thailand	<ul style="list-style-type: none"> <li data-bbox="331 1397 1065 1432">i. From the filing to the order of opening: 3 weeks <li data-bbox="331 1449 1065 1501">ii. From the order of opening to the confirmation of the plan: 5 months

Table 6 Quantum Requirements for Reorganization Plan

	Secured Creditors	Unsecured Creditors	Shareholders
Indonesia - Composition Plan	Not required (the standstill is not applied to secured creditors)	1/2 in number & 2/3 in value	3/4 in case of asset grant as collection
Korea - Corporate Reorganization	3/4 (4/5 in an extraordinary situation)	2/3	1/2 (if shareholders have voting rights)
Korea - Composition	Not required (the plan is not applied to secured creditors)	3/4	Not required
Malaysia- Scheme of Arrangement	1/2 in number & 3/4 in value		Not required
Singapore - Scheme of Arrangement	3/4 in number & in value		Not required
Singapore - Judicial Management	1/2 in number & in value		Not required
Thailand - Reorganization	(Cases filed before April 22, 1999) 1/2 in number & 3/4 in value (Other cases) 1/2 in value of total debts and 1/2 in number & 3/4 in value from one affected group		Not required
The Philippines	Not required		Not required

The cram-down option rendered by the court aims at inducing a more efficient and expedient collective bargaining by discouraging a strategic holdout by marginal creditors. Korea provides an example of cram down. The Corporate Reorganization Act of Korea has a provision authorizing the court to approve the reorganization plan under certain conditions, even if the subset of creditors fails to reach an agreement on the proposed plan. The stipulated conditions, which are intended to protect the rights of dissenting interested parties, are as follows: 1) the collateral for the secured creditors is to be preserved, or 2) the proceeds from the sale of assets or collateral are to be fairly distributed to the secured creditors, unsecured creditors and shareholders respectively, or 3) fair values of claims determined by the court are to be paid to claim holders. In reality, however, the Korean court has never exercised such an option. In the Philippines, cram down does exist, in the sense that the SEC has the authority to approve any payment plans despite creditors' objections.

3.2.3 *Expertise and Experiences*

Any insolvency proceeding requires extremely complex information processing and professional judgement about the value of firms and the likelihood of rehabilitation, among other key considerations. In addition, insolvency proceedings are typically managed under strong pressure generated by the acute conflict of interests among involved parties. In light of this, the expertise of the court is an indispensable ingredient for the successful and fair resolution of corporate failures. The enhancing of expertise and expansion of knowledge cannot, however, be achieved overnight. The process requires a great deal of practical experience. In this sense, the lack of expertise is one of the most serious challenges faced by most East-Asian countries with respect to insolvency proceedings.

The issue of expertise in insolvency proceedings is not confined to the human capital of the court or other authorities. Rather, it can be extended to the realm of the institutional setup, that is, the access to accurate information by the key decision-makers, and the role of the creditors in the insolvency proceedings. An attractive option to address these issues is the establishment of specialized courts that have exclusive jurisdiction over insolvency cases. Another measure to ensure rational decision-making is to encourage the participation of creditors, incumbent managers and other experts in the insolvency proceedings.

(1) Specialized Courts

The capacity and knowledge of the mediator institution are critical components of a fair and efficient resolution of corporate failures. The first question that arises in this context is which institution, the court or the government, should supervise the insolvency proceedings. In principle, the court may have an advantage in terms of fairness and legal enforceability, assuming the judicial system is not corrupted. There is merit, on the other hand, in terms of specialty and efficiency if the role of the mediator is played by one of the executive branches of the government, such as the financial supervisory authority. It should be noted, however, that the answer to such a question varies across countries.

More important is how to upgrade the expertise and specialty of the mediator. In this regard, the establishment of a court that specializes in bankruptcy proceedings could be an answer. Specialized courts could be established within the existing judicial system to deal solely with corporate insolvency. Specialization would enhance the human capital and experience of the judges. Another alternative would be to create specialized courts outside of the existing judicial system, composed of not only judges but also business experts, such as

accountants and financial analysts who would be able to make decisions in a more efficient and expedient way.

In the Philippines, the venue for all proceedings under the Insolvency Law (enacted in 1909) has been vested exclusively in the regular courts. The economic turmoil in the Philippines that began to brew in 1979 created the need for the establishment of an agency that would be able to handle proceedings under the Insolvency Law with a high level of efficiency and expediency. At the same time, there has been a growing demand for an agency to supervise the rehabilitation process of troubled firms. In this regard, the SEC seems to be the logical choice for such an agency. Once it is given quasi-judicial powers, it may be able to act faster than the regular courts²⁸. The regular courts are hardly utilized for insolvency proceedings, as corporations prefer to seek debt relief from the SEC. However, the SEC has been criticized for its way of handling debt relief cases. The raised criticisms range from allegations of corruption, long delays in the procedure, the SEC being lenient to debtors and the prejudice of the creditors.

In Thailand, the new Bankruptcy Court commenced operations in June 1999, with 12 judges appointed²⁹. In Indonesia, in the year following the establishment of the first Commercial Court in Jakarta in August 1998 in the domain of the Central Jakarta District Court, four additional Commercial Courts were established. Commercial courts have exclusive jurisdiction over insolvency cases. Although it is premature at this time to assess the contribution of specialized courts to the efficient resolution of corporate failures, it is clearly expected that by establishing these courts, the respective countries will be able to acquire better knowledge and expertise in dealing with insolvency cases.

Although Korea had gone through long debates on the establishment of bankruptcy courts prior to the 1998 amendment of insolvency laws, the idea of specialized bankruptcy courts was not incorporated in the amendment. The main rationale behind such decision was three-fold. First, a more careful analysis of the costs and benefits of specialized courts is necessary given that the future trend in corporate bankruptcy is uncertain. Second, under the current system of judge rotation, the judges of the specialized bankruptcy court may not be able to acquire sufficient knowledge and expertise through learning by doing. Third, external specialists may enhance expertise of judges. Currently, Korea has a specialized division within each district court that has exclusive jurisdiction over insolvency proceedings.

(2) Participation of Creditors, Incumbent Managers and Experts

Financial expertise is a critical element of the efficiency of the insolvency mechanism given the complexity involved in the reckoning of composite information, such as financial and managerial data and the valuation of assets and liabilities. In general, however, it is hard to expect such skills and finesse from the ruling authorities of South-East Asian countries in their insolvency proceedings. There is little question that the participation of creditors and other experts in the insolvency proceedings will expand court access to necessary information and knowledge, particularly with respect to financial assessment and restructuring decisions.

The participation of creditors in the insolvency proceedings seems reasonable in that they have a host of financial information about the firm in question as well as technical expertise in the financial dealings of asset sales. The participation of incumbent managers of troubled firms, however, presents both merits and costs. The incumbent managers are perhaps best informed about the business prospects and the financial status of a firm, thus, utilizing their knowledge and information would enhance the efficiency of insolvency proceedings. At the same time, however, they may have distorted incentives with respect to the rehabilitation of firms due, for example, to a conflict of interests, moral hazard, and/or rent-seeking motivation, and hence could incur additional costs to creditors. The balance between these merits and costs needs to be carefully maintained.

East-Asian countries demonstrate differences in terms of the role of incumbent managers in the insolvency proceedings. In Indonesia and the Philippines, the bankruptcy laws render the incumbent managers a leading role in the rehabilitation process. The Bankruptcy Act of Thailand balances the interests of debtors and creditors. The law stipulates that in cases where more than one person is proposed as the planner, the person proposed by the debtor should be the planner. The creditors, however, can change the planner with a two-thirds majority vote.

In Singapore and Korea, the participation of incumbent managers in the insolvency proceedings is allowed or denied depending on the modality of restructuring. Singapore allows the company in question to execute and manage the rehabilitation measures itself under the Scheme of Arrangement. But in the case of Judicial Management envisaged in the Companies Act, a judicial manager appointed by the court carries out the rehabilitation plans. In principle, the court appoints an approved company auditor as a judicial manager so that his or her knowledge and information about the firm in question can be utilized in the rehabilitation process. Discharged debtors or persons who are deemed to be responsible for illegal acts in relation to the management of firms are excluded from the list of possible candidates for the judicial manager³⁰. Like Singapore,

Korea has different provisions for the participation of incumbent managers depending on the modality of the resolution. Under the Corporate Reorganization Act, the incumbent managers are excluded from the corporate reorganization proceedings, while they may continue to exercise managerial control in composition cases.

3.2.4 *Enforceability*

Given that debt collection is essential to any insolvency proceedings, perhaps the most important aspect of the judicial infrastructure with regard to insolvency mechanisms is legal enforceability, regardless of restructuring or liquidation. Creditors' confidence, or the lack of it, on the enforceability of debt collection will critically affect the behavior of not only the creditors themselves but also debtors.

In general, the Indonesian judicial system has not been effective in enforcing debt collection or bankruptcy proceedings. Judicial remedies are often time-consuming and expensive. Even more importantly, decisions made by the Indonesian judicial system have been inconsistent and unpredictable in that they are allegedly influenced by non-judicial factors, such as political corruption. In contrast, legal enforceability in Malaysia and Korea is reliable and effective, although considerable delays are often observed in obtaining hearing or trial dates due to the heavy loads of courts. Singapore's judicial system is highly efficient in that the debt collection is made in a timely and successful manner.

In Thailand, even before the economic crisis, the courts were overloaded with insolvency cases. The shortage of manpower and limited logistical capacity of the courts have been the biggest impediment toward justice. Despite the establishment of the new Bankruptcy Court in June 1999, there are more than 3,000 insolvency proceedings, including personal bankruptcy cases, to be dealt with in the court. The overload of the courts will not be eased for a considerable time in the future given that the number of cases filed for bankruptcy proceedings are on an increasing trend. In response, Thailand plans to establish regional bankruptcy courts in the future³¹.

Actual experience and know-how in dealing with insolvency cases also seem to affect enforceability in a positive way. Indeed, countries with a long history of personal bankruptcy laws have also shown relatively superior performance in the handling of corporate bankruptcy. Malaysia is a prime example in this regard. Prior to the formation of Malaysia in 1963, the State of Malaysia, Sabah and Sarawak had their own bankruptcy laws. Uniform legislation on bankruptcy was introduced in 1967, and since then, personal bankruptcy cases have increased significantly, as shown in Table 7. Malaysia's abundant experience in

personal bankruptcy cases seems to have served as an effective cornerstone for a relatively efficient corporate insolvency mechanism.

Table 7 Trends in Personal Bankruptcy Cases of Malaysia

Year	1950	1955	1960	1965	1970	1975	1980	1985	1988
Cases	15	51	44	129	336	286	857	1 888	4 920
Year	1990	1991	1992	1993	1994	1995	1996	1997	1998
Cases	4 202	7 695	7 273	7 035	5 780	5 954	6 711	7 395	8 110

Source: Official Assignee/ Official Receiver Office of Malaysia

3.2.5 Ancillary Institutional Environment

The effectiveness of criminal and civil charges against persons or parties who are liable for insolvency has strong implications for the behavior of corporate managers and owners. Obviously, an effective prosecution of, and civil sanctions against, fraudulent deeds would discourage such acts, and hence, reduce the frequency of insolvency. Prosecution and/or sanctions could also contribute to the successful recovery of losses by creditors and other stakeholders.

Pressing criminal and civil charges against managers of insolvent firms for their fraudulent actions or expropriations has important implications for the efficiency and the credibility of the insolvency mechanism, as it reduces the scope for moral hazard in an ex ante sense and establishes justice in an ex post sense. Specifically, it could enable creditors and shareholders to, at least partially, recover losses incurred by a manager’s expropriation. In addition, it could induce managerial efforts to maintain sound financial structures and to refrain from forbearance activities at the time of financial difficulties.

In Indonesia, company directors are subject to civil liability if they are responsible for corporate failures and incurred losses. They also could be pressed with criminal charges. However, the application of the Criminal Code seems to have been ineffective in that it takes an undue amount of time for the judicial proceedings in Indonesian courts to reach their final decision, not to mention the time needed to enforce such a decision. Because of this difficulty in pursuing claims through the Indonesian judicial system, civil claims on losses are generally settled through negotiations and compromises. Should such negotiations fail, individual creditors may either pursue legal actions through

the Indonesian courts or decide to write off these claims. Even the government of Indonesia is perceived as neglectful with regard to these issues, in that it has made no coherent effort to improve matters, although it has shown keen interest and sought aggressive restitution if the government itself suffers from any losses incurred by fraud³².

In Korea, insolvency in itself is not a crime, and accordingly, the managers of insolvent firms are not considered criminals. Neither the Corporate Reorganization Act nor the Criminal Code orders any criminal investigation upon the commencement of the corporate reorganization process. Criminal charges against a corporate director are not common in Korea, even in a bankruptcy situation. But the prosecutor may begin an indictment process against managers if evidence emerges of embezzlement or breach of trust in the midst of conflicts between creditors and the management of debtor companies.

Civil charges may be pressed against directors by their own company if they act against their duty or laws and cause damages to the company. Derivative suits may be used by the shareholder(s) with 3 per cent of issued shares (or more than 0.01 per cent for listed companies) if the company does not exercise its claims. The Corporate Reorganization Act stipulates a summary procedure, named 'assessment', against the directors who are liable for the damages of the failed company. If the damages are deemed to be caused by directors, the court orders the director to compensate for the pecuniary damages without resorting to a regular recovery suit, which is costly and time-consuming in nature.

Civil and criminal charges against directors have not often been exercised, particularly in the case of large companies, including listed companies. But the crisis in 1997 changed the situation to some extent. The rights of minority shareholders have become an important agenda item in citizen activism. An activist group brought a derivative action against the former president and directors of Korea First Bank. The local court ordered them to pay compensation of US\$ 33 million for the damages incurred by them to the Bank. The case was reported as the first derivative suit against a listed company in Korea's economic history. It is doubtful whether the accused directors can pay the damages because they do not have liability insurance or sufficient property to use as recompense. However, legal actions with respect to the responsibilities of directors are expected to increase, as shareholder activism has grown more prevalent after the crisis.

The insolvency laws of Malaysia have provisions for restitution in relation to the self-dealing of directors, fraud, and the misappropriation of corporate property. Criminal laws also allow sanctions against theft, expropriation of property, breach of trust, fraudulent deed and disposition of property. Therefore, as a matter of policy and practice, fraudulent deeds are to be punished at both

civil and criminal levels, rather than settled and hushed up. However, the success rate in the application of these laws is rather disappointing, mainly because of inadequate manpower and expertise³³. The special administrator is conferred with powers of investigation under the Pengurusan Danaharta Nasional Berhad Act of 1998. If fraud, malfeasance or other misconduct is found in the course of investigation, it is obligatory to report the findings to the relevant regulatory authority.

In the Philippines, it is possible in principle to press civil and criminal charges against directors and managers of failed firms. In fact, there has been a prevailing perception in the Philippines that corporate failures, particularly in the case of large failures, are mostly associated with corruption and fraud by the managers and owners of firms. As a result, civil and criminal charges have been pressed regularly whenever there is suspicion of managers' fraud. However, in many cases, criminal investigations cannot be executed due to the flight of the suspected managers to foreign territory³⁴.

Singapore has a strong legal base with respect to civil charges against liable persons or parties. In addition to criminal charges, under the Companies Act, the court can declare any person who is guilty of fraudulent trading to be personally responsible without limitation for the debts of the insolvent company. The application of criminal charges is effective. The prosecuting authorities regularly prosecute such fraud and the courts are prepared to impose deterrent sentences to uphold ethical standards of business³⁵. Thailand also allows both criminal and civil charges against fraudulent deeds.

3.3 *Comparative Analysis of Informal Insolvency Mechanisms*

The informal insolvency mechanisms of East Asian countries can be categorized into two types: a workout based on structured bargaining, whose rules are explicitly specified by laws, decrees or by a collective agreement in some countries; and a private arrangement made on a contractual basis. Structured workout programs have been implemented in Indonesia, Malaysia, Korea and Thailand, while private arrangements on a contractual basis have been utilized in all countries although its format varies widely from country to country. In this section, analysis will focus on the structured workout programs of the four countries.

Since the crisis, Indonesian financial institutions have suffered from an increased burden of foreign debt servicing due to the drastic devaluation of the domestic currency. Furthermore, the managers of financial institutions that had been newly appointed by the government did not have an effective incentive to strike a deal with debtor companies for debt restructuring. As a result, the

resolution of corporate failures has been delayed. Resorting to a formal insolvency proceeding, which is an alternative to structured bargaining at the private level, has been neither efficient nor preferred by creditors due to the underdeveloped legal framework and practices associated with the proceedings. Despite the fact that the 1998 amendment of the Bankruptcy Law provided a much-improved legal framework, the organizational capacity and human resources of the court appear insufficient to meet the extraordinary demand for debt settlement posed by massive bankruptcies, including those of large business conglomerates³⁶.

Under these circumstances, the Indonesian government launched the so-called “Jakarta Initiative” to push for the workout of ailing firms, and at the same time, established various institutions to support the workout program. The Jakarta Initiative was formulated to facilitate out-of-court commercial negotiations between creditors and debtors on an expedient basis. The President appointed the Jakarta Initiative Task Force (JITF) whose main functions are 1) to facilitate negotiation, 2) to refer cases of ‘public interest’ to the court under the Bankruptcy Act, and 3) to provide a central reference point for obtaining government approval necessary to implement the restructuring plan. The Indonesian Debt Restructuring Agency (INDRA), which covers the cases of non-financial business firms, has focused on the negotiation and settlements of foreign debts. The Indonesian Bank Restructuring Agency (IBRA) is a public agency established under Presidential Decree No. 27 of 1998, whose main duty is to handle and support the restructuring of the banking sector by injecting public funds for the disposal of non-performing loans and recapitalization.

According to the Jakarta Initiative, creditors form a creditor committee and make a preliminary agreement on issues such as standstill, interim financing and corporate disclosure. In the meantime, debtors prepare a business plan and corporate restructuring proposal to be submitted to the creditor committee. Advisors on the creditor committee, independent of the debtors, evaluate the company and make a report to the committee. The creditor committee negotiates with the debtors on the corporate restructuring proposal. The final approval of the plan by the committee requires that the creditors vote, and that the number of consenting votes meets the requisite level. Without the approval of the creditor committee or consent of the creditors, the firm is put into bankruptcy procedure or other proceedings. It should be noted that the Jakarta Initiative, which is an informal insolvency procedure, may be converted into a formal procedure. Given that unanimity among all creditors is illusive in practice, the newly amended Bankruptcy Act allows access to the Commercial court for approval of the pre-negotiated plan to make it binding on all creditors provided that the pre-negotiated plan complies with the requirements of the law. More than 250 workout cases have been registered to settle corporate debts through the JITF. Out of this, only 27 cases have been successfully completed.

In Malaysia, the informal workout appears to have been applied to corporate borrowers who have had a good relationship with their financiers and are seen as responsible. Formal bankruptcy proceedings have been immediately activated to other firms with no such established business reputation. In order to induce a more efficient resolution of corporate failures, the Malaysian government established three major institutions. First, the Corporate Debt Restructuring Committee (CDRC) was set up in July 1998 to provide a platform for both borrowers and creditors to work out debt problems to the mutual interests of both parties in an amicable and collective manner. This is to ensure that viable businesses continue to have access to financing.

The main objectives of the CDRC are to minimize losses to creditors, shareholders and other stakeholders by facilitating voluntary coordinated workouts, to preserve viable businesses, and to design and implement a comprehensive framework for debt restructuring. The workout process is composed of five steps: 1) initial meetings of debtors and creditors to explore debt restructuring and obtain a temporary standstill, 2) the formation of a creditor committee and the selection of a lead creditor, 3) the appointment of consultants if necessary, 4) consultants' initial review and recommendations on the viability of firms in question, and 5) the execution of restructuring plans with the approval of a formal standstill by creditors. The CDRC had received 48 applications for debt restructuring for a total amount of RM 22.7 billion as of August 1999. Two restructuring plans have been implemented thus far, and 26 Creditor Committees have been formed to oversee the restructuring efforts of the remaining cases.

Second, Danaharta was established under the Pengurusan Danaharta Nasional Berhad Act of 1998 as an institution that is equivalent to the Resolution Trust Corporation (RTC) of the United States. Danaharta has purchased and managed NPLs acquired from financial institutions amounting to RM 21.7 billion in total. Out of this, RM 15.1 billion was from the banking sector. These NPLs accounted for 20 per cent of the total NPLs in the banking sector as of the end of 1998. As a result, the size of the banking sector's NPLs (loans in arrears for 6 months or longer) as a percentage of the total loans declined from 8.1 per cent at the end of September 1998 to 7.6 per cent by the end of the same year.

In addition to its legal authority to purchase NPLs from financial institutions for the purpose of restructuring, Danaharta has been endowed with authority to manage corporate borrowers by appointing Special Administrators (SAs) with the consent of the Oversight Committee. Danaharta also has the power to impose a 12-month moratorium on all claims to allow the SAs to work out their restructuring proposals. Danaharta has adopted a market-based approach and international best practices in its operations with an emphasis on transparency and the disclosure of accounting information. Also, in order to ensure the

efficiency and transparency of the internal governance structure, Danaharta's board of directors includes two non-executive directors from the international community.

Third, Danamodal Nasional Berhad (hereafter, Danamodal) was established in August 1998 as a wholly owned subsidiary of Bank Negara Malaysia (Malaysia's central bank) to support the recapitalization of banks. Danamodal serves as an interim funding vehicle for banks in meeting capital adequacy requirements. As a strategic shareholder in the recapitalized banks, it also has played a catalytic role in facilitating the consolidation and rationalization process of banks. Danamodal had injected some RM 6.2 billion into ten banking institutions as of August 1999, out of the raised funds of RM 11 billion (RM 3 billion from the BNM's seed capital and RM 8 billion from bond issues). In order for the shareholders of recapitalized banks to regain their ownership, they have to repay Danamodal the injected principal plus 12 per cent premium per annum. Such a high premium reflects the authority's concern about moral hazard of bank owners and managers.

Prior to the crisis, Korea did not have well-structured workout programs. In response to a string of large bankruptcies of business conglomerates in 1997, financial institutions formulated the Anti-Bankruptcy Agreement and the Cooperative Loan Agreement with the objective of discouraging destructive debt collection by individual creditors. However, these agreements were not effective in that their internal incentive structure was not conducive to coordinated efforts and full participation by all creditors, nor were the decision-making criteria clear.

After the crisis, more sophisticated workout programs were devised based on the agreements made among financial institutions on corporate restructuring (Corporate Restructuring Agreements) signed in June 1998. The workout process is first initiated when the main bank of a debtor company calls for a meeting of creditor institutions. Upon this demand, all creditor institutions immediately suspend their claims for up to 4 months. During this temporary standstill period, due diligence is conducted by an accounting firm to assess the value of the firm for each contingency. Based on this assessment, a workout plan is negotiated in the council of creditors. The plan, usually prepared by the main bank, can include a wide range of restructuring measures: debt rescheduling and restructuring, additional financing, dissolution of cross loan guarantees, debt equity conversion, asset and business sales, and injection of fresh capital from foreign investors, among others.

The plan needs to be approved by the creditors representing more than 75 per cent of the firm's total debt. If the creditors cannot reach an agreement after three trials, the case is referred to the Corporate Restructuring Committee

whose arbitration ruling becomes final. Financial institutions that breach the Corporate Restructuring Agreement or the approved workout plan may be subject to penalties of up to the amount of 30 per cent of its claims or 50 per cent of the amount in violation.

As of June 1999, 81 companies in total were under the workout procedure, 77 of which had acquired a final approval for the proposed workout plans. The total indebtedness of those 77 companies turned out to be 33.6 trillion won. Out of this, 3 trillion won was converted into equity while 20.6 trillion won was rescheduled at reduced interest rates. In addition, the debtor companies pledged to execute self-rehabilitation efforts by raising new capital and/or reducing debts by 8.3 trillion won in total.

Actual progress in restructuring under the workout scheme, however, has been rather disappointing. By June 1999, only 2.7 trillion won had been recovered through self-rehabilitation efforts. Creditor banks have been more interested in securing their claims than supporting and supervising rehabilitation programs, whereas the debtor companies have been reluctant to accept debt for equity swaps for the fear of the loss of managerial control. Many financial experts have speculated that more than 60 per cent of the corporations under the workout programs will not be able to recover.

In Thailand, the 1998 amendment to the Bankruptcy Act introduced provisions for a court-supervised rehabilitation. This measure set the stage for the development of less formal workout programs. The Bank of Thailand (BOT) set up the Corporate Debt Restructuring Advisory Committee (CDRAC) in 1998 to take charge of informal workouts. The CDRAC consists of members from the BOT, the Thai Bankers' Association, the Association of Finance Companies, Foreign Banks' Association, the Board of Trade of Thailand, and the Federation of Thai Industries. An office of secretariat for the CDRAC was established under the umbrella of the BOT.

The operation of CDRAC refers to guidelines contained in the Bangkok Approach, established in August 1998. The guidelines stipulated in the Bangkok Approach have served as a non-binding and non-statutory framework for restructuring managed by the CDRAC. The CDRAC portrayed itself as a facilitator of negotiations between creditors and debtors. In March 1999, the Inter-Creditor Agreement was drafted as a binding device to encourage creditors to proceed in a more structured manner. Most financial institutions signed the Agreement under the supervision of the Bank of Thailand. Failure to comply with the agreed framework subjects the financial institutions to pecuniary penalties of at least 1 million baht but not exceeding 50 per cent of the claims.

Another agreement between creditors and debtors, the Debtor-Creditor Agreement, was produced in March 1999. This agreement is also to be used as a binding instrument for debtors and creditors to follow the stipulated restructuring scheme and the timeframe set up by the CDRAC. Failing parties are subject to at least a half million baht, but not exceeding 10 per cent of the claims. The agreement was later simplified in May 1999. The new agreement focuses on the resolution of failures of small- and medium-sized firms. The CDRAC asked each party financial institution (about 35) to file 15 to 20 petitions for restructuring per month. The Agreement also encourages creditors to be more proactive in supporting the rehabilitation of firms.

The CDRAC represents a structured mechanism whose working principles are borrowed from the Bankruptcy Act, but with increased flexibility. The CDRAC has encouraged financial institutions and debtors to submit petitions to its jurisdiction. The CDRAC accepted around 300 petitions for large companies in the first round, and then another 350 cases filed by financial institutions. Recently, the CDRAC has been working on selecting about 900 additional petitions to be filed for restructuring. At this juncture, it should be noted that many of the cases of voluntary restructuring that were settled outside of the jurisdiction of the CDRAC also received the same tax incentives and other supporting measures as the cases directly managed by the CDRAC.

In summary, informal insolvency proceedings of East-Asian countries incorporate most steps and measures stipulated in the formal procedures. Nonetheless, these countries show some difference in terms of actual practices and operation. For instance, Malaysia is different from Indonesia, Korea, and Thailand in that its government has not been involved much in informal settlements of corporate failures. Rather, it has limited its role to providing the legal structure for informal proceedings. In contrast, the governments of Indonesia, Korea and Thailand have played a leading role in inducing creditors and debtors to negotiate debt restructuring not only by establishing guidelines but also through mounting pressure for settlements, as implied by the Jakarta Initiative in Indonesia, the Corporate Restructuring Agreement as seen in Korea, and the Bangkok Initiative in Thailand.

4. Concluding Remarks

Most of the East-Asian countries have had a business environment that is more relationship-based than arms' length or market-based. In particular, the systems of these countries have failed in efficiently allocating financial resources in both the ex ante and ex post sense. Ex ante, the poor governance structures of financial intermediaries, as well as ineffective prudential supervision, have led to inefficient lending and monitoring activities. Ex post, insolvency mechanisms

were incomplete and inadequate and have led to inefficient outcomes with respect to the operations of bankrupt firms and the debts held by them.

In fact, as a result of heavy intervention by the governments in bankruptcy proceedings, formal and informal insolvency mechanisms that depend on the voluntary participation of stakeholders have not been given a fair chance of developing. Furthermore, the governance problems in firms and financial institutions gave the managers of both debtor firms and creditor institutions weak incentives to try to resolve insolvency in an efficient manner. We also found that the industrial policy of some of the governments was behind the inefficient insolvency mechanisms, most notably in Korea.

Except for the Philippines, all of the countries have court-supervised formal insolvency proceedings similar to the reorganization proceedings under Chapter 11 of the United States. However, we found that there is great room for improvement in terms of expediency and transparency in the way the formal bargaining is organized in most countries. Lack of expertise is another serious challenge faced by most countries. There is not only a shortage of experienced legal experts in these countries, but also a lack of institutional arrangements that allow relevant parties access to necessary information and to efficient ways of coordinating actions.

More fundamentally, bankruptcy proceedings are not recognized explicitly in most of the Asian countries as a bargaining process whose main objective is to induce an efficient and equitable reallocation of the resources of bankrupt firms through debt-equity swaps. As a consequence, bankruptcy proceedings frequently yield outcomes that involve unilateral forgiving of debts, the amount of which is often too small for the efficient operation of the firm and, hence, maximization of the economic value.

In most of the countries, except for Singapore and possibly Malaysia, informal bankruptcy proceedings are closer to government-managed financial rescue plans than voluntary bargaining played by lenders and debtors. It is also often the case that informal bankruptcy proceedings initiated by the government substantially replace court-supervised formal bankruptcy proceedings rather than the case of the latter determining the boundary of the former.

No country has adopted the absolute priority rule in formal or informal proceedings. Based on scattered pieces of information and results of interviews with experts in the region, we conclude that deviation from the absolute priority rule seems far greater than the level needed to induce efficient behavior of the managers of debtor firms in most reorganization cases. This suggests that reorganization plans are generally not consistent with the efficiency of the financial market.

Large deviation from the absolute priority rule also implies that the corporate governance of debtor firms in financial trouble is not changed much by the reorganization processes. Letting the old management team of an insolvent firm maintain control during and after insolvency proceedings is likely to entail higher risks of agency problems in East Asian countries than in more advanced countries, such as the United States. Many firms in the region, except in Singapore and Japan, share the characteristics that (1) they are run by dominant families, (2) they are heavily indebted, and (3) they have serious corporate governance problems. Consequently, it is often the case that the dominant shareholder of a bankrupt firm has been personally responsible for the failure of the firm and that his or her personal net wealth from the firm is negligible if a reasonable division rule is applied in the bankruptcy state. Allowing the dominant shareholder to continue to run the firm is likely to lead to serious asset stripping as his incentive to increase the firm value is small.

There is no single set of measures that fits the need of all of the countries in their pursuit of optimal bankruptcy proceedings, as they differ widely in their legal traditions, level of economic development, and so forth. However, we can offer the following observations that generally apply to most of the six Asian countries.

First, the reform of insolvency proceedings in the region should be part of a larger set of reform measures that includes liberalization of the financial markets, strengthening of prudential supervision and reinforcing of the institutional arrangements regarding corporate governance. In particular, the reform measures should give stronger incentives to managers of financial institutions to try to maximize the value of their institutions as creditors. This implies that the banks that have been nationalized should be privatized as early as possible and that the privatized banks should be allowed to be run by profit-oriented management. In addition, most of the countries seem to be in need of installing and enforcing a set of regulatory measures that could effectively deter bureaucrats and politicians from trying to interfere with the running of financial institutions.

Second, while the East-Asian countries undoubtedly need to increase the capacity of their court systems concerning insolvency and make a larger number of qualified professionals available, they also need to look at alternative proceedings that do not require much in terms of experts and resources. We believe that the key to reforming insolvency mechanisms lies in implementing a speedy and low-cost way of converting debts into equities based upon the valuation by market forces.

The Bebchuck scheme offers a good starting point for consideration. A variant of the Bebchuck scheme could be a more efficient alternative to mechanisms

that require costly bargaining processes or that crucially depend on the existence of a super arbiter who can be trusted by most stakeholders to possess superiority in information and computation as well as impartiality. However, it should also be noted that insolvency proceedings that rely on debt-equity swaps based upon market valuation of the firms require a well-functioning financial market to yield desired outcomes, which most Asian countries lack. Thus, improving the legal infrastructures with regard to corporate governance and the prudential supervision of financial institutions is seen to be a crucial element that critically affects the success rate of market-based reform of insolvency proceedings.

Third, we expect that the government will continue to play a key role in informal proceedings for quite a while as the reform in bankruptcy proceedings and normalization of financial markets will take considerable time in most countries. Thus, it is crucial that, during this transitional period, the government maintains transparency, efficiency, impartiality, and consistency in its role in informal bankruptcy proceedings. In the long run, as the formal bankruptcy proceedings and the state of the financial markets become sufficiently reliable and efficient, the government needs to reduce its role in informal proceedings and leave the resolution to voluntary bargaining by interested parties.

Lastly, we note that reform of the financial systems and insolvency proceedings will require reconsideration of the industrial policies that have been pursued by some countries in the region, as the reform will make it impossible to promote industrial policies that need heavy government intervention. In particular, for the funding of large-scale projects, reform in the financial systems and insolvency proceedings requires countries to adopt new ways of financing that depend on market forces rather than government intervention. We do not believe that the old mechanisms that allowed the government to allocate financial resources at the lending stages, as well as in bankruptcy states ceased to function after the onset of the crisis. In fact, we are not convinced that these countries have come up with an alternative system of allocating financial resources that replaces the old system.

NOTES

1. The relationship between a lack of institutional infrastructure and the recent economic crisis has been discussed by several authors. For instance, see Rajan and Zingales(1998) and Nam, Kang, and Kim (1999).
2. Unlike banks, non-bank financial institutions could be run by private shareholders. However, failure in the governance structures within these institutions and inadequate prudential regulation allowed dominant shareholders (managers) of many of these institutions to divert massive amounts of funds.
3. We also suspect that this systematic link between the financial sector and the insolvency mechanisms may also exist in such countries as Thailand, Indonesia, and the Philippines, where banks are owned and run by the families who also own and manage firms in the real sector under poor prudential regulation.
4. This paper is based in part on the country reports for the six countries. We also acknowledge that we benefited from the results of recent ADB research on similar issues.
5. Stiglitz (1999) gives an excellent review of the literature relevant to the efficiency of insolvency mechanisms, from which we borrow heavily here.
6. Similarly, insolvency proceedings will affect the supply of equity investment in the financial market.
7. To hide financial difficulties to creditors, to indulge in activities that lead to asset stripping, and so on.
8. Nam (1993) and Nam and Kang (1999) proposed mechanisms for Korea that can be classified as belonging to Regime 1.

9. Bargaining over an insolvent firm and its economic value almost never proceeds without some rules provided by the state. If there are no rules governing the liquidation or reorganization process of insolvent firms in a country, bargaining will proceed based upon other parts of the legal infrastructure, such as debt collection proceedings and the general clauses concerning property rights protection.
10. In some countries, agencies belonging to the administrative branch of the government are charged with the supervisory role. However, most countries that have this type of proceedings give the authority to the court, although the nature of the court and the degree of discretion given to the court vary from country to country.
11. Loss of efficiency will follow, directly from the definition of the optimal division rule.
12. For instance, most of the large insolvency cases that occurred during the recent economic crisis have been dealt with by workouts rather than by U.S. Chapter 11-style formal bargaining proceedings in Korea, Indonesia and Thailand seem to share the same tendency.
13. For instance, the methods in Aghion, Hart, and Moore (1992) that depend on the third party's decision fall in this category.
14. It should also be noted that ex post efficiency of an insolvency mechanism depends in part on the ability of the mechanism to restrain the strategic behavior of some creditors aimed at extracting concessions from the other stakeholders and thereby increasing their wealth. However, to the first order approximation, the profit-oriented management of creditor institutions is a dominant variable in any effective insolvency mechanism.
15. The industrial policies aimed at promoting an industry in the end lead to subsidies to firms. It is very difficult to distinguish industrial policies from firm policies designed to support firms rather than industries in some cases, especially when the government pushes to build an industry from scratch.
16. Country reports for this research generally support this conclusion, although they do not give definitive assessments or systematic analyses.

17. Korean banks have been subject to a restriction that limits their holdings in listed non-financial companies. The ceiling was 10 per cent before the onset of the crisis, which was later relaxed to 15 per cent in order for the banks to be able to participate in debt equity swaps involving bankrupt debtor firms. As mentioned above, banks in Korea did not have dominant private shareholders and as a consequence were not subject to the kind of conflicts of interest that the banks in the above three countries faced.
18. See, for instance, Corsetti, Pesenti, and Roubini (1998).
19. Two examples seem to aptly illustrate this point. A major bank that fell into financial trouble in 1998 as a result of the bankruptcies of its debtor chaebol companies offered a very high interest rate in a desperate attempt to attract savings and avoid bankruptcy. This method cost the bank heavily, and the bank eventually went under. In a parallel example, Daewoo Motors introduced a large discount on its automobiles, which was viewed by creditors as an asset stripping marketing strategy aimed at temporary relief from liquidity problems in the final days before bankruptcy was officially acknowledged.
20. Many financial institutions failed in Thailand and Indonesia too. However, we do not have data that accurately reflect the situation in the two countries.
21. For details on ownership distribution and concentration of control in Asian firms, see Claessens et al. (1998) and La Porta et al. (1998).
22. See, for instance, Nam, Kang, and Kim (1999).
23. For instance, a reorganization plan needs the consent of the majority of shareholders in order to be approved by the court in formal proceedings in Korea. In informal workouts too, a workout plan needs to get a majority approval at the general shareholders' meeting in addition to an approval of at least two-thirds of the creditors. Situations in the other countries are not much different.
24. For instance, Wisitsora-at (1999) reports that debt equity swaps are frequently included in reorganization plans in Thailand.
25. Probably because creditors are inefficient as financial institutions, due to their own poor governance structures.
26. See the country report for Korea for a detailed discussion on the rationalization policies of Korea.
27. Rabindra S. Nathan, Report on Malaysia (ADB, 1999) p.58.

28. Teodoro D. Regala, Report on the Philippines (ADB, 1999) p.39
29. Second Comparative Report, (ADB, 1999) p.57.
30. Sarjit Singh Gill, Report on Singapore (ADB, 1999) p.55.
31. Second Comparative Report (ADB, 1999), p.57.
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Appendix 1

SUMMARY OF INSOLVENCY MECHANISMS IN INDONESIA

I. Introduction

The insolvency statute of Indonesia is the Bankruptcy Law enacted in 1906 and amended in 1998. Despite the slow improvements in the implementation of the Bankruptcy Law, there has been some change in attitudes toward the use of formal insolvency processes. The Bankruptcy Law has played an instrumental role in encouraging corporate debtors to negotiate the settlement of their debts with creditors. While most creditors appear to be willing to endure some losses, they have been less tolerant towards substantial debt write-offs, not to mention the time taken for debt recovery through the insolvency process.

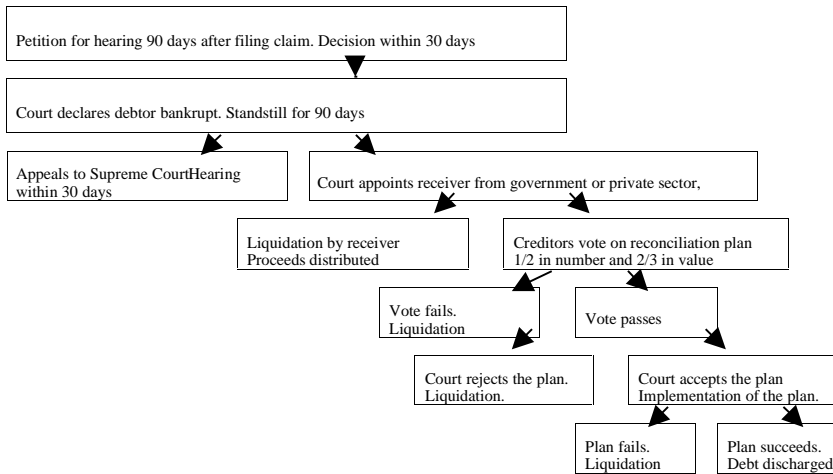
II. Court Procedure

Pursuant to the Bankruptcy Law, two insolvency procedures are available for corporate debtors: 1) a bankruptcy petition by debtor or creditors; and (2) an application for suspension of debt payments by the concerned debtor. Exclusive jurisdiction over insolvency cases is vested in the Commercial Courts, the first of which was established in August 1998.

(1) Bankruptcy Procedure

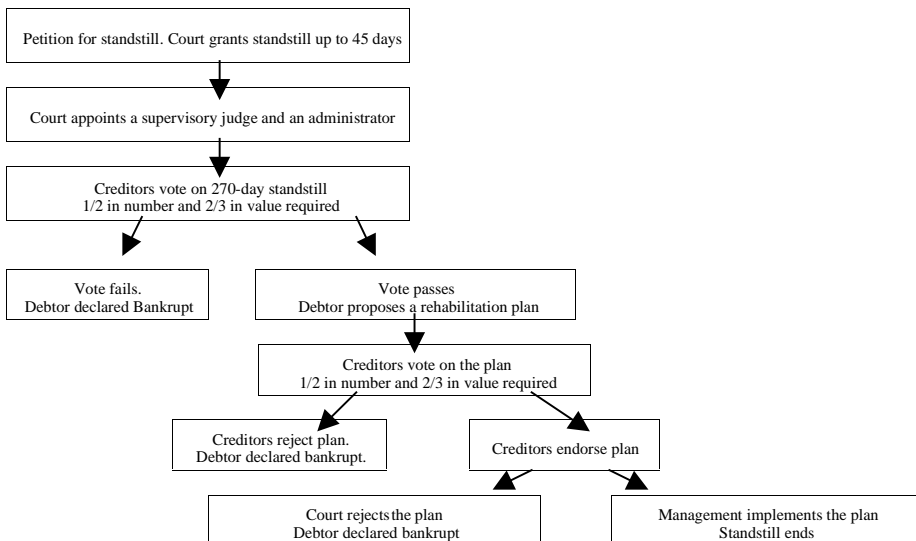
Chart 1 summarizes the operational structure of the bankruptcy procedures of Indonesia. Once the bankruptcy petition is filed at the Commercial Court with the fulfillment of all legal requirements, the bankruptcy proceedings should begin within 20 days after filing. The court may accept the petition by declaring the bankruptcy, or reject the petition. When the court accepts the bankruptcy petition, the settlement of debt payment will be undertaken by a receiver under the supervision of a supervisory judge. During the settlement process, it is possible that the corporate debtor will be restructured and reorganized by the receiver in order to maximize the value of bankrupt assets. If the creditors accept the reconciliation plan proposed by the debtor, then insolvency does not occur.

Chart 1 Operational Structure of the Bankruptcy Procedure



Source: Goldman Sachs (JCI: 367)

Chart 2 Operational Structure of the Reorganization Procedure



Source: Goldman Sachs (JCI: 367)

(2) *Reorganization Procedure*

As shown in Chart 2, the reorganization procedure begins with the petition for the standstill. Court may grant standstill up to 45 days. The court appoints a supervisory judge and administrator. The debtor and creditors jointly prepare the reorganization plan with the assistance of the appointed administrator and under the supervision of the Commercial Court. The incumbent managers continue to manage the company subject to the suspension of payment procedure. The creditors may also form a Creditors' Committee to oversee the management of the corporate debtor.

Over the period from August 1998 to October 1999, 112 petitions were filed at the Jakarta Commercial Court. Out of this number, 24 petitions for bankruptcy were accepted and 43 petitions were rejected, while 18 petitions were withdrawn for out-of-court settlements between the creditors and debtor. For composition and reorganization, 12 petitions were accepted.

III. *Workout*

After the crisis, Indonesian financial institutions suffered from an increased burden of servicing their foreign debts due to the drastic devaluation of the domestic currency. Furthermore, newly appointed managers of financial institutions by the government did not have an effective incentive to strike a deal with debtor companies for debt restructuring. As a result, the resolution of corporate failures has been delayed. Resorting to a formal insolvency proceeding, which is another alternative to structured bargaining at the private level, has been neither efficient nor preferred by creditors due to the under-developed judicial framework and practices associated with formal insolvency proceedings. Although the 1998 amendment of the Bankruptcy Law has provided a much improved legal framework, the organizational capacity and human resources of the court seem insufficient to meet the extraordinary demand for debt settlement posed by massive bankruptcies, including those of large business conglomerates.

Under these circumstances, the Indonesian government implemented various institutions and settlement schemes in order to facilitate the resolution of corporate failures. The Indonesian Debt Restructuring Agency (INDRA), which covers the cases of non-bank business firms, has been focusing on the negotiations and settlements of external debts and providing the debtor with exchange rate protection. The Jakarta Initiative was formulated to facilitate the out-of-court commercial negotiations between creditors and debtors on an expedient basis. The government plays a limited but crucial role in facilitating and encouraging the process. This initiative complements the newly amended

Bankruptcy Law and facilitates the bank restructuring process and the use of INDRA. The Indonesian Bank Restructuring Agency (IBRA) is a public agency established under Presidential Decree No 27 of 1998, the main duty of which is to handle and support the restructuring of the banking sector by injecting public funds for the disposal of non-performing loans and recapitalization. The Exchange Offer Program has dealt with the settlement of the foreign debts of the banking sector by converting the short-term external liability of domestic banks into new loans with a longer maturity of up to four years.

As a financial supervisory authority, the Bank Indonesia (BI) has played an active role in private debt restructuring by listing all corporate debtors with foreign debts. BI is also responsible for supervising and supporting the INDRA program. Since the onset of the crisis in 1997, more than 250 workout cases have been registered to settle corporate debts under the Jakarta Initiative. Only 27 cases have been successfully completed internally outside the court proceedings and the Jakarta Initiative scheme.

IV. Insolvency of Banks

Under Article 1 of the Bankruptcy Law, the petition for bankruptcy may only be filed against a bank by BI. Pursuant to Government Regulation No. 25 of 1999, the liquidation of a bank can be conducted in two ways: (1) by selling the bank's assets and/or claiming the receivables from the debtors, followed by the payment of the bank's obligations to creditors, and (2) by assigning all assets and obligations of the bank to another party approved by BI. In November 1997, 16 banks were closed and liquidated. Then, in April 1998, IBRA revoked the business licenses of 7 banks as a pre-step for the liquidation.

In May 1998, Bank Central Asia, Indonesia's largest private bank, was placed under the IBRA restructuring program. It was taken over by the government three months later. In August 1998, six banks run by IBRA were declared insolvent. Eventually, three of these were closed, while others were nationalized. In March 1999, the government closed another 38 banks and nationalized seven more banks. In April, Bank Niaga and Bank Bali were nationalized, as these two banks failed to raise new money for recapitalization.

Banks subject to the IBRA's restructuring process are being supervised intensively. The IBRA has restricted foreign exchange transactions and installed its officials to supervise these banks directly. In the case of nationalized banks, the IBRA immediately suspended shareholders' rights and replaced the banks' management. In conjunction with these measures, a governance contract is drawn up with a state-owned bank to provide new management with full control over the bank. For suspended banks, their liabilities to customers are transferred

to sound banks while rights of shareholders are suspended and management is replaced. Such actions have usually been followed by the revocation of the bank's license, and liquidation.

V. Discussion for the Future

In order to accommodate the needs of companies in financial difficulties and financial providers for a fairer and more just judicial system, the Indonesian government has been drafting a bill to amend the Bankruptcy Law. Another bill on Debt Restructuring and Company Reorganization also has been deliberated. In addition, the Parliament has also raised the issue of evaluating and examining the skills and accountability of Supreme Court judges.

To improve the efficiency of overall insolvency mechanism, several measures should be taken as follows. First, the salaries of judges and other government law enforcement officials should be substantially increased. Currently, the salary levels of judges are too low to prevent corruption. Second, an effective monitoring system for judges needs to be implemented. Judges need more training while incompetent judges should be dismissed. More importantly, corrupt judges should be prosecuted. To this end, judiciary reform should be a high priority, and the strong initiative of the government, including the Supreme Court, is crucial in this regard. Third, corrupt lawyers should be subject to disciplinary proceedings and prosecution. The creation of a single, mandatory, state-centered bar may assist in this effort.

Appendix 2

SUMMARY OF INSOLVENCY MECHANISMS IN KOREA

I. Introduction

Over the four decades of industrialization, the Korean government has intervened in financial markets within the context of industrial policy. It has not only directed credits to targeted sectors, but also bailed out troubled firms, particularly large corporations, for fear of the adverse impact on the overall economy and the soundness of financial institutions which are under government control. As a result, moral hazard problems have been prevailing in both financial and corporate sectors.

Rationalization measures have often been taken by the government in order to address the financial troubles and the insolvency of business firms until the late 1980s, the culmination of which was the so-called 'August 3rd Measure' which banned all payment of debts by companies by the Presidential Emergency Order. It was an emergency rescue measure to save insolvent companies that had suffered huge losses due to the first oil shock. The August 3rd Measure also included the Industry Rationalization Measure, which specified 61 types of businesses eligible for Industry Rationalization Support and provided them with financial and tax support.

After the crisis of 1997, the government addressed the bankruptcy issues of the top 64 *chaebols* and several large independent companies in three ways. The first consisted of an exit order by the main bank to companies that were deemed to stand little chance of rehabilitation. The second was the workout process. The third was an exchange of companies between the top five *chaebols*, referred to as Big Deals.

The exit order was executed for 55 selected companies, and the FSC ordered the creditor institutions to stop extending new loans and to call in existing loans when they were due. Most of those selected companies were merged into their affiliated companies or filed for the formal insolvency procedures. Only a

handful of them have actually been in the process of liquidation. The idea of Big Deals, originally political, is to exchange or merge some business sectors among *chaebols* in order to reduce their debts and concentrate on core businesses. Some business sectors including aeromechanics, trains, and petrochemicals were successfully restructured as a result of a mutual understanding among *chaebols*. The semiconductors sector was traded between the Hyundai and LG groups through government pressure. The Big Deals in the area of automobiles and electronics were not realized because of disagreement on debt appreciation between involved parties.

II. Formal Insolvency Procedure

Insolvency laws had not been commonly applied before the crisis in 1997. There were several reasons for this. The Civil Procedure Act has usually been employed for debt collection on an individual basis. In most cases, the demand for collective measures for debt collection was weak because most assets of a debtor were already subject to mortgage or security. Secured creditors divided their portion according to the order of priority. Almost nothing was left for unsecured creditors. Currently, Korea has three statutes on insolvency: the Bankruptcy Act, the Composition Act, and the Corporate Reorganization Act. The Bankruptcy Act deals with the liquidation of individuals and companies. The Composition Act provides composition (arrangement) proceedings for individuals and companies. The Corporate Reorganization Act covers the reorganization process of corporations (joint stock companies). First enacted in 1962, there had been no significant amendments to these statutes until 1998.

Table 1 **The number of cases under insolvency laws**

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
<i>Boodo*</i>	U/A	U/A	4,107	6,159	10,769	9,502	11,255	13,992	11,589	17,168	22,828
Liquidation	21	37	27	16	14	26	18	12	18	38	467
Composition	-	2	-	-	-	-	-	13	9	322	728
Reorganization	26	27	15	64	87	45	68	79	52	132	148

* number of companies which could not pay checks or notes

Source: Court Administration Agency (1998), Bank of Korea (1998)

1. *Corporate Reorganization*

Corporate reorganization proceedings are applied only to the insolvency of stock corporations, and normally initiated with the petition to the court for commencement by the insolvent firms to the court. As the Corporate Reorganization Act does not envisage automatic stays, the applicant firm should file a petition for a temporary protection order whereby an interim trustee is appointed, the disposal of assets and repayment of debt by the insolvent company are prohibited, and/or other enforcement procedures are stopped. All creditors are required to file their claims in order to protect them and to exercise their voting rights. In contrast, the failure to file claims does not result in their loss in case of composition.

Based upon the fixed claims and the result of due diligence, the trustee makes a draft of the reorganization plan. The plan must be presented to the court within four months from the petition. In order for the proposed plan to be implemented, it should acquire consents of the creditors and the approval of the court. As a reorganization plan is usually organized with a duration of 10 years, it takes several years to implement it completely. An M&A would be the common cause of early conclusion of the plan. If it becomes apparent that the company cannot be rehabilitated, the court may decide to discontinue the reorganization proceedings either before or after the approval of the plan. However, the change of the claims or discharge stipulated in the plan would be effective even after the cessation of the procedure once the plan is approved by the court.

Normally, the reorganization plan divides all stakeholders into four categories: creditors of common benefits, secured creditors, unsecured creditors and shareholders. The payment to creditors of common benefits has absolute priority over other claims. The plan usually allows junior claimants to be paid even if senior claimants do not acquire full payment. The differential treatment between secured and unsecured creditors has been applied in terms of interest rates and duration of payment. Debt restructuring, which is the most essential part of the plan, includes debt write-offs and rescheduling. The postponement of debt services can be made for a maximum of 10 years.

2. *Composition*

The composition procedure is similar to that of corporate reorganization, though there are several differences. Only the debtor, whether an individual and a company, can file a petition for the composition, and the petition should state the terms and conditions of the composition ("composition plan"), including the method of payment and the nature and extent of collateral. Automatic stay is not

allowed in the composition procedure either. Before the commencement of the composition, the court may issue a temporary protection order appointing an interim administrator and/or prohibiting disposal of assets and repayment of debt by the insolvent company. An order to stop other enforcement procedures is not allowed by interpretation. Upon the order of the commencement, the court appoints an administrator and sets the period for filing claims and the date for the creditors' meeting.

Creditors who intend to participate in the composition process must file their claims with the court in order to preserve and enforce their claims. Priority claims are not subject to the composition proceeding. Contrary to the corporate reorganization procedure, there is no process for the confirmation of claims. The list of claims is not deemed to be the title of debts. Even if a debtor does not file its claims, or part of them, by the fixed date, the debtor does not lose its claims. The filing is just for participation in the creditors' meeting and to exercise voting rights.

The administrator in the composition procedure does not have full authority, as in the case of the reorganization procedure. The administrator has authority to monitor the activities of a debtor. Transactions outside the scope of the ordinary course of business are subject to the consent of the administrator, and even transactions falling within the scope of ordinary business may not be undertaken if the administrator raises an objection. The creditors meet on a date fixed by the court and review the reports and opinions of the administrator and the examiner on the condition of the debtor. The creditors will then vote on the proposed terms of the composition. The acceptance of a composition plan by the creditors requires affirmative votes by a majority (in number) of the creditors present who represent three-fourths or more of the total amount of claims filed.

A composition plan accepted at the creditors' meeting will be examined by the court to see if it satisfies all the legal requirements. If it is found satisfactory, the court will approve the plan. The Court may order the debtor company to provide the shares of major shareholders as collateral to the creditor as a precondition to the commencement of the composition procedure. After the approval of a composition plan, the business is run by the debtor without any interference by the court. The implementation of the plan is placed in the hands of the debtor. The Court has discretion to discontinue the composition proceedings if it finds that the debtor has not met, or may not be able to meet in the future, repayment obligations.

3. *Bankruptcy*

A petition for bankruptcy may be filed by the debtor, its creditor or by a third party. In the case of a corporation, it may also be filed by a corporate director. At the time of adjudication of bankruptcy, the court appoints a receiver and the property of the bankrupt firm is converted into a bankruptcy estate and put into the disposition of the receiver. The receiver distributes the proceeds from the bankruptcy estate to the creditors in proportion to their claims, where claims entitled to distribution are differentiated according to whether or not a right of priority exists.

A bankruptcy proceeding is concluded with a court decision after the receiver has made final distributions and presented a report thereof at the creditors' meeting. Before such conclusion, a bankruptcy proceeding may also be discontinued by a court decision (i) based on an application of the debtor when the creditors have agreed to discontinue or (ii) based upon an application of the receiver or ex officio when the value of the bankrupt estate is smaller than the amount of the expenses for the bankruptcy proceeding.

III. Public Workout

Prior to the crisis, Korea did not have well-structured workout programs. In response to a string of large bankruptcies of business conglomerates in 1997, financial institutions formulated the Anti-Bankruptcy Agreement and Cooperative Loan Agreement, whose main objective was to discourage destructive debt collection by individual creditors. However, these agreements were not effective in that their internal incentive structure was not conducive for coordinated efforts and full participation by all creditors, nor were the decision-making criteria clear.

After the crisis, more sophisticated workout programs were devised based on the agreements made among financial institutions on corporate restructuring, (Corporate Restructuring Agreements) signed in June 1998. The workout process is first initiated when the main bank of a debtor company calls for a meeting of creditor institutions. Upon this demand, all creditor institutions should immediately suspend their claims for up to 4 months. During this temporary standstill period, due diligence is conducted by an accounting firm to assess the value of the firm for each contingency. Based on this assessment, a workout plan is negotiated in the council of creditors. The plan, usually prepared by the main bank, can include a wide range of restructuring measures: debt rescheduling and restructuring, additional financing, dissolution of cross loan guarantees, debt equity conversion, asset and business sales, and injection of fresh capital from foreign investors, among others.

The plan needs to be approved by the creditors representing more than 75% of the firm's total debt. If the creditors cannot reach an agreement after three trials, the case is referred to the Corporate Restructuring Committee whose arbitration ruling becomes final. Financial institutions which breach the Corporate Restructuring Agreement or the approved workout plan may be subject to penalties of up to the amount of 30 per cent of its claims or 50 per cent of the amount in violation.

As of June 1999, 81 companies in total were under the workout procedure, 77 of which have acquired a final approval for the proposed workout plans. The total indebtedness of those 77 companies turned out to be 33.6 trillion won. Out of this, 3 trillion won was converted into equity while 20.6 trillion won was rescheduled at reduced interest rates. In addition, the debtor companies pledged to execute self-rehabilitation efforts by raising new capital and/or reducing debts by 8.3 trillion won in total.

The actual progress in restructuring under the workout scheme, however, has been rather disappointing. By June 1999, only 2.7 trillion won has been recovered through self-rehabilitation efforts. Creditor banks have been more interested in securing their claims than supporting and supervising rehabilitation programs, while the debtor companies have been reluctant to accept debt for equity swaps for the fear of the loss of managerial control. Many financial experts have speculated that more than 60% of the corporations under the workout programs will not be able to recover.

IV. Bank Insolvency Regime

The Act on Structural Improvement of a Financial Industry regulates the bank insolvency. Prior to the crisis, this Act was never used to restructure or liquidate any financial institution despite the deteriorating soundness of financial institutions and growing concern regarding the poor performance of Korea's banking industry. Most of the problems were not exposed publicly or dealt with judicially. Some financial institutions were merged or acquired by other institutions under the guidance of the Ministry of Finance.

The financial crisis finally provided an opportunity to apply this act openly. The law gives the Financial Supervisory Commission (FSC) the authority to order management improvement measures, including mergers, the amortization of stocks, suspension of directors, appointment of trustees, transfer of businesses and third party acquisitions. The FSC may also suspend a bank's business for a stipulated period and cancel the bank's license.

On December 22, 1997, the FSC issued management improvement orders to Seoul Bank and Korea First Bank (known as Cheil Bank in Korea), two of the five largest banks in Korea. Two months later, the FSC issued management improvement orders to twelve banks that did not meet the BIS ratio. After reviewing the management normalization plans and performing an on-the-spot examination of assets, the FSC announced the liquidation of five banks and their acquisitions. Seven other banks have been restructured through mergers, new investment of foreign capital and trimmed business operations.

The FSC has continued the restructuring project on financial institutions on an ongoing basis. Sixteen out of thirty merchant banks, four securities brokers, four out of eighteen insurance companies, ten out of twenty-five leasing companies, and seven out of thirteen investment trust companies (ITCs) have been driven out of the market so far.

V. Discussion for the Future

There has been prolonged criticism in and out of the country that the reorganization procedure of Korea is too slow. However, no empirical evidence seems to support this criticism. Nonetheless, the government has taken some measures to speed up the initial process by proposing new amendments of the insolvency laws. The automatic stay was first considered but failed to be incorporated in the new amendments, as the introduction of automatic stay was seen as a form of favoritism to the debtor. Given the failure to introduce automatic stay, an alternative to the government was to reduce the time for the court to issue the commencement order to as short as one month. The commencement order has the power to stop all actions against the debtor's assets, as is the case with the automatic stay. Pursuant to the Draft Amendment, the court seems to grant the ruling to most companies filing the petition.

As mentioned earlier, Korea has three statutes on insolvency, which have different historical backgrounds and purposes. There has been much talk on the desirability and feasibility of unifying these Acts into one statute. A special project to draft a unified insolvency act will be launched next year after the submission of the final report of the joint research project with the IBRD to the Ministry of Justice. As the government plans to propose a unified insolvency act in a few years, the 1999 Draft Amendment covers just a few restricted areas so as to avoid any practical confusion.

Appendix 3

SUMMARY OF INSOLVENCY MECHANISMS IN MALAYSIA

I. Introduction

The concept of bankruptcy resolution within the judicial system has not been unfamiliar to the people of Malaysia. The nation had much experience with such practices even prior to the enactment of the Bankruptcy Act in 1967. Indeed, the number of personal bankruptcy cases had been steadily increasing since long before the legislation of the Bankruptcy Act. Such a historical background seems to provide a favorable environment for a corporate insolvency mechanism to be well established. In Malaysia, corporate insolvency is governed by the Companies Act and Companies Winding-up Rules. The Companies Act of Malaysia is largely similar to the Singapore Companies Act, although Singapore has no provisions similar to the Judicial Management of the Malaysian Companies Act.

II. Court Procedure

1. Court Approved Scheme of Arrangements

There is no Chapter 11-type reorganization process in Malaysia. A similar process is a scheme of arrangement pursuant to section 176 of the Companies Act. A scheme of arrangement requires the decision of the High Court. At the same time, it must have the consent of creditors before the court's approval. To obtain the consent of creditors, the scheme should acquire a majority vote of the creditors participating in the voting, and the acquired votes should represent at least 75 per cent of the total claims to the firm in question. The applicant firm can submit to the court the petition for granting an order of stay. All creditors of the company are bound by this statutory scheme and must comply with the terms thereof.

2. *Private or Court Appointed Receiver*

A secured creditor may appoint a receiver under the terms of a debenture. The receiver takes possession of the assets that are subject to the crystallized charge in the debenture instrument, and he may sell those assets through a private treaty. A court appointment is made when there is no express contractual power to appoint, but the assets of the debtor are in danger of being split away. The power of a court appointed receiver is spelled out comprehensively in the appointment order issued by the court.

3. *Winding Up*

Creditors can initiate winding up proceedings by filing a winding up petition under section 217 and section 218 of the Companies Act. The Petition is then advertised in two or more national newspapers and set for hearing. Any creditor is entitled to appear on the hearing of the petition to support or oppose the petition provided that he has filed a “Notice of Intention to Appear” beforehand. If the winding up order is made, the court will appoint a liquidator, who will oversee the liquidation process to ensure an orderly realization of assets and repayment of creditors and members.

III. *Public Workout*

In Malaysia, the informal workout seems to have been applied to the corporate borrowers who have had a good relationship with their financiers and are perceived to be responsible. Formal bankruptcy proceedings have been immediately activated at other firms with no such established business reputation. In order to induce a more efficient resolution of corporate failures, the Malaysian government established three major institutions. First, the Corporate Debt Restructuring Committee (CDRC) was set up in July 1998 in order to provide a platform for both the borrowers and creditors to work out debt problems to the mutual interest of both parties in an amicable and collective manner. This would ensure that viable businesses continue to have access to financing.

The main objectives of the CDRC are to minimize losses to creditors, shareholders and other stakeholders by facilitating voluntary coordinated workouts; to preserve viable businesses; and to design and implement a comprehensive framework for debt restructuring. The workout process is composed of five steps: 1) initial meetings of debtors and creditors to explore debt restructuring and obtain a temporary standstill, 2) the formation of a creditor committee and the selection of a lead creditor, 3) the appointment of

consultants if necessary, 4) consultants' initial review and recommendations for the viability of firms in question and 5) the execution of restructuring plans with the approval of a formal standstill by creditors. The CDRC has received 48 applications for debt restructuring of a total amount of RM 22.7 billion by August 1999. Two restructuring plans have been implemented thus far, and 26 Creditor Committees have been formed to oversee the restructuring efforts of the remaining cases.

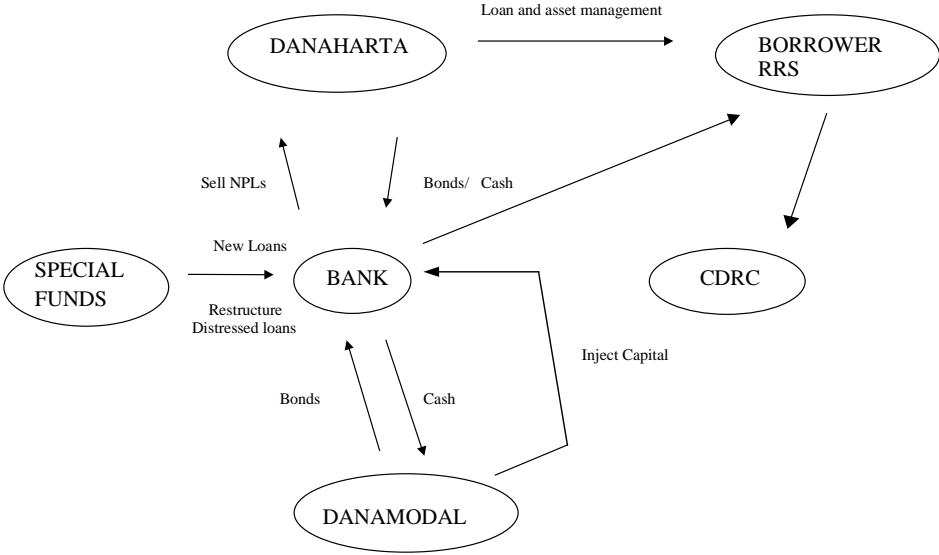
Second, Danaharta was established under the Pengurusan Danaharta National Berhad Act 1998 as an institution equivalent to the Resolution Trust Corporation (RTC) of the United States. Danaharta has purchased and managed NPLs acquired from financial institutions, amounting to RM21.7 billion in total. Out of this, RM15.1 billion was from the banking sector. These NPLs accounted for 20 per cent of total NPLs in the banking sector as of the end of 1998. As a result, the size of the banking sector's NPLs (loans in arrears for six months or longer) as a percentage of the total loans declined from 8.1 per cent at the end of September 1998 to 7.6 per cent by the end of the same year.

Danaharta has been endowed with legal authority to purchase NPLs from financial institutions for the purpose of restructuring, as well as to manage the corporate borrowers by appointing Special Administrators (SAs) with the consent of the Oversight Committee. Danaharta also has the power to impose a 12-month moratorium on all claims to allow the SAs to work out their restructuring proposals. Danaharta has adopted a market-based approach and international best practices in its operations with an emphasis on transparency and the disclosure of accounting information. Also, in order to ensure the efficiency and transparency of the internal governance structure, Danaharta's board of directors includes two non-executive directors from the international community.

Third, Danamodal Nasional Berhad (hereafter, Danamodal) was established in August 1998 as a wholly-owned subsidiary of Bank Negara Malaysia (Malaysian central bank) to support the recapitalisation of banks. Danamodal serves as an interim funding vehicle for banks in meeting capital adequacy requirements. As a strategic shareholder in the recapitalised banks, it also has played a catalytic role in facilitating the consolidation and rationalization process of banks. Danamodal has injected some RM 6.2 billion into ten banking institutions by August 1999, out of the raised funds of RM 11 billion (RM 3 billion from the BNM's seed capital and RM 8 billion from bond issues). In order for the shareholders of recapitalized banks to regain their ownership, they will have to repay Danamodal the injected principal plus 12 per cent premium per annum. Such a high premium reflects the authority's concern about moral hazard of bank owners and managers.

The CDRC, Danaharta and Danamodal operate in a systematic and sophisticated way with well-specified job descriptions for each institution, as summarized in Chart 1 at the next page. The CDRC arranges workout programs between creditors and debtor firms. Danaharta supports financial institutions (creditors) by purchasing NPLs from them. Danamodal injects new capital to financial institutions in order to make up for their capital losses incurred by the failures of their client firms. This triangular system reflects the tight linkage between financial and corporate restructuring. In other words, corporate restructuring inevitably erodes the soundness of financial institutions, while the financial health of creditors is crucial in inducing successful rehabilitation of troubled but viable firms.

Chart 1 Operational Scheme of Danaharta, Danamodal & CDRC



Appendix 4

SUMMARY OF INSOLVENCY MECHANISMS IN THE PHILIPPINES

I. Introduction

The Philippines is unique among the East Asian countries in our study in that the Securities Exchange Commission (SEC), which is not a judicial agency, exercises legal jurisdiction on formal insolvency proceedings according to the provisions in Presidential Decree (PD) No. 902-A. An amendment to the decree in 1981 authorized the SEC to act as the legal authority for regulating insolvency/reorganization proceedings (specifically, petitions for suspension of payments), previously regulated by the general courts under the Insolvency Law (enacted in 1909). Therefore, in the Philippines, not only the court, but also the SEC, can regulate formal insolvency proceedings. However, the SEC does not have its own implementing regulations with regard to the insolvency procedures under it. Instead, judicial precedents and a brief set of internal guidelines circulated in October 1997 provide the regulatory basis of the SEC proceedings.

II. Formal Procedure

1. Overview

The currently available insolvency mechanisms in the Philippines can be categorized into five procedures:

- Voluntary proceedings under the jurisdiction of the SEC for simple suspension of payments when the debtor has assets sufficient to cover all of its liabilities,
- Voluntary proceedings under the jurisdiction of the SEC for suspension of payments, coupled with a prayer for appointment of

a rehabilitation receiver or management committee when the debtor lacks sufficient assets to cover its liabilities,

- Voluntary insolvency proceedings for liquidation under court supervision according to the Insolvency Law,
- Involuntary insolvency proceedings under court supervision according to the Insolvency Law,
- Composition regulated by the court by which a debtor may avoid insolvency by reaching an agreement with its creditors at the early stages of a liquidation.

The procedure most resorted to is that of suspension of payments under the jurisdiction of the SEC. Although the court remains as a venue for both voluntary and involuntary insolvency proceedings, few entities, if any, have utilized this route in recent years. Table 1 summarizes statistics related to the SEC rulings on petitions for suspension of payments in recent years.

Table 1 Cases of Suspension of Payments (i.e. Reorganization)

	1995	1996	1997	1998	1999	<i>Total</i>
Filed Cases	10	9	19	36	12	86
Dismissed/Denied Cases	5	3	12	11	4	35 (40.7%)
Voluntarily Withdrawn Cases	2	1	3	5	0	11 (12.7%)
Rehabilitation Plan Approved Cases	1	4	1	4	0	10 (11.6%)
Pending Cases	2	1	3	16	8	30 (34.8%)

2. *Suspension of Payment under the SEC*

Although the Insolvency Law contains a detailed description of procedures for handling petitions for suspension of payments, the SEC has not followed them. Instead, the SEC follows its own set of policy pronouncements. A set of SEC guidelines, issued in October 1997, set forth a skeletal description of the procedures on how these cases should be settled. The guidelines and precedents establish the following framework:

1. A debtor files a petition attached with relevant financial information. In its petition, the debtor should indicate whether or not it is solvent.
2. The SEC appoints a three-person hearing panel that includes a SEC commissioner as a required member.
3. In cases of petitions for simple suspension of payments, the hearing panel issues a provisional suspension of payments order for thirty days. In cases of petitions with a prayer for the appointment of a rehabilitation receiver (where the debtor is insolvent), the hearing panel appoints an interim receiver and issues a provisional suspension of payments order for thirty days.
4. In both cases, creditors are required to comment on the petition within twenty days of the filing.
5. The hearing panel dismisses or grants the petition for suspension of payments (appointing a permanent rehabilitation receiver when warranted). Normally, the debt moratorium should not last longer than six months, although this period may be extended if approved by the SEC.
6. If the SEC determines during the proceedings that a more intrusive external management scheme is needed (for instance, if evidence of abuse by current management arises), it may appoint a management committee.

With such minimum standards, the judicial precedents have played a relatively important role. For instance, a series of cases in the mid-1990s established the principle that claims of secured creditors are stayed upon the appointment of a rehabilitation receiver. This was a particularly crucial development, as secured creditors were previously free to act unilaterally to enforce their claims under the Insolvency Law. This line of development also strengthened the SEC's arguments that the provisions of the Insolvency Law are not binding with respect to the suspension of payments cases before the SEC.

Recent studies of insolvency systems in the Philippines have characterized the SEC's procedures as being debtor-friendly and overly litigious. From an efficiency perspective, a debtor-friendly insolvency proceeding distorts pre-existing contractual arrangements and encourages forum shopping. Indeed, anecdotal evidence points out that financially troubled debtors have used the filing of a petition with the SEC as a threat to induce creditors' concessions toward individual arrangements.

III. Individual Arrangements

Partly due to the perceived shortcomings of the formal insolvency procedures at the SEC, and the difficulty of acting unilaterally to collect debt through the court rulings, banks and other creditors have actively undertaken individual arrangements as a means of resolving problem loans. The Philippines has no specialized legislation for initiating and finalizing workout negotiations. The basis for a workout is a contract between the debtor and its creditors. Usually the creditors act collectively in the negotiation with the debtor for a set of obligations to be applied to all creditors alike, after which individual loan agreements takes place by means of a novation.

The key players in a workout are primarily the banks and the debtor themselves. The government usually does not involve itself directly. However, debtors in several cases have been calling for regulatory actions by the government to improve the debtor's position vis-à-vis foreign competition (through higher tariffs) in order to make a debt restructuring plan more attractive and, hence, avoid a bankruptcy.

IV. Bank Insolvency Regime

The task of responding to bank insolvency rests with both the BSP (central bank of the Philippines) and the Philippine Deposit Insurance Corporation (PDIC). The Central Bank Act contemplates the appointment of a conservator or a receiver depending on the financial status of the bank in question. The body within the BSP that makes these decisions is the Monetary Board, which is headed by the Governor of the BSP.

If it comes to the attention of the Monetary Board that a bank is unable or unwilling to maintain a liquidity condition sufficient to protect the monetary interests of the depositors and creditors, the Board may appoint a conservator to take over the bank's operations. The conservator is on duty until the Board determines that the bank can operate on its own, or that the continued operation of the bank would result in losses to its depositor or creditors. In any case, the term of the conservatorship should not exceed one year and the conservator should be skilled in bank management.

The Monetary Board may close or suspend the bank and appoint the Philippine Deposit Insurance Corporation as a receiver under the following circumstances: (1) the bank is illiquid, (2) the bank is insolvent, (3) the continued operation of the bank would likely result in losses to bank depositors or creditors, or (4) the bank has violated a cease and desist order.

The PDIC receiver supplants the management of the bank by taking charge of its assets and liabilities and representing it personally for the benefit of the bank's creditors. The appointment of the receiver exempts all property of the bank from garnishment, attachment, or other collection proceedings. Within ninety days of the appointment of a receiver, the Monetary Board determines whether the bank is to be rehabilitated or liquidated. Liquidation entails the appointment of a liquidator, the approval of a liquidation plan, and the filing of a formal liquidation proceeding at the regional trial court.

V. Discussion for the Future

At this juncture, three reform issues can be identified with regard to formal insolvency proceedings. In the immediate term, the SEC needs to improve its own procedures for the suspension of payments cases. In the longer term, the Philippines needs to establish a more transparent and effective legal structure with respect to insolvency mechanism. To this end, several members of the Philippine Congress have called for new insolvency legislation. Finally, in addition to addressing the substantive rules, the Philippines should decide whether the SEC continues to remain as a venue of the resolution of corporate insolvency or not. The natural alternative would be to transfer the legal authority of the SEC to a specialized court or the regional trial courts.

The SEC has begun its effort to improve the regulations regarding corporate insolvency proceedings. In August 1999, after several months of drafting and deliberation, the SEC circulated the "Rules of Procedure for Corporate Recovery" to the public for review and comment. This circulation, as well as two public hearings on the Rules, generated a significant amount of input on how the Rules could be modified. By the time of writing this report, the Rules have not been finalized.

The Rules provide detailed regulations on two avenues of debt relief that had developed under the SEC. Rule III of the Rules governs petitions for suspension of payments and rescheduling of debts. Rule IV governs petitions for corporate rehabilitation. The Rules also establish the means by which a company would be liquidated when debt rescheduling or rehabilitation fails. From an efficiency perspective, a controversial question regarding the Rules is whether two separate routes (Rule III and IV) for corporate reorganization are necessary. It would be desirable if the Rules could minimize the debtor's stalling tactic of first seeking suspension of payments and then switching to rehabilitation.

Another controversial issue is the right of the creditors *vis-a-vis* the SEC in deciding whether a debt moratorium or rehabilitation plan is justified. The proposed Rules allow no creditor vote in connection with approval of a

suspension of payments order. With regard to rehabilitation, the proposed Rules allow the SEC to override the creditors' objections if it considers the objections manifestly unreasonable. In theory, the creditor-driven decision making is more likely to arrive at a more efficient solution. However, the introduction of creditor voting adds to procedural complexity and increases the likelihood of dispute and litigation, not to mention liquidation (when a plan is voted down). In contrast, the regulator-driven decision making can avoid procedural complexity and can push through rehabilitation, but is less likely to produce an outcome favorable to creditors. As currently being formulated, the proposed Rules are inclined toward the regulator-driven decision making.

The legislation that shapes the insolvency process in the Philippines includes the Insolvency Law, PD 902-A, the Civil Code, and to a certain extent, the Corporation Code. This patchwork of legislation appears to be internally contradictory, and offers insufficient coverage. Indications are that efforts to draft legislation that would address these concerns will begin soon. However, it will be several years before the new legislation is ready. In light of this, the reform of the SEC ruling process is crucial as an interim measure.

Appendix 5

SUMMARY OF INSOLVENCY MECHANISMS IN SINGAPORE

I. Introduction

Within a highly effective judicial system, Singapore has developed an efficient insolvency mechanism. In 1995, the Singapore Parliament passed the new Bankruptcy Act, which repealed the old Bankruptcy Act of 1888. The revision of the bankruptcy law was timely because when the economic crisis started, the insolvency mechanisms under the new Bankruptcy Act were well poised to deal with the economic crisis and instill confidence in the creditors as well as debtors. The Bankruptcy Act and the Companies Act regulate personal and corporate insolvency cases, respectively.

II. Court Procedure

In Singapore, there are four types of corporate insolvency mechanisms regulated by the court under the Companies Act.

I. Scheme of Arrangement

A scheme of arrangement may be proposed between a debtor company and its creditors or any class of them or its members or any class of them under section 210 of the Companies Act. The term ‘arrangement,’ in the context of insolvency, includes a reorganization of the share capital of a company by the consolidation of shares of different classes and/or by the division of shares of different classes. As a necessary condition for the scheme to become binding, a majority of the affected creditors representing at least 75 per cent of their total claims must consent to the arrangement. The arrangement will be made binding upon the approval of the court. No administrative organ needs to be involved in the implementation and management of a scheme of arrangement. It is often done by the company itself with its specialist advisors. In some cases, however,

a scheme may provide for an independent administrator to be appointed at the creditors' insistence in a corporate insolvency case. The powers and duties of the scheme administrator are determined by the scheme document.

2. *Receivership*

Under the provisions of a debenture document, the lender is entitled to appoint a receiver when the stated events of default arise. The appointment of receiver and/or manager is regulated by Part VIII of the Companies Act. The duty of the receiver is to realize the secured creditors' claims and, thereby, is not concerned with rehabilitation of the company. The effect of a receivership on the powers of the board of directors depends on the scope of the receivership. More commonly, a receivership will result in the company ceasing its business.

3. *Liquidation*

Liquidation of a company is regulated by Part X of the Companies Act. The entire liquidation process after the company is ordered by the High Court to be wound up is managed by the liquidator and the Official Receiver. The Official Receiver's Office is a government department, and by law the Official Receiver will become the liquidator of the company ordered to be wound up unless a private liquidator is appointed. Private liquidators are officers of the court and subject to the supervision of the Committee of Inspection, the High Court and the Official Receiver.

4. *Judicial Management*

In order to provide troubled but viable firms with some breathing room for reorganization, the Companies Act was amended in 1987 by incorporating a new Part VIII based on the administration provisions of the English Insolvency Act (1986). In judicial management, the company can continue its business under the control of the judicial manager. The directors of the company lose managerial control during the term of judicial management as the power of the board of directors is suspended upon the inception of the judicial management order.

A petition for judicial management may be filed by the company, its directors or creditors. The petition must nominate an approved company auditor to act as a judicial manager under the restriction that the auditor of the company in question cannot become a judicial manager.

When a judicial manager is appointed, he has 60 days to formulate and present a statement of his proposal before the creditors at a meeting called for that purpose. A creditor is not entitled to vote at the meeting unless he has first lodged proof of debt. A secured creditor is not allowed to vote if his security covers the debts owed to him. However, he may vote if he surrenders the security or if part of the debt owed to him is unsecured. The proposal may be approved by the majority of the creditors in number and value. Shareholders do not have any say in the approval of a plan. The meeting may propose modifications to the judicial manager's proposal, but they will be effective only if the judicial manager consents to the suggested modification.

In addition, the court cannot approve a proposed plan that fails to acquire the consent of the creditors. If the creditors reject the proposals, the court may require that the judicial management order be discharged. This is not the only case, however, as the court has wide powers to adjourn the creditors' meeting and issue interim orders that it thinks fit. Once the judicial manager's proposals are approved, he must manage the company in accordance with those proposals¹.

III. Workouts

Workouts in Singapore are not governed by statute or government regulation in any sense. These are purely managerial or contractual arrangements between the involved parties. The workout process is initiated by the banks and their borrowers. The government and supervision authorities are not concerned unless the liquidation of the borrower would have a substantial economic or social impact on the specific sector or economy in general. The sanctioning of the formal insolvency process generates pressure on the involved parties to agree. Also, the popular understanding in Singapore is that a successful workout would provide greater benefits to all of the parties than what one can expect from resorting to the insolvency law.

IV. Bank Insolvency

Under the Banking Act, any bank must notify its insolvency to the Monetary Authority of Singapore (MAS). Upon notification, the MAS may: 1) require the bank to take corrective measures that the MAS considers necessary, 2) appoint a person to advise and ensure that the bank is properly conducting its business and 3) take managerial control of the bank and continue business operations, or

¹ Sarjit Singh Gill, Report on Singapore (ADB, 1999), pp.44-45.

direct some other persons to do so. The MAS also has the power to file a petition with the High Court for winding up the bank.

V. Discussion for the Future

At the current stage, the main policy agenda in Singapore with respect to the insolvency mechanism addresses the issue of early discharge of individuals who become insolvent because of business misfortune. The major motivation behind such policy concern is that it is imperative for Singapore to encourage technology-intensive investments and businesses as well as enhance entrepreneurship and the corporate climate. In order to do so, corporate failures in the technology-intensive sectors must be carefully resolved, and effective rescue measures for insolvent individuals should be in place. In addition, the Official Assignee/Receiver also intends to study how he can further strengthen the business laws including those governing bankruptcy and insolvency so as to promote economic development.

Appendix 6

SUMMARY OF INSOLVENCY MECHANISMS IN THAILAND

I. Introduction

Formal insolvency procedures are currently governed by the Thai Bankruptcy Act. This Act went through four amendments in 1968, 1983, 1998 and 1999 since its enactment in 1940. Basically, there are two mechanisms provided by the current law: liquidation and reorganization. Under the new amendment, the Thai Parliament also gave approval to the establishment of a specialized bankruptcy court.

II. Formal Procedure

1. Liquidation

Upon the petition for insolvency proceedings, the court issues the receiving order if the petition meets the requirements specified in the Bankruptcy Act. Once the receiving order is issued, the debtor will cease control of his assets which are to be vested in the official receiver. By law, the official receiver must be a qualified lawyer recruited by the Ministry of Justice. It is the responsibility of the official receiver, with assistance from the creditors, to undertake the collection of all assets which are to be distributed according to the bankruptcy law. The official receiver may apply by motion to the court to nullify the transfer of property. Every unsecured creditor is required to submit a formal claim, known as a proof of debt, to the official receiver within a period of two months from the date of publication of the receiving order.

The debtor can be released from bankruptcy in three major ways – a composition after bankruptcy, a discretionary discharge or an automatic discharge. The debtor may propose a composition plan at the meeting of creditors to settle the issue. In order to become effective, the proposal needs a special resolution by a majority of creditors whose claims represent at least 75% of the total claims of creditors.

2. *Reorganization*

The reorganization procedure under the new law is more like a hybrid of US Chapter 11 and the Judicial Management of Singapore. The law subjects indebted enterprises to a reorganization proceeding if a creditor or the debtor files a petition with the court, and if the debtor owes at least 10 million baht to one or more creditors. Upon filing the petition, a moratorium or automatic stay comes into effect. A court trial is set to decide if the reorganization order is to be issued. It is stated very clearly in the law that the trial must be conducted in a speedy manner in order to prevent any delays. If the court decides that the debtor is insolvent but has the potential for successful rehabilitation, the court issues the reorganization order. Once the order is issued, the court appoints a planner to draft a reorganization plan. The planner also has the power to run the business during the reorganization process under the supervision of an official receiver and the court.

The proposed plan must be put to creditors' voting within three months of the appointment order and must be approved by a special resolution of creditors of a certain qualified majority. Only creditors who have filed proof of their claim within one month from the publication of an appointment order have the right to vote. If the plan receives approval from the creditors, it will then be submitted to the court for confirmation. Motions against the confirmation may be filed on the grounds of unfair treatment of creditors.

The debtor may have a strategic edge over the creditors, as the law stipulates that if there is more than one person nominated as the planner, the debtor's choice should be the planner, unless his choice is rejected by the two-thirds of the creditor's votes in value. Therefore, the incumbent management may or may not change hands during the formulation of the plan.

Once the plan is completed and submitted to the creditors' meeting, however, there may be another chance for management change. The proposed plan should specify the plan administrator, who will exercise the authority to run the business within the parameters of the plan. In Thailand, the planner and the plan administrator could be different people. The plan administrator must report on the implementation of the plan to the official receiver every three months. The new law gives the creditors complete decision-making authority over the future of the company as they can change the plan itself if deemed necessary. By October 1999, only 8 reorganization plans had been submitted to the creditors' meeting, five of which were approved.

Insolvency does not constitute a criminal offense in Thailand. Nonetheless, directors of companies still have a fiduciary duty to the shareholders and must inform them if the equity capital of the company depreciates to one-third of the

previous value. Failing to do so can lead to an order for compensation. To begin case proceedings the shareholder may rely on the law of torts. Due to the fact that most companies in Thailand are family-owned, it is rare to see any action raised by shareholders. The company law prevents shareholders and directors from being personally liable for the insolvency. However, the practice of Thai banks somehow forces stakeholders to give personal guarantees on loans.

III. Workout

In Thailand, the 1998 amendment to the Bankruptcy Act introduced provisions for a court-supervised rehabilitation. This measure set the stage for the development of less formal workout programs. The Bank of Thailand (BOT) set up the Corporate Debt Restructuring Advisory Committee (CDRAC) in 1998 to take charge of informal workouts. The CDRAC consists of members from the BOT, the Thai Bankers' Association, the Association of Finance Companies, Foreign Banks' Association, the Board of Trade of Thailand, and the Federation of Thai Industries. An office of secretariat for the CDRAC was established under the umbrella of the BOT.

The operation of CDRAC refers to guidelines contained in the Bangkok Approach, established in August 1998. The guidelines stipulated in the Bangkok Approach have served as a non-binding and non-statutory framework for restructuring managed by the CDRAC. The CDRAC portrayed itself at the beginning as a facilitator of negotiations between creditors and debtors. In March 1999, the Inter-Creditor Agreement was drafted as a binding device to encourage creditors to proceed in a more structured manner. The Agreement was signed by most financial institutions under the supervision of the Bank of Thailand. The failure to comply with the agreed framework subjects the financial institutions to pecuniary penalties of at least 1 million baht but not exceeding 50% of the claims.

Another agreement between creditors and debtors, the Debtor-Creditor Agreement, was produced in March 1999. The Agreement is also to be used as a binding instrument for debtors and creditors to follow the stipulated restructuring scheme and the timeframe set up by the CDRAC. Failing parties are subject to at least a half million baht but not exceeding 10% of the claims. The Agreement was simplified in May 1999. It is currently signed by more than 35 financial institutions with the BOT. The new Agreement focuses on the resolution of failures of small and medium-sized firms. The CDRAC asked each of those 35 financial institutions to file 15 to 20 petitions for restructuring per month. The Agreement also encourages creditors to be more proactive in supporting the rehabilitation of firms.

In summary, the CDRAC represents a structured mechanism whose working principles are borrowed from the Bankruptcy Act, but with increased flexibility. The CDRAC has encouraged financial institutions and debtors to submit petitions to its jurisdiction. The CDRAC accepted around 300 petitions for large companies in the first round, and then another 350 cases filed by financial institutions. Recently, the CDRAC is selecting about 900 additional petitions to be filed for restructuring. At this juncture, it should be noted that many cases of voluntary restructuring, which have been settled outside of the jurisdiction of the CDRAC, also receive the same tax incentives and other supporting measures as the cases directly managed by the CDRAC.

IV. Discussion for the Future

Although the functioning of the insolvency mechanism seems to have been improved since the onset of the crisis, the debtors still have only weak incentives to settle insolvency within the judicial system. The declining popularity of the reorganization procedure prompted the need for improvement of the system. At this time, the direction of improvement seems to be twofold. Specifically, it has been argued that the system should provide stronger incentives for debtors to use the system as a shelter and for creditors to use it as a bargaining leverage. From the perspective of the debtors, this argument suggests that the system allow debtors to have exclusive rights for the submission of a reorganization plan and the control of the company during the reorganization. From the perspective of the creditors, the argument implies that the creditors should be able to prove the insolvency of debtors more easily.

As the utilization of formal procedures has become less popular, the Ministry of Justice is now evaluating the situation. Although the recent amendment of the Civil Procedure Act improved the enforceability of debt securities, the actual effect is yet to be seen as the amendment has been in force for just a short period. The default judgment bill, whose passage has been pending in the Parliament, will have a positive impact on the enforceability of debt securities. The Ministry of Justice is now preparing another bill to expand the coverage of floating charges, which is also expected to significantly improve the Thai security law.

COUNTRY REPORT FOR INDONESIA

by
Darrell Johnson

I. A Summary of Overall Economic Conditions and the Extent of the Debt Crisis in Indonesia

A. *The size of debt by different groups of debtors and creditors, in both absolute terms and relative terms (e.g., relative to firm size)*

In spite of the fact that it is difficult to obtain information on the size of corporations with debt problems or their debt levels in particular cases, it is true that Indonesia's economic crisis has affected all corporations in Indonesia, irrespective of size. Corporates in particular sectors have been differently affected by the economic crisis. Figure 1 provides an illustration of the main trends in the Indonesian economy in 1998, and those estimated for 1999 through 2003, thus providing a general view of the impact of the economic crisis on Indonesia.

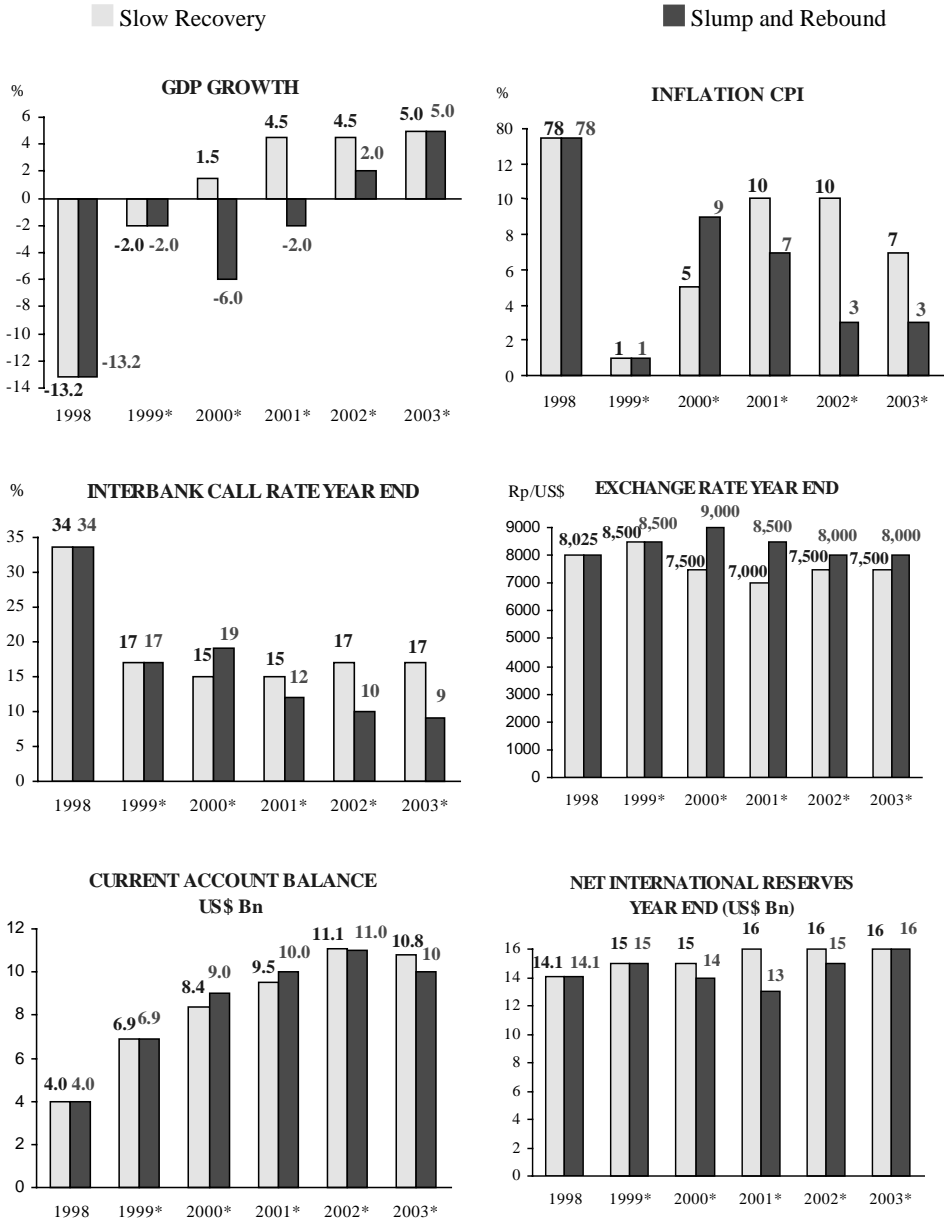
Figure 2 illustrates the decline of the Indonesian economy in various sectors, for the period 1997-1999

B. *The extent of bad debts and their impact on debtor firms, creditors and the government*

1. *Number and size of firms that fell into financial difficulty, the size of their bad debts, causes of the financial difficulty, and impact of financial difficulty on their performance in relevant markets*

The Jakarta Initiative Task Force ("JITF") has advised that as of July of 1999 there were over 2000 corporate debtors consisting of private and state-owned companies facing financial difficulties and requiring debt restructuring and reorganization. Another view of the magnitude of the problem is that the total non-performing loans by borrowers from Indonesian banks is approximately Rp.593.89 billion, or approximately US\$84.85 billion.

Figure 1 Main Trends



Sources: BI, CBS, TCG

Figure 2 **Decline of the Economy 1997 – 1999**

% by industrial origin			
		BPS	
	1997	1998	1999*
GDP	4.7	(13.2)	0.1
Construction	7.4	40.5)	0.1
Finance and Banking	5.9	(26.6)	(9.2)
Manufacturing Industry	5.3	(11.9)	0.4
Trade, hotel & restaurant	5.8	(18.0)	0.8
Mining & quarrying	2.1	(3.1)	(1.0)
Transportation & communication	7.0	(15.1)	3.3
Electricity, gas & water supply	12.4	1.9	3.3
Services & public adm. & defense	3.6	(3.2)	2.3
Agriculture, livestock etc.	1.0	0.8	1.2
% by type of expenditure			
		BPS	
	1997	1998	1999*
GDP	4.7	(13.2)	0.1
Imports of Goods and Services	14.7	(5.3)	(43.6)
Change in Stocks	(43.1)	(431.2)	(78.8)
Exports of Goods and Services	7.8	11.2	(34.0)
Fixed Capital Formation	8.6	(35.5)	(20.3)
Private Consumption	7.8	(3.3)	(0.9)
Government Consumption	0.1	(15.4)	1.8

*CBS estimate

Sources: CBS, Castle Group

A primary cause of Indonesia's financial crisis was that corporate borrowers financed long- and medium-term projects, with anticipated returns in Indonesian Rupiah, by borrowing foreign currency, principally in US dollars, on a short-term basis (i.e., commercial paper and promissory note borrowing) or on a medium-term basis. With the currency crisis, i.e., the devaluation of the Indonesian Rupiah following the decision by Bank Indonesia on 14 August 1997 to float the Rupiah, short-term lenders either called their debts or refused to roll-over debt on maturity, and Indonesian corporates were unable to meet their obligations. As Indonesian corporates began to fail, sources of local financing were unavailable or too expensive. As the local banking system began to fail, debtors were unable to switch into local currency obligations at any price. In a significant number of cases, these problems were exacerbated by derivatives transactions where corporates speculated against the Rupiah.

2. *Number and size of banks and non-bank financial institutions (NBFIs) that fell into financial difficulty, and size of their bad debts and capital shortage*

In 1997, 16 small to medium-sized commercial banks were closed and liquidated by the Government of Indonesia (the “GOI”) on the ground that they were insolvent. During 1998 and 1999, 41 banks had their licenses revoked, 11 banks were taken over by the Indonesian Bank Restructuring Agency (“IBRA”) and seven private banks were recapitalized by the Government.

The cost of private bank recapitalization is presently estimated to be approximately US\$100 billion. This figure continues to grow because of the interest obligations averaging 10-15 percent on bonds that were issued to support the bank recapitalization program. The Government also merged four state banks (Bank Exim, Bank Bumi Daya, Bank Pembangunan Indonesia and Bank Dagang Negara) into a new bank, Bank Mandiri, in August 1999. The cost of the recapitalization of Bank Mandiri is thought to be about US\$20 billion. The Government is also in the process of recapitalizing the remaining three state banks, Bank Rakyat Indonesia, Bank Negara Indonesia and Bank Tabungan Negara, but it is too early to determine the cost of recapitalization of these banks.

The following tables provide details on the non-performing loans of Indonesian banks.

Figure 3 Non performing Loans – Indonesian Banks¹
as of December 1998

Type of Bank	Credit Amount (Rp. Trillion)	Non performing Loans	
		(Rp. Trillion)	(%)
National Private Banks	545	316.1	58
State-Owned Banks	280	145.6	52
Foreign Exchange Private Banks	180	129.6	72
Non Foreign Exchange Private Banks	7	2.59	37

1. InfoBank, Indonesian monthly magazine on banking, March No. 235/1999.

Source: Bank Indonesia; reprocessed by the Research Bureau

Figure 4 **Non-Performing Loans at State-Owned Banks by Category and Projection** (in Rp Trillions)

Collectability	March 1999					December 1999				
	BNI	BRI	BTN	Bank Mandiri	Total	BNI	BRI	BTN	Bank Mandiri	Total
Special Attention	9	2.1	0.9	12.8	21.7	10.3	2.0	0.6	6.8	19.7
Substandard	7.2	1.9	0.8	15.2	25.1	3.2	5.8	0.4	8.9	18.3
Doubtful	16.4	8.6	0.3	21.3	46.6	2.1	2.7	0.1	5.5	10.4
Loss	0.9	2.2	0.4	2.0	5.5	0.3	2.2	0.0	3.0	5.5
SUB TOTAL	30.4	14.8	2.4	51.3	98.9	15.9	12.7	1.1	24.2	53.9
Liquid	13.8	18.6	5.9	0.4	38.7	20.9	21.1	7.1	27.4	76.5
Total Non Performing Loans	44.2	33.4	8.3	51.7	137.6	36.8	33.8	8.2	51.6	130.4

Source: The Office of the State Ministry for the Empowerment of State Owned Enterprises

C. *The impact of the economic crisis on debt problems*

The corporate debt problems in Indonesia are both an effect and cause of Indonesia's continuing economic crisis. The effect of the monetary crisis and specifically the devaluation of the Indonesian Rupiah on Indonesian corporates have been discussed above. In addition, the problems of Indonesian corporates led to the collapse of the Indonesian banking system. As the statistics indicated above demonstrate, Indonesian corporates are unable to service their debts. Even those Indonesian corporates whose businesses generate export earnings or which have been relatively unaffected by the economic crisis (such as Indonesian agricultural companies) are unable to raise capital from a moribund banking system. It is widely perceived that until the banking system can be re-built, so that funds can be channeled to productive enterprises, Indonesia's economy will continue to stagnate. The Government has sought to re-build the Indonesia banking system by closing some banks, re-capitalizing others and merging yet others. In addition, the Government has sought to encourage corporate debt restructuring through the adoption of both formal (a new bankruptcy law) and informal mechanisms (such as the Jakarta Initiative Task Force or "JITF").

The JITF, supported by the International Monetary Fund and the World Bank, should help accelerate the Indonesian economic recovery by increasing employment opportunities, promoting the recovery of the banking and financial sectors and generating tax revenues for the state. JITF aims to promote the availability of interim financing to companies being restructured, as well as to assist these companies in preparing their restructuring proposals to be effectively evaluated by their creditors.

An out-of-court commercial negotiation between a company and its creditors, on an expedited basis, is the best method to accomplish corporate debt restructuring. The Government should play a limited but crucial role in facilitating and encouraging this process such as by providing a fixed exchange rate determined by the Indonesian Debt Restructuring Agency (“INDRA”).

Another agency set up with regard to company reorganization, especially for commercial banks is IBRA. IBRA is an institution directly under the control of, and responsible to, the Minister of Finance of the Republic of Indonesia. IBRA was first established by Presidential Decree No. 27 of 1998 (26 January 1998). By the issuance of Government Regulation No. 17 of 1999 (27 February 1999), IBRA was appointed as the special institution in charge of handling the Indonesian banking restructuring program as referred to in Law No. 10 of 1998 on the amendment to the Banking Law (Law No. 7 of 1992).

D. The degree of effectiveness of insolvency mechanisms on the economic crisis

The Indonesian Bankruptcy Law, Law No. 4 of 1998 (9 September 1998), (the “Bankruptcy Law”), was adopted by the Indonesian Government in response to Indonesia’s economic crisis. The Indonesian Government had determined that an effective bankruptcy law was an important component of its plan to restructure Indonesian corporate debt. The expectation was that if a number of companies were declared bankrupt and liquidated, or went into successful restructuring plans under the procedure contained in the Bankruptcy Law, other corporate debtors would be encouraged to reach settlements with their creditors and the corporate debt backlog would be reduced. Unfortunately, these expectations have not been realized.

It is first important to note the accomplishments that have been realized by the Bankruptcy Law:

1. Expedited Proceedings: The Bankruptcy Law established expedited procedures to decide bankruptcy cases and these have largely worked as planned.
2. Written Decisions: The Bankruptcy Law requires written decisions to be issued and this greater transparency in the judicial process is an important step forward in the area of judicial reform generally. Publicly available written decisions allow for evaluation and criticism of the decisions rendered by the Commercial Court and the Supreme Court, in order to judge their effectiveness.

Despite the above improvements, the Bankruptcy Law has not achieved the goal of encouraging out-of-court restructuring of corporate debt. Different opinions, of course, exist concerning the decisions of the Commercial Court and the Supreme Court. However, it is widely felt that many of the decisions have not applied the law correctly based on the known facts of these cases. A description of some of the more significant decisions are set forth below in Section H.1.

There is wide-spread speculation about the reasons for these results, ranging from an inadequate understanding of the legal principles involved to allegations of corruption and collusion. In any case, the adoption of the Bankruptcy Law has had no obvious effect on corporate debtors' incentives to restructure their debt.

Up to September 1999, 350 cases had been handled by the JITF involving 250 medium to large-scale companies. Twenty-seven restructuring cases have been successfully completed. This represents slightly more than 10 percent of the total cases recognized by the JITF.

It would appear that, in general, debtors are not afraid of adverse results from the bankruptcy system and have taken the view that it is preferable to wait out the problem in the hope that (i) general improvements in the economy will help save their business and (ii) creditors will grow discouraged with the lack of results with the bankruptcy law and will eventually accept a more favorable settlement, from a debtors' point of view, than they are now willing to do. Some debtors have also expressed the view that eventually the Government will set the terms of a debt write-down to be applied to all debtors across the board, or perhaps to specific sectors across the board, and that it is better to wait for that result than to negotiate individually. To a degree, this view is encouraged by the fact that so much corporate debt is in the hands of IBRA, because IBRA has acquired much of Indonesian corporates debt through its control of Indonesian private banks.

Creditors, for their part, have been generally unwilling to accept debt reduction. In part, creditors were encouraged that the Bankruptcy Law would be effective and they waited for the decisions of the Commercial Court to debtors the incentive to voluntarily restructure their debt. As noted above, this has not occurred. Complaints about the Commercial Court's decisions have become so common and widespread that some creditors believe the Indonesian Government will eventually be forced to deal with this problem. This expectation, which has grown as a result of the new Indonesian Government, has lead to a wait-and-see attitude on behalf of some creditors.

Many creditors also seem as yet unwilling to accept that there is little likelihood of recovery of a substantial part of their debts. The devaluation of the

Indonesian Rupiah has left many corporates unable to pay their foreign debts. Sufficient revenues cannot be generated in Rupiah to do so. This has made it difficult to find a common ground for compromise.

II. A Summary of the Characteristics of Debtor-Creditor Relationships

A. Banks

a) Banking Industry Configuration

A distinction must be drawn between Indonesian private banks, Indonesian state banks and foreign banks. With Indonesian banks (both state and private), the business relationship between debtor and creditor has been permanent. Loan documentation and even rigorous credit review have been of secondary importance. This focus on the business relationship, combined with poor corporate governance within the banks themselves, may have led to poor lending practices. For example, it is commonly believed that collateral was over-valued in many cases to justify loans that would not have otherwise been made. In any case, there is a significant difference in the complexity and sophistication of loan documentation between Indonesian and foreign banks.

As between local banks, state banks have been in a preferred position because Indonesian debtors have tried to maintain their relationship with state banks above all others. The power of the state to seize assets of debtors if the state suffers losses has also encouraged debtor compliance with the requirements of state banks.

In the case of local banks, loan documentation tends to be much less complex than it is for foreign banks. While extensive security interests are commonly taken by both types of banks, the security documentation in the case of foreign banks again tends to be more complex than that for local banks. Foreign banks tend to conduct extensive due diligence of their borrowers before providing credit. Local bank due diligence is more modest, perhaps partly due to their greater familiarity with their borrower. Foreign banks more frequently use lawyers, especially outside counsel, to check corporate authorizations, and other legal compliance issues, and to issue legal opinions with respect to the documentation, whereas local banks' use of lawyers is much less frequent or is done solely by in-house lawyers.

b) *Characteristics of banks in terms of corporate governance and their relationship with the government*

As noted above, poor corporate governance within Indonesian banks has been a major cause of concern. It is widely-believed that Indonesian conglomerates and politically well-connected individuals have been able to draw on the resources of the state banks, which the management could only refuse at the risk of being discharged. In the private bank sector, many banks were established by corporate conglomerates, which drew on the resources of their bank to fund group expenses. In many cases, legal lending limits established by the central bank (Bank Indonesia) were violated.

c) *Historical performance records*

In general, it appears that there has been inadequate supervision of private banks and inadequate enforcement of central bank rules by Bank Indonesia. From 1992 onwards, at least one bank failed every year because it had violated the legal lending limits. However, notwithstanding the facts, in retrospect there seems to have been inadequate supervision. It is noteworthy that at present the Indonesian Government has not sought criminal sanctions against banks that violated legal lending limit rules.

d) *State of prudential regulation*

Please refer to our comments above. Prudential regulations do not appear to have been effective in practice due to the lack of (i) supervision by the central bank and (ii) legal enforcement through the imposition of penalties.

B. NBFIs

a) *Corporate governance and size*

Most NBFIs are banks' subsidiaries. NBFIs are channeling agents between banks and clients, providing small-scale credits. NBFIs corporate governance is consequently controlled by the respective banks.

According to the Report on the Development of Financial Companies' Activities during 1990-1998 issued by the Department of Finance (the "DOF Report"), there were 245 registered NBFIs in 1998 with total assets of Rp.43,629 billion, total equity of Rp.1,310 billion, and net investment of Rp.29,278 billion.

b) *Historical performance records*

Again referring to the DOF Report, the DOF registered 121 NBFIs in 1990. This number reached a peak of 254 NBFIs in 1995 before decreasing to 245 NBFIs in 1998. NBFi activities covered by the DOF Report include leasing, factoring, consumer financing, and credit cards. The total value of business activities was Rp.5,810 billion in 1990, which increased to Rp.59,434 billion in 1995, but then sharply declined to Rp.16,790 billion in 1998.

Recently, only around ten NBFIs have been active. Most NBFIs face two major problems: (i) negative spreads and (ii) the large number of loans that have become bad debts. NBFIs are the second largest debtors to IBRA.

In 1995, the Minister of Finance announced that no further business permits would be issued for finance companies engaged in leasing, factoring, credit cards, and/or consumer financing, by Decree No. 609/KMK.017/1995 on the Discontinuation of Business Permits for Finance Companies.

c) *State of prudential regulation*

In practice, not all NBFIs submit monthly finance statements, mid-year activity report or financial statements audited by a public accountant, which should cover the calculation of debt equity ratios, as regulated in Minister of Finance Decree No. 606/KMK.017/1995 regarding Provisions on Loans Received, Participation, and Reporting by Finance Companies. This inevitably leads to difficulties in monitoring the compliance of NBFIs with the prudential regulations.

C. *Firms*

a) *Corporate governance*

Indonesia's Company Law No. 1 of 1995 regarding Limited Liability Companies (March 7, 1995), provides that the primary duty of the Board of Directors ("BOD") of a company is the management of the company. In performing their management duties, members of the BOD are jointly and severally empowered to represent the company in its external relations, including before the court, unless specifically restricted by the company's articles of association or in the event of a conflict of interest. The Company Law provides that the members of the BOD are responsible for the good conduct of the business of the company. They are not personally liable to third parties for acts performed by them on behalf of the company, provided that such

acts are within the limits of their authority as prescribed in the articles of association. However, the members of the BOD may be liable to the company's shareholders and creditors for ultra vires acts, acts of negligence and acts of bad faith in the discharge of their responsibilities.

The Company Law allows shareholders and creditors to sue the members of the BOD and the Board of Commissioners ("BOC") for losses they have suffered. Creditors of the company also have statutory rights against Directors whose negligence or mistakes have caused the bankruptcy of the company, if the company's assets are inadequate to provide relief to such creditors.

b) Financial structure and modes of financing

The following description of the financial structure and methods of finances is based on general experience and our knowledge of the economic situation in normal times. At present, the Indonesian economic crisis has distorted what would be a typical answer to this question.

Prior to the present economic crisis, most private companies would first obtain financing from local borrowing sources. As a company became larger, it would turn to foreign lending markets. Foreign loans were often sought when Indonesian Rupiah interest rates became extremely high; in such times, lower US Dollar interest rates made foreign currency borrowing more attractive. Upon reaching the next stage of growth, the company would typically turn to capital markets to raise a portion of its financing requirements.

Cooperatives are widely used in Indonesia for some purposes. These organizations generally would rely on retained earnings or on capital raised from their members. Law No. 25 of 1992 on Cooperatives allowed cooperatives to also obtain financing from local borrowing sources, such as banks and other financing institutions. Cooperatives may also issue debentures or commercial paper.

State-owned enterprises would most likely depend on equity injections from the Government to finance investment and operations. We note that the retained earnings of state-owned enterprises are considered revenues of the GOI, but that the GOI allows companies to retain a portion of such retained earnings for working capital purposes.

D. Relationships Between Creditors and Debtors

- a) *How active and effective are creditors in assessing risks and monitoring the performance of debtor firms?*

The Indonesian Government has issued a regulation for financial institutions, that sets forth the procedure for assessing risks and monitoring the performance of their debtors, Bank Indonesia Decree No. 27/162/Kep/Dir/1995 on the Obligation of Commercial Banks to Formulate and Implement Bank Credit Policies (March 31, 1995). However, in practice we believe that local banks have been lax in assessing these risks. As noted above, credit decisions appear to be based more on the quality of the relationship involved than on a close examination of the business of the debtor or the integrity or value of the collateral involved. In addition, there have been two factors that have made credit risk analysis difficult: a judicial system that is commonly perceived as weak and poorly trained and possibly corrupt. This makes it extremely difficult for creditors to judge whether they have any reasonable possibility of prevailing in litigation against debtors and in foreclosing collateral. This problem is particularly acute for those creditors who are unwilling or unable to litigate by the same standards that may be employed by their debtors, i.e. if corrupt practices are involved. In particular, foreign lenders who may be constrained by their domestic legislation from making such payments (such as U.S. companies subject to the Foreign Corrupt Practices Act), even if they were otherwise willing to engage in such practices. It appears that a number of U.S. banks have moved to reduce their Indonesian debt portfolio and have decided to make no new loans to Indonesian borrowers pending the implementation of judicial reform that would allow them a reasonable expectation to recover their debts and foreclose security.

Another impediment to effective creditor rights is an underdeveloped security registration system. Until recently, Indonesia has had no security registration law for movable property. In September 1999, however, Indonesia adopted a law to create a registration system for movable property. Law No. 42 of 1999 regarding Fiduciary Transfer and Its Registration is a significant step forward. Although the law has difficulties, most notably in the failure to adopt a notice system, and while the Law will not be effective, the registration system will be useful. However, this law in and of itself does not address the most significant problems faced by creditors: effective judicial enforcement of their rights as creditors.

- b) *What is the normal course of action when a creditor finds the risks of a debtor to be excessive?*

This depends on the risk involved. If a debtor has defaulted, creditors will accelerate the loan, if the loan documentation permits. If the loan agreement has a cross default clause and the debtor has defaulted on another agreement, the practice of local lenders is often to try to accelerate payment unofficially (without declaring a default) and/or obtain additional collateral.

- c) *Is the usual response of a debtor to provide additional collateral or a personal or corporate guarantee?*

See our response above.

- d) *Standards for financial information supplied respectively by debtor firms and creditors, and rigor of enforcement of the standards.*

Under BI Decree No. 27/121/Kep/Dir/1995 on the Submission of Taxpayer Numbers and Financial Reports with regard to Credit Applications, as amended by Decree of BI No. 28/83/Kep/Dir/1995 jo. BI Decree No. 27/162/Kep/Dir/1995 On the Obligation of Commercial Banks to Formulate and Implement Bank Credit Policies (March 31, 1995) (“Joint Decree No. 27/162”), the bank must require the debtor to provide it with a copy of the financial report which was included in the Tax Payment Form (SPT) for Income Tax from the most recent year, along with the relevant receipt from the Tax Office.

A bank usually requires a prospective debtor to provide: (i) balance and profit and loss statements for the last three years, usually audited by an independent auditor; (ii) a marketing plan, consisting of such items as the volume of goods to be distributed, the marketing plan, and the price of each unit; (iii) third party funding sources other than banks; and (iv) other funding sources. The same requirements are also made by creditors other than banks, with some variation depending on the debtor’s business sector. Information may also be obtained regarding (i) the liquidity ratio (the ability of the debtor to fulfill its short term obligations); (ii) the leverage ratio (to measure the role and influence of outside capital in financing the debtor’s assets); (iii) the activity ratio (to estimate the effectiveness of usage of the debtor’s assets); (iv) the capability ratio (to estimate the competency of the debtor’s management to make a profit); and (v) the growth ratio (to estimate the growth rate of the debtor).

Joint Decree No. 27/162 was promulgated to reduce the tendency of creditors to emphasize the relationship over financial data, with the result that financial information became a secondary consideration for the creditor.

The Indonesian Government also recently required certain financial information to be supplied to the public generally, pursuant to Government Regulation No. 64 of 1999 (“GR No. 64”) (9 July 1999), an amendment to Government Regulation No. 24 of 1998 on Information Annual Corporate Financial Reports (“GR No. 24”). The purpose of this Regulation is to allow the public to obtain financial information on certain types of companies. All corporate financial information reported should be publicly available. The type of information required to be disclosed to the Department of Industry and Trade is as follows: (i) a corporate balance sheet; (ii) a profit/loss statement; (iii) changes of equity; (iv) a cash flow report; and (v) liabilities and receivables, including bank credits and list of capital participation. (Article 3 (1) of GR No. 64)

To achieve uniform financial information, Article 1(1) of GR No. 64 assigns the task of further describing and breaking down the Annual Financial Report to the Minister of Industry and Trade in coordination with the Minister of Finance as the administrator of public accountants.

GR No. 64 requires only the following types of companies to provide annual reports to be audited by a public accountant: (i) a publicly-listed company; (ii) a company mobilizing private funds; (iii) a company issuing debentures; (iv) a company having total assets or property of at least Rp.50 billion (approximately US\$ 7.14 million); (v) a debtor of a bank requesting an audited financial report of said company; (vi) a foreign company domiciled and operating its business in Indonesia under the prevailing laws, including any of its branch offices, supporting offices, subsidiaries, or representatives that have the capacity to enter into an agreement; and (vii) certain state-owned companies and regional state-owned companies.

Aside from the provisions of GR No. 64, Article 56 of the Company Law requires the Company’s Directors to provide an annual report to be submitted to the company’s general meeting of shareholders for its approval. The annual report must at least contain:

- a. annual statements, consisting of the balance sheet and profit and loss statement for the past financial year, with explanations of the same;
- b. the combined balance sheets of companies in the same group, and the respective balance sheets of each company;

- c. a report on the condition and operations of the company and results achieved;
- d. the main activities of the company and any changes within the past financial year;
- e. details of any issues arising during the past financial year that affected the company's activities;
- f. the names of the Directors and Commissioners; and
- g. salary and other remuneration for the Directors and Commissioners.
- h) Composition of debts

According to data provided by the Indonesian Economy and Finance Resilience Council (DPKEK) and presented at its assembly on 30 April 1999, total domestic loans of Indonesian private companies amounted to Rp.150 trillion, while offshore loans amounted to US\$65 billion.¹

E. Regimes for Property Right Protection

1. Rule of law for the distribution of wealth among debtors and diverse creditors in individual bankruptcy cases and liquidation cases

Pursuant to the Indonesian Civil Code (the "ICC"), all movable and immovable property, current or future, can be given as security for a debtor's personal agreements. Further, the Bankruptcy Law provides that as of the bankruptcy declaration all the assets of the debtor, including any assets obtained while the bankruptcy proceeding progresses, will be considered assets of the bankrupt estate. Upon a bankruptcy declaration, the authority to manage the bankrupt assets shifts from the debtor to a receiver appointed by the Commercial Court.

In summary, all assets owned and possessed by the debtor are included as part of the bankrupt assets and are available to the receiver to satisfy the claims of creditors. However, the Bankruptcy Law excludes those assets encumbered as collateral to secured creditors, as well as the following items:

- goods stipulated in Article 451 of the Civil Procedures *Reglement*; monies or annual salaries and intellectual property which cannot be

attached, as stipulated in Article 749 of the Civil Procedures *Reglement*;

- the entire personal income of the debtor during the bankruptcy period, derived from his personal jobs, salary, allowances from a certain position, pension or other monies as stipulated by the supervisory judge;
- monies for living expenses provided to the debtor pursuant to the prevailing laws;
- monies stipulated by the Commercial Court judge (Articles 311 and 312 of the ICC);

allowances for the debtor's children (Article 318 of the ICC).

The Bankruptcy Law stipulates that any secured creditors may exercise their rights as if there were no bankruptcy proceeding. However, secured creditors are prevented from executing their rights for a maximum period of 90 days from the date of the bankruptcy declaration. A debtor may request the Commercial Court to suspend debt payments during the bankruptcy proceeding. If this request is granted, the debtor will have a maximum period of 270 days to put forward a settlement proposal to unsecured creditors in order to restructure its debts. If the unsecured creditors refuse to accept the settlement proposal during such period, the Commercial Court will declare the debtor bankrupt. On the other hand, if the unsecured creditors accept the settlement proposal, then the bankruptcy proceeding will be closed. During this period, the secured creditors may not foreclose their collateral.

Secured creditors can thus be prevented from exercising their rights to foreclose the collateral for up to 270 days as of the date the provisional settlement granted by the Commercial Court. At the expiration of the 270 day period, the secured creditors will then have two months to exercise their rights, failing which they will surrender their rights to the receiver but still receive the payment from the proceeds of the sale of the collateral. If the secured creditors do not commence foreclosure proceedings within this period, the receiver will foreclose the secured assets. If the collateral security is not sufficient to cover the debts, secured creditors share in the proceeds realized from the sale of unsecured assets with the unsecured creditors.

2. *In the case of firms not being liquidated, the rule of law or principles behind the law as to the preservation or maximization of economic value and distribution of wealth among stakeholders (e.g.*

classification of creditors and priority among them, absolute priority rule)

Pursuant to the ICC, there are two types of creditors, secured creditors and unsecured creditors. Secured creditors are those holding (i) security on land pursuant to Law No. 4 of 1996 regarding Security Rights over Land and Any Goods Related Thereto (“Law No. 4 of 1996”); (ii) pledges pursuant to the ICC or (iii) fiduciary securities pursuant to Law No. 42 of 1999. Secured creditors have a priority right over their collateral security over other creditors. As discussed in the previous section, the Bankruptcy Law provides that secured creditors may exercise their rights over their collateral security (subject to the temporary stay discussed above) as if there were no bankruptcy proceeding. Unsecured creditors are entitled to the unsecured assets of a bankrupt debtor on a pro-rata basis.

As noted above, secured creditors are prevented from executing their rights for a maximum period of 90 days as of the bankruptcy declaration or a maximum period of 270 days in case a settlement proposal is ratified by the court. This stay period is required by the Bankruptcy Law for the purposes of:

- (i) increasing the possibility of a composition plan being agreed;
- (ii) increasing the possibility of maximizing the value of the bankrupt’s assets; or
- (iii) allowing the receiver to carry out his duties in an optimal manner.

During this stay period, the receiver may use or sell inventory and movable assets, whether secured or not, if adequate protection has been provided for the interests of the secured creditors for this purpose. This protection may consist of:

- (i) compensation for the decline in value of the bankrupt’s assets;
- (ii) the net proceeds of the sale;
- (iii) replacement rights in rem;
- (iv) fair and reasonable remuneration and other cash payments.

Please see our answer below for details on the classification of creditors, the priority among them, and the absolute priority rule.

3. *Room for value-destroying waiting games by debtors and creditors respectively and the rationale for such room*

This topic calls for an analysis of creditors’ remedies generally, as well as an analysis of creditors’ rights under the Bankruptcy Law. As a general

proposition, creditors have not been successful in pursuing debtors by use of typical judicial remedies. The same problems discussed above that affect the Commercial Court and the Supreme Court generally are also true for the country's district courts and high courts, except the problems of lack of training and familiarity with modern commercial transactions are probably more pronounced in courts outside Jakarta. The lack of judicial recourse for creditors places pressure on the administration of bankruptcy as creditors attempt to use the Bankruptcy Law to recover debts that, were the judicial system more effective, they would recover under other procedures. Prior to the adoption of the Bankruptcy Law, debtors were able to use the judicial process to their advantage and delay enforcement by creditors of their debts from three to five years, sometimes longer. The Bankruptcy Law, with its requirement that decisions be rendered quickly by the Commercial Court and the Supreme Court, means that debtors can no longer employ such delaying tactics. However, this may allow the Bankruptcy Law to be used as a substitute for ordinary creditors rights remedies in cases where it should not be, simply because it contains expedited enforcement procedure.

Once a bankruptcy proceeding is filed, the Bankruptcy Law appears to work well in ensuring that the matter is adjudicated quickly. The only ability of the debtor to delay proceedings are those circumstances where the law specifically permits such delays, such as for suspension of payment proceedings.

III. Formal Insolvency Mechanisms

A. Overview

1. *Types of insolvency mechanisms, applicable laws, presiding authority, experts frequently employed in bankruptcy proceedings and their roles in each mechanism (e.g. debt collection enforcement, reorganization, composition, liquidation, others)*

In Indonesia, an involuntary bankruptcy declaration may be issued under the Bankruptcy Law, or a company may voluntarily liquidate pursuant to the Indonesian Company Law.

Pursuant to the Bankruptcy Law, a creditor can apply to the Commercial Court to have a debtor declared bankrupt by the filing of a bankruptcy petition. A debtor may also apply to the Commercial Court for an application for a reorganization, without a creditor's application for bankruptcy being filed first. Alternatively, if a bankruptcy application is filed, the debtor can apply for a suspension of payments, which allows time for the debtor to propose a reorganization plan to its creditors.

In the event the Court accepts a bankruptcy petition, and the debtor applies for a settlement of debt payments, the settlement plan will be undertaken by a receiver under the supervision of a supervisory judge. Under this process, it is possible that the corporate debtor will be restructured and reorganized by the receiver in order to maximize and increase, if possible, the value of the debtor's assets. Once a settlement plan is implemented and creditors have been paid pursuant to the terms of the plan, an insolvent corporate debtor can either be liquidated or remain in existence as a legal entity.

Please see our answer below in Section II.B.1 for the details on the mechanism of the reorganization process and bankruptcy proceedings.²

The following are the powers given by the Bankruptcy Law to each type of administrator during bankruptcy proceedings and the reorganization process:

1) Supervisory Judges:

- (i) The supervisory judge controls the management and settlement of the bankrupt estate.
- (ii) The Commercial Court is obligated to hear the advice of the supervisory judge before deciding any matters related to the management and settlement of the bankrupt estate.
- (iii) The supervisory judge is authorized to hear witnesses or order an investigation by experts (i.e. lawyers, accountants, appraisers, or others) in order to obtain relevant information during the bankruptcy proceedings.

2). Receivers:

- (i) The receiver manages and settles the bankrupt estate. In the event of settlement proceedings, the incumbent managers of the debtor still have the authority to manage the company together with the receiver.
- (ii) The receiver may obtain loans from third parties to increase the value of the bankrupt estate.
- (iii) With the approval of the creditors committee, the receiver may continue the business of a bankrupt debtor, notwithstanding that an appeal to the Supreme Court has been made or a judicial review filed in respect of a bankruptcy declaration.

- (iv) A receiver appointed for a specific task based on a bankruptcy declaration is authorized to act independently within the scope of its assignment.
- (v) The receiver is not required to obtain the approval of or to give prior notice to the debtor to conduct the above actions, notwithstanding that under other circumstances such approval or notice would be a requirement.

A cassation appeal may be filed with the Supreme Court to appeal the decision granting or denying a bankruptcy petition made by the Commercial Court. This appeal must be filed within eight days from the date of the decision upon which the appeal is filed, and must be heard and decided within 30 days from the date the appeal is registered at the Court.

A review petition may be filed with the Supreme Court in respect of decisions of the Commercial Court that have become final. This is the final legal action that can be taken in respect of the decision on a bankruptcy petition. A review petition may only be filed if (i) there is important new written evidence which, if known at the previous session of the Commercial Court, would have resulted in a different decision, or if (ii) the Commercial Court committed a serious error in the application of the law in rendering its judgement.

2. *A summary description of the implementation structure and capacity to handle bankruptcy cases, including a summary description of the court system, number of judges overseeing bankruptcy cases, their workload, infrastructure of professionals such as administrators, etc.*

The Court Structure: As will be noted from the discussion above, the Commercial Court has jurisdiction over bankruptcy cases. Appeals are taken directly to the Supreme Court.

The Number of Judges: Thirty-two judges have been appointed by the Supreme Court to serve as Commercial Court judges throughout Indonesia. Seventeen of them have been stationed in the Jakarta Commercial Court while the other fifteen judges are stationed in the Commercial Courts in four other provinces in Indonesia: Ujung Pandang, Surabaya, Semarang and Medan. These judges underwent special training conducted by the Department of Justice.

Infrastructure of Professionals: At present, there are 73 licensed receivers and administrators having professional backgrounds as lawyers and/or public accountants or auditors. As with Commercial Court judges, these receivers and

administrators all underwent special training before obtaining their licenses from the Department of Justice.

B. *Flow chart and key aspects for each of the proceedings*

1. *Flowcharts and Description of Key Steps*

(e.g. filing, provisional measures, order of opening, lodging of claims, verification of claims, creditors' meetings, approval of the plan, and closing of the proceedings)

Article 1 of the Bankruptcy Law provides that a debtor with two or more creditors, at least one of whose loan is due and payable, shall be declared bankrupt by a decision of the Commercial Court, upon the petition of either the debtor or of one or more of its creditors.

The filing of a bankruptcy petition by the creditors is an alternative to submitting a lawsuit to the District Court to obtain payment from the corporate debtor for debts owed to the creditors. If declaration of bankruptcy is issued, and no reorganization plan is approved by creditors the assets and property of the debtor will be liquidated and distributed to its creditors.

A debtor may apply for a suspension of the obligation to pay its debts, for the purpose of submitting a composition or reorganization plan which will include an offer of payment of all or a part of the debts due to its unsecured creditors.

The following is the procedure for filing petitions for bankruptcy and applications for suspension of debt repayments:

- (i) filing of a bankruptcy petition;
- (ii) Commercial Court hearing;
- (iii) filing of a request for a temporary suspension of payments;
- (iv) decision on the temporary suspension of payments;
- (v) decision on the bankruptcy petition;
- (vi) discretion of the Court concerning the bankruptcy petition;
- (vii) appointment of a supervisory judge and a receiver;

- (viii) payment of bankruptcy costs;
- (ix) publication of the bankruptcy decision;
- (x) management of the bankrupt assets by the receiver under the supervision of a supervisory judge and a creditors committee, if applicable;
- (xi) verification of debts;
- (xii) sale of goods from the bankrupt estate's assets;
- (xiii) distribution to unsecured creditors of payments resulting from the sale of the bankrupt assets;
- (xiv) objections by dissatisfied creditors;
- (xv) possibility of a settlement proposal;
- (xvi) acceptance of the settlement proposal;
- (xvii) suspension of payments:
 - a) Commercial Court decision;
 - b) temporary suspension of payments for a maximum period of 45 days;
 - c) composition proposal for a permanent suspension of payments;
 - d) negotiation between creditors and the debtor;
 - e) acceptance or refusal of the composition proposal;
 - f) court hearing concerning acceptance or refusal of the composition plan for permanent suspension of payments;
 - g) court legalization of an accepted composition plan;
 - h) permanent suspension of payments for a maximum period of 270 days (including the 45 day period for the temporary suspension of payments);
 - i) formation of a creditors committee;

- j) preparation of a list of acknowledged and unacknowledged creditors and their claims on debts;
 - k) appointment of the administrator;
 - l) appointment of the expert(s) required to assist the administrator in handling the management and settlement of the debtor's assets and business;
 - m) management acts by the debtor under the supervision of the administrator and the supervisory judge;
 - n) settlement of payments to creditors;
 - o) termination of suspension of payments;
 - p) in case the implementation of the composition plan does not satisfy the creditors and the 270 day period has lapsed, the creditors shall notify the Court to reopen the bankruptcy proceeding;
 - q) the debtor will be deemed bankrupt by law; and
 - r) settlement of payments to creditors as set forth in points (viii) to (xiv) above; and
- (xviii) end of the bankruptcy proceedings.

2. *Comparison and Transferability Between Proceedings*

C. *Proceedings under the Insolvency Laws*

1. *Opening Procedure*

a. Filing of a petition

- (i) Criteria of insolvency (e.g. balance sheet test/liquidity test/others): Pursuant to Article 1 of the Bankruptcy Law, a debtor having two or more creditors and failing to pay at least one mature debt may be declared bankrupt through a court decision. Therefore, the insolvency procedure is commenced upon non-payment of one mature debt, which is the criterion for a declaration of bankruptcy.

- (ii) Who can file the proceedings? (e.g. debtor / creditor / shareholder / others): An individual debtor or a corporate debtor can be declared bankrupt at the request of:
 - (i) the debtor itself;
 - (ii) one or more creditors; or
 - (iii) the public prosecutor.

If the debtor is a bank, the bankruptcy petition may only be filed by BI, while if the debtor is a securities company, the bankruptcy petition may only be filed by the Stock Exchange Supervisory Agency (Bapepam).

- (iii) What kind of penalties do the laws have for filing delays? There are no penalties.

b. Automatic Stay

Does filing have the legal effect of banning any payment or collection of debt? If not, can any provisional measures be allowed? The filing of a bankruptcy petition does not ban any payments of debts by the debtor or collections of debts by creditors except that secured creditors may not foreclose their collateral. However, as a practical matter, the creditors filing for a bankruptcy petition shall not receive any payment of their debts from the debtor unless they are willing to settle the debts outside the court and withdraw the bankruptcy petition.

In order to prevent a debtor from disposing of its assets and possibly prejudicing the interests of the other creditors, Article 7 of the Bankruptcy Law allows any creditor or the public prosecutor, prior to the declaration of bankruptcy, to file a petition with the Commercial Court to:

- (i) seize part or all of the assets of the debtor; or
- (ii) appoint an interim receiver to:
 - a) supervise the management of the debtor's business; and
 - b) supervise payments to creditors, and transfers or encumbrances of any assets of the debtor which, in the framework of bankruptcy, require the approval of the receiver.

This petition will only be granted if such actions are necessary to protect the interests of creditors. The court may require the creditors to provide security in a reasonable amount if the petition is granted.

c. Order of Opening

- (i) Is the order of opening needed for the procedure? No. Once the bankruptcy petition has been appropriately filed at the Commercial Court and has fulfilled all legal requirements, the bankruptcy proceeding should begin at the latest 20 (twenty) days after the registration date of the petition with Clerk of the Commercial Court.
- (ii) Requirements of order of opening (e.g. consent of creditors/viability of the firm/public interests/economic considerations/consent of employee/others): Not applicable. (See above)
- (iii) When is the estate created and with what? Upon the declaration of bankruptcy, all the assets of a bankrupt debtor will be included as the bankrupt estate's assets.

Pursuant to Article 19 of the Bankruptcy Law, the bankruptcy estate includes all of the wealth of the debtor at the time of the bankruptcy declaration, including any acquired during the bankruptcy proceedings. The bankrupt estate of the debtor also covers assets of the debtor located outside of Indonesia, as well as any inheritance the debtor obtains during the bankruptcy proceeding. However, Article 40 of the Bankruptcy Law stipulates that any inheritance the debtor obtains during the bankruptcy proceeding should not be automatically included as part of the bankrupt estate, unless by a special right to register it as part of the bankrupt estate. The actual operation of this Article is unclear.

In summary, all assets owned and possessed by the debtor are included as part of the bankrupt estate and are available to the receiver to satisfy the claims of unsecured creditors. The only exceptions are assets that have been encumbered as collateral to secured creditors.

Article 1131 of the ICC provides that all movable and immovable assets of the debtor, either present or future, are regarded as security for the debtor's personal agreements. Article 1132 of the Civil Code provides that the proceeds of the debtor's assets shall be divided among creditors in proportion to their loans, unless there already exists a legal order of priority among the creditors.

- (iv) Who manages the firm (e.g. court-appointed trustee/incumbent managers/ creditors/ others)
 - (a) from the filing through the order of opening
 - (b) from the order of opening to the approval of the reorganization plan
 - (c) from the beginning of the plan's execution?

The corporate debtor will still be managed by its existing management (the BOD and the BOC) from the time of the filing through the order of opening of the bankruptcy proceedings. If a debtor files for a suspension of debt payments, the incumbent managers will continue to manage the company until the reorganization plan is approved by the creditors and legalized by the Court. The managers will continue managing the company through the execution of the reorganization plan, under the supervision of the administrator and the supervisory judge appointed by the Court. The creditors may also form a Creditors' Committee to oversee the management of the corporate debtor.

The receiver takes over the management of the corporate debtor if the reorganization fails and the bankruptcy declaration is issued against the debtor.

2. *Deliberation Procedure*

a. Claims

- (i) With whom do creditors lodge their claims? (e.g. debtors/trustees/court/others): During the bankruptcy proceeding, the creditors lodge their claims with the Commercial Court. After the Court declares the corporate debtor bankrupt, or the reorganization plan is accepted and legalized, outstanding claims are lodged with the receiver or administrator appointed by the Court.
- (ii) Who verifies lodged claims? (e.g. debtor/court/creditors' meeting/others): The lodged claims will be verified by the debtor and the receiver, together with the Creditors' Committee, if any, at a verification meeting. In case of any objection at that meeting, the creditor whose claims are being objected to will have the right to challenge such objection and prove the authenticity of its claims.
- (iii) Are late lodgings allowed? If so, how long and at what disadvantages? Yes, late lodgings are allowed so long as the settlement for payment from the proceeds of the sale of bankruptcy assets has not yet been finalized. If a creditor files its claim after such settlement is finalized, it is only entitled to obtain payment from the balance of any undistributed proceeds realized from the sale of assets.
- (iv) Non-allowable claims in insolvency proceedings? Claims lodged by secured creditors shall only be eligible if the secured creditors have released the collateral and become unsecured creditors, considering that secured creditors can execute or foreclose the collateral as if there were no bankruptcy.

- (v) Priority of claims (e.g. secured/non-secured, suppliers/money lenders/shareholders, large/small, tax and government charges, labor compensation, administrative claims, claims incurred after the opening, preferred/ subordinated): The Indonesian Civil Code recognizes certain privileges and priorities among unsecured creditors. Pursuant to Article 1138 of the ICC, the specific privileges conferred by Article 1139 rank above those general privileges created by Article 1149. Apart from these provisions, the Income Tax Law No. 10 of 1994 provides that claims for national and local taxes take priority over either type of privilege.

Article 1139 of the ICC provides that certain specific assets of the debtor are subject to priority claims from certain categories of creditors, and that such claimants are entitled to the proceeds of sale of these specific assets prior to claims of general unsecured creditors. The privileges created by Article 1139 of the ICC are as follows:

- (i) claims for court costs arising solely from the auction of movable or immovable property (these claims also have an expressly stated priority over claims based on a pledge or mortgage);
- (ii) claims relating to leases of real property attached to the property concerned;
- (iii) claims of unpaid sellers of movable goods for the sale price of those goods attached to such goods;
- (iv) claims for costs incurred in connection with the storage or conservation of goods attached to such goods (e.g. the claims of an unpaid warehouseman or conservator);
- (v) claims of workmen for work performed upon movable goods attached to such goods, regardless of the location of the goods;
- (vi) claims of an innkeeper attached to goods of the debtor in the custody of the innkeeper;
- (vii) claims with respect to freight costs and related expenses attached to the goods carried;
- (viii) claims of workmen, such as carpenters, for work performed in connection with the construction and repair of immovable property attached to the property, provided that the claims are not more than three years old and the debtor still owns the property; and
- (ix) certain claims against public servants as a result of a breach of their obligations.

Article 1149 of the ICC sets out general priorities as follows:

- (i) legal fees, exclusively arising from auction and the safeguarding of estates. (These costs have priority over pledges and mortgages.);
- (ii) reasonable claims for burial costs;
- (iii) claims for medical and hospital expenses in connection with a terminal illness;
- (iv) employee wage claims for the current and preceding year;
- (v) claims for supply of basic necessities to the debtor and his family for the preceding six months;
- (vi) claims of boarding schools; and
- (vii) claims relating to debts of minors and persons under guardianship and claims relating to expenses incurred in the maintenance and education of minors.

In summary, the assets of the bankrupt estate will be applied to the creditors' claims in the following order of priority:

- (i) court and auction costs;
- (ii) taxes;
- (iii) claims of secured creditors;
- (iv) privileged creditors;
- (v) unsecured creditors.

b. Avoidance, Executory Contracts

(i) Who has avoidance powers? (e.g. not allowed/creditors/trustee/court/others): The receiver or a creditor may file a request to nullify actions undertaken by the bankrupt debtor before its bankruptcy declaration, if it can be proven that such actions intentionally harmed the creditors' interests and that this was known by the debtor.

Under Article 36 of the Bankruptcy Law, if at the time a bankruptcy is determined there is an executory agreement, the party with which the debtor entered into such agreement may petition the receiver to confirm the continued implementation of such agreement within the period agreed upon by the receiver and said party.

If no agreement is reached concerning the agreed period, the supervisory judge shall determine such period. If within said period, the receiver does not respond or is not prepared to continue the implementation of such agreement, the agreement shall terminate and the concerned party may claim compensation and shall be treated as an unsecured creditor.

If the receiver is prepared to implement the agreement, said party may request the receiver to provide a guarantee of the implementation of such agreement.

In addition, Article 1341 of the ICC provides that a creditor may invalidate any non-compulsory act committed by the debtor, which is detrimental to the creditors, if it is proven that while committing the act the debtor and the party with whom it committed the act or on whose behalf it acted, were aware that it would be detrimental to the creditors. Rights obtained by a third party in good faith over the goods subject to the invalid action shall be honored.

Pursuant to Article 41 of the Bankruptcy Law, in the interest of the bankrupt's assets, any legal actions of a bankrupt debtor causing loss to the creditor's interests and undertaken before the bankruptcy declaration may be requested to be nullified.

Nullification may only take place if it can be proven that at the time of such legal action the debtor and the party with which such action was undertaken were aware or should have been aware that such action would cause loss to the creditors. Exceptions to nullification include legal actions of debtors undertaken on the basis of an agreement and or because they are required by law.

(ii) Avoidable Payments: The Bankruptcy Law states that legal acts causing losses to the creditors undertaken within one year of the declaration of bankruptcy and not actually required to be undertaken by the debtor may be nullified, if such actions:

- (i) were payments in which the debtor's liability substantially exceeded the obligation of the party with which such commitment was entered into; or
- (ii) constitute a payment for, or a guarantee for, a debt which has not yet reached maturity or which is not yet payable; or
- (iii) were undertaken by a debtor with certain specified relatives or affiliates.

In other words, if a payment meets one of the foregoing criteria, a receiver can move to annul the payment without having to prove that the debtor and the third

party were aware or should have been aware that such action would cause losses to the creditor, unless it can be proven to the contrary. Note that the annulment under Article 42 is limited to transactions undertaken within one year of the bankruptcy proceeding.

(iii) Please explain the principles of executory contracts: Article 1320 of the ICC provides that in order for an agreement to be valid, it must satisfy the following four conditions:

1. there must be consent of the individuals who are bound thereby;
2. there must be the capacity to conclude the agreement;
3. a specific subject; and
4. an admissible cause.

Under Article 1321 of the ICC no agreement is of any value if granted by error or obtained by duress or fraud.

Pursuant to Article 1338 of the ICC, all legally executed agreements bind by law the persons who have concluded them. They cannot be revoked other than by mutual agreement, or pursuant to reasons legally declared to be sufficient. They must be executed in good faith. Accordingly, as long as the contract meets the above texts, which are the pre-requisites for a valid contract under Indonesian Law, a party is legally obligated to perform a contract that it has made. The filing of a bankruptcy petition by the counterparty to the contract against the debtor or by another creditor will not relieve the debtor of its obligations under the contract.

(iv) Are there any special provisions on derivatives? Yes. Bank Indonesia has provided certain regulations, among others, BI Decision No. 28/119/Kep/Dir/1995 on Derivative Transactions and BI Circular Letter No. 28/13/US/1995.

These BI regulations were issued to provide prudent banking principles on derivative transactions. These guidelines among others provide the minimum operational guidelines on derivatives transactions drawn up by banks, the standard terms that should be provided in derivative transaction agreements, and the internal control system to ensure the banks apply sound banking practices.

Under BI Decree No. 28/119/Kep/Dir/1995, commercial banks may only conduct derivative transactions related to foreign exchange and interest rates, and banks are prohibited to channel funds to their customers for the purpose of derivative transactions.

D. *On Managers (debtors)*

1. Is the act of insolvency itself a criminal act? If so, what are the penalties? There are no penal sanctions in the Bankruptcy Law for insolvency. However, we note that there are criminal law provisions for non-payment of debts that lead to a company's insolvency, as mentioned below.

2. Does the law stipulate a criminal investigation of chief managers including directors for their illegal activities related to the insolvency? If so, are debtors usually accused by public prosecutors? Yes. The law provides for criminal investigations of directors and commissioners who conduct illegal activities that may cause their company to become insolvent.

Chapter XXVI of the Indonesian Criminal Code regulates the provisions on actions damaging the interests of creditors. Article 403 of the Criminal Code provides that members of the BOD and BOC of a company who assist in or permit any action contrary to the articles of association of the company, thus causing the company to fail to fulfill its obligations or causing its dissolution, shall be subject to a maximum fine of Rp.150,000 (approximately US\$25 at current exchange rates). This monetary amount is contained in the original legislation, when the Rupiah value was considerably different than it is today. However, the amount of the fine has not yet been revised. There is no imprisonment sanction.

3. Are there any legal grounds for the debtors to sue chief managers for the damages caused by the insolvency on the basis of tort law? If so, how often are those legal actions taken?

As noted above, Article 90 of the Company Law imposes sanctions on a member of the BOD if a member has been "negligent" in conducting his duties and such negligent actions cause the company to become bankrupt. Each such member is jointly and severally responsible with other members who have done such acts.

Article 85 (3) of the Company Law also allows shareholders and creditors to sue directors and commissioners for losses suffered by such creditors or shareholders. Shareholders may bring an action against directors or commissioners, when the shareholders have suffered a loss as a result of a director's or commissioner's negligence or error, provided that the shareholder owns at least ten percent of the company's issued share capital. The directors shall also be severally and jointly liable when the shareholders have suffered losses from the company's failure to follow proper procedures in the repurchase of shares from existing shareholders (Article 30 (2 and 3) of the Company Law).

In addition, Article 1365 provides a separate cause of action for the commission of an unlawful act.

4. Is the liability of business entities extended to shareholders or directors personally? If so, to what extent?

Yes. Again, please see our answer to (b) above.

E. Disclosure Procedure

1. *How does information flow between*

- a. debtor-creditor?
- b. trustee-creditor?
- c. court-creditor?
- d. debtor-court?
- e. trustee-court?

Answer:

(i) Information between the debtor and creditor: The debtor is commonly required to provide relevant information on the ongoing operation of its business and its financial condition to enable the creditors/investors to observe the solvency of the debtor to use, manage, and repay their funds. Under the Bankruptcy Law, the obligation to provide relevant information may exist at the meetings on verification of debt. During the bankruptcy proceeding, the debtor shall provide information to its creditors. The creditors may consider the composition plan only if the debtor provides them with required and substantial information on the debt and the settlement plan thereof.

(ii) Information between trustee and creditor: Please note that Indonesian Law does not recognize the term “trustee”. However, the duties and responsibilities of a trustee and of the “receiver” under the Bankruptcy Law are the same. Upon the bankruptcy declaration, the Commercial Court will appoint, among others, the receiver(s). As of the date of the bankruptcy declaration the receiver is authorized to manage the bankruptcy assets. Within five days after the bankruptcy declaration, the receiver must announce such declaration and related information in the Indonesian State Gazette and in two daily newspapers determined by the supervisory judge. The receiver must also provide a quarterly report on the condition of the bankruptcy assets, including his management of the bankruptcy assets, to the supervisory judge, which report is available for the public.

(iii) Information between court and creditor: Article 18 of the Bankruptcy Law stipulates that the Commercial Court clerk shall provide a register book regarding bankruptcy cases containing a summary of the bankruptcy declaration, a brief summary of the composition plan, the amount of the debt settlement, any cancellation of the bankruptcy petition, and rehabilitation. The register book can be reviewed by the public free of charge. Moreover, during the bankruptcy proceeding the Commercial Court shall forward any information to the relevant parties, including the debtor, the creditors, the supervisory judge and the receiver.

(iv) Information between debtor and court: As we discussed in subsection (ii) above, upon the bankruptcy declaration, the debtor has no authority to manage its assets, since such authority has been transferred to the receiver. Therefore, the receiver is authorized to provide the Commercial Court with a periodic report regarding the bankrupt assets and the management thereof pursuant to its observation on day-to-day operation and information from the debtor.

(v) Information between trustee and court: As we discussed in sections (ii) and (iv) a receiver, whose duties are equal to of the trustee, has to provide a quarterly report on the condition of the bankruptcy asset to the court.

2. *How useful is the information? Is it reliable? Is it provided in a timely manner?*

Answer:

The information is not only useful to the parties directly involved in the bankruptcy case, but also allows the public to obtain legal certainty on the status of a debtor. Other than the information provided by a debtor to a creditor, most of the information is reliable. In order to comply with the timetable required by the Bankruptcy Law, most information is delivered in a timely manner.

F. Reorganization/Composition Plan

1. *Preparation of the Plan*

a. Who can draw up the plan? (e.g. debtor/creditor/court/ trustee/ others)

Answer:

In the event of reorganization or composition, the debtor shall prepare the composition plan together with the creditors, with the assistance of the appointed administrator, under the supervision of the Commercial Court.

- b. Who initiates negotiations in preparing the plan? (e.g. debtor/creditor/court/ trustee/others)

Answer:

In general, the debtor initiates the negotiation and preparation of the composition plan. However, it can only be finalized with the agreement of the creditors.

2. *Contents of the Plan*

- a. What kinds of methods are usually used for the plan? (e.g. changes of debts/debt-equity swaps/sales of equities/others)

Answer:

The methods used for the composition plan are determined unanimously by the creditors and debtor. They may include a debt-equity swap or a rescheduling, a hair cut and/or buy back loan, or other methods.

- b. How to classify creditors and stakeholders

- (i) secured/unsecured creditors?
- (ii) large claims/small claims creditors?
- (iii) bond holders?
- (iv) preferred/normal shareholders?
- (v) suppliers/money lenders?
- (vi) employees?
- (vii) others

Answer:

Creditors are classified as secured, preferred, and unsecured creditors. There is no classification of large claims and small claims, bondholders or bank lenders. Please see our discussion above regarding the priority of claims.

- c. What is the priority between creditors and stakeholders?
- (i) in the normal judicial enforcement process:
 - (ii) in the plan:

Answer:

In both the bankruptcy proceeding and the composition plan, the creditors will be prioritized over the shareholders. However, for the bankruptcy proceeding, the wages and severance payments of employees of the bankrupt corporate debtor shall have priority over both preferred and unsecured creditors.

- d. Is inflation reflected in the plan?

Answer: Usually, yes.

3. *Confirmation of the Plan*

- a. Quantum for consent by creditors and stakeholders
- (i) secured creditors?
 - (ii) unsecured creditors?
 - (iii) shareholders?
 - (iv) others?

Answer:

- (i) Secured creditors: Not required.
- (ii) Unsecured creditors: Pursuant to Article 141 of Bankruptcy Law, the composition plan shall be accepted if approved in the creditors' meeting by creditors representing more than 1/2 (one half) of the unsecured creditors attending the meeting whose rights are admitted or provisionally admitted, representing no less than 2/3 (two-thirds) of the total unsecured claims, both admitted and provisionally admitted, of the unsecured creditors or their proxies attending such meeting.
- (iii) Shareholders: Not specifically provided in the Bankruptcy Law or the Company Law. In the event the composition plan provides a grant of substantial assets as collateral, it will require the approval of shareholders representing at least 75% of the total votes cast in the general shareholders meeting attended by shareholders representing at least 3/4 of the total shares having valid voting rights (Article 88 of the Company Law).

- (iv) Others: Not applicable.
- b. Other requirements for the approval of the plan by the court (e.g. consent of employee/public interests/others)

Answer:

In the case of a composition plan involving banks or companies under the supervision of BPPN, BPPN's approval will also be required.

- c. Can the court deny the consented plan? In which cases?

Answer:

Yes, it can. Pursuant to Article 149 of the Bankruptcy Law, the Commercial Court will reject the ratification of the composition plan if:

1. the bankruptcy assets, including any goods on which rights of withholding are exercised, considerably exceed the sum stipulated in the composition plan;
 2. the composition plan is not fully guaranteed; or
 3. the composition plan is based on fraud, giving unusual benefits to one or more creditors, or uses other unfair means, regardless whether the bankrupt debtor was involved in conducting such acts or not;
- d. Can the court approve a plan that has not received consent (cram down)? In which cases?

Answer: No, it cannot.

- e. Are these criteria taken into consideration in the confirmation process?
 - (i) absolute priority rule?
 - (ii) best interest test?
 - (iii) feasibility test?
 - (iv) economic test?

Answer: In general, yes; all these criteria are considered.

G. *Post-confirmation Procedures*

1. *Management*

- a. Who manages the firm under the plan? (e.g. former managers/person recommended by the creditor/person recommended by the court)

Answer:

The incumbent managers, and any person(s) recommended by the creditors, if they wish, under the supervision of the administrator, the court, and the creditors' committee, if any.

- b. What kinds of incentives are provided to managers? (e.g. stock option/bonus/others)

Answer:

None are provided by law, but incentives may be provided upon agreement of the creditors and the debtor.

- c. How are managers who execute the plan controlled? (e.g. terms/salary/dismissal/others)

Answer:

The creditors (or creditors committee) and the administrator may request the corporate debtor and the managers to provide all information regarding the management and settlement of the corporate debtor and its assets, and may also give their suggestions on such management and settlement. The administrator must prepare a quarterly report to be submitted to the court and also made available to the public.

2. *Monitoring the Firm*

Monitoring mechanism by creditors

- (i) reporting mechanism:
- (ii) suggestion mechanism:

- (iii) filing for the cancellation of the proceeding:
- (iv) others:

Answer:

With regard to (i) and (ii), please see our answer above. As to (iii), filing for the cancellation of the composition plan shall be conducted pursuant to the following provisions:

Article 160 of the Bankruptcy Law allows any creditor to request the cancellation of the ratified composition plan if the debtor neglects to comply with the contents of such reconciliation. Proof of fulfillment of the reconciliation is the obligation of the bankrupt debtor. The supervisory judge is authorized to require the bankrupt debtor to fulfill such obligation within one month.

A request to cancel the composition plan shall be filed and decided in the same manner as the submission of a petition for bankruptcy (Article 161 of the Bankruptcy Law).

A decision to cancel a composition plan should also include an order to re-open the bankruptcy proceeding, as well as the appointment of the supervisory judge and creditors committee (if the previous bankruptcy proceeding had appointed such committee). The supervisory judge who is appointed, as well as the committee members, must be the same persons who filled such positions in the previous bankruptcy proceeding (Article 162 of the Bankruptcy Law).

H. Statistics

1. Total number of cases in the past five years

- (i) bankrupt firms:
 - (ii) liquidation:
 - (iii) composition:
 - (iv) reorganization:
 - (v) others:

Answer:

Before the establishment of the Commercial Court on August 20, 1998, all bankruptcy proceedings were proceeded through and decided by district courts. At that time, the losing or objecting party might take three legal actions

following the decision of the district court: first, the filing of an appeal at the high court located in each province; second, the filing of a cassation appeal at the Supreme Court; and third and finally the filing of a review appeal at the Supreme Court.

Upon its enactment, the Bankruptcy Law specially empowers the Commercial Court to hear and adjudicate petitions for bankruptcy declarations and for suspension of debt payments. The losing party or any objecting party may file an appeal directly to the Supreme Court for cassation and/or review.

We are unable to provide data on the total number of insolvency cases in the past five years since there is no centralized and integrated record system for decisions issued by the courts through Indonesia. The following data was obtained from the Jakarta Commercial Court and the Supreme Court.

The 112 petitions filed with the Jakarta Commercial Court as of August 1998 until the end of October 1999, resulted in the following:

- (i) Bankrupt firms and liquidation: 24 petitions were accepted by the Court declaring 18 companies and approximately 12 persons bankrupt;
- (ii) Composition and reorganization: 12 petitions were accepted for reorganization;
- (iii) Others: 43 petitions for bankruptcy were rejected;
- (iv) Withdrawn petitions: 18 petitions were withdrawn by the petitioners for out-of-court settlements amongst the creditors and debtor;
- (v) Pending decisions: 15 petitions.

2. *Ratio*

Answer:

- (i) Number of orders for opening and number of filings: 100%. All petitions submitted to the Commercial Court were proceeded, and some of them are still in the process of proceeding;

- (ii) Number of confirmations of the plan and number of orders for opening: 100% (see our answer above);
- (iii) Number of recovered firms and number of confirmations of the plan: As noted above, of the 112 petitions submitted to the Commercial Court, 12 were accepted for reorganization and 18 were withdrawn due to out-of-court settlements. However, since most of the compositions and reorganizations are still under process of recovery of the corporate debtors, we are unable to provide a precise number of successfully recovered firms.

3. *Average time between the processes*

Answer:

- (i) From the filing to provisional measures: Less than 30 days from the date of submission of the bankruptcy petition, because the petition itself must be decided within 30 days of registration the Commercial Court.
- (ii) From the filing to the order of opening: Within nine days as of the date of registration of the bankruptcy petition with the Commercial Court, the Court must appoint a Panel of Judges and decide on the date of the first hearing, which may not be later than 20 days after the registration date. However, with the approval of the Commercial Court, the first hearing may be delayed for up to five more days.
- (iii) From the order for opening to the confirmation of the plan: Approximately 36 days, for the confirmation of provisional composition.
- (iv) From the confirmation of the plan to the closing of the proceedings: Approximately 225 days, for the completion of the permanent composition plan. Or, 270 days as of the date of the provisional composition is stipulated by the court.

IV. Effect of Insolvency Proceedings on the Efficiency and Welfare of Creditors and Debtors

(If there is more than one proceeding, each process may be explained separately)

A. *Criteria for a reorganization decision and its effect on the economic value of the firm*

Answer:

There are no specific criteria for reorganization except that (i) the corporate debtor must still be feasible and there is a potential for reorganization, and (ii) that the creditors must agree to renegotiate the terms of payment.

B. *Process of drawing up reorganization plans and its effect on the relative bargaining position of stakeholder*

Answer:

The reorganization plan is drawn up by the corporate debtor with the terms and conditions agreed by the creditors.

- (i) Petitioner files a suspension of payment application at the Commercial Court, enclosing the composition plan;
- (ii) the Commercial Court grants a temporary suspension of payment for a maximum period of 45 days;
- (iii) the Commercial Court appoints an administrator and a supervisory judge for the suspension of payment process;
- (iv) the administrator calls for a creditors' meeting within 45 days after the decision on the temporary suspension of payments;
- (v) in the creditors meeting, the Court examines the corporate debtors, the creditors, the supervisory judge and the administrator and discusses the composition plan proposed by the debtor;

- (vi) to be approved, the composition plan requires more than 1/2 the affirmative votes of the unsecured creditors, representing more than 2/3 of the total debt claims;
- (vii) if the composition plan is approved, then the Court shall grant a permanent suspension of payments for a maximum period of 270 days after the decision to temporarily suspend payments;
- (viii) if the composition plan is rejected, then the Court will reopen the bankruptcy proceeding of the debtor.

C. *Corporate governance of the firm during insolvency proceedings and while the firm is in a reorganization process*

Answer:

A corporate debtor being petitioned for bankruptcy will still be managed by its directors/managers, so long as the Court does not declare it bankrupt, as well as while the firm is in the reorganization process. The firm may assign a provisional receiver to manage the firm in the interim, either upon a request from the creditors to the court or if the firm itself wishes to do so.

D. *Quantum or other rules for the adoption of a plan*

Answer:

Please see our answer to Section III.F.a and b.

E. *Cram down*

Answer:

The Bankruptcy Law does not contain any provision authorizing the Commercial Court to confirm a composition plan (with respect to a request for the suspension of payments), notwithstanding the creditors' opposition.

F. *Division of economic values by various stakeholders, particularly among shareholders and creditors.*

Answer:

Please see our answer above on the rank of priority of creditors (including stakeholders). Practically speaking, the shareholders of the bankrupt corporate debtor may not get any portion of the monies distributed from the bankruptcy assets.

G. *Any special or favorable treatment of a particular stakeholder such as employees?*

Answer:

Yes, there is favorable treatment of employees in the event the corporate debtor is deemed bankrupt. Please see our answer above on the priority of claim payments for further details.

H. *Duration of time for the proceedings and their effect on the economic value of the firm as well as the welfare of various stakeholders; and statutory limitations on the duration of time for proceedings and their practical effects.*

Answer:

The bankruptcy proceeding at the Commercial Court will be completed within 30 days as of the date of registration of the bankruptcy petition at the Court.

Under Article 1967 of the ICC, claims are generally subject to the 30-year statute of limitations. The complete wording of this article is as follows:

"All legal claims, material and personal, will become void by the lapse of thirty years, without any obligation on the part of the party claiming a lapse of the statute of limitations to produce any basis for its argument, and no exceptions shall be allowed, including any based on bad faith".

The effect of duration of time for the proceedings on the economic value of the firm and the welfare of various stakeholders:

I. Course of actions that follow non-adoption of a plan or termination of the proceedings, and their impact on the firm's operation and value as well as on the payoffs to various stakeholder.

Answer:

Any creditor may request the cancellation of the ratified reconciliation if a bankrupt debtor neglects to comply with the composition plan. In this case, the evidence of the fulfillment of the reconciliation shall be the obligation of the bankrupt debtor (Article 1601 of the Bankruptcy Law).

An order to re-open the bankruptcy proceeding shall be included in the decision to cancel the reconciliation and declare the debtor bankrupt. In this event, the appointed receiver will immediately take over the firm's operation and settle its bankruptcy assets into liquidation (Article 165 of the Bankruptcy Law).

If, pursuant to the agreed composition plan, there are certain creditors who have been paid either partly or in full, then the other creditors and new creditors, if any, that have not been paid shall be paid first, based on the percentages previously agreed in the composition plan. The balance of the unpaid claims shall be divided amongst all creditors on a pro rata basis (Article 166 of the Bankruptcy Law).

J. Availability and convenience of the sale of assets, operations, or the firm itself to a third party during insolvency proceedings.

Answer:

As mentioned above, upon the declaration of bankruptcy, the management of the corporate debtor and its assets shall be assigned to and taken over by the receiver. The receiver will also be responsible for and entitled to the proceeds from the sale of assets, the operation of the firm and its relations to third parties, because the directors, commissioners and shareholders of the corporate debtor no longer have authorization over the firm and its assets.

K. Impact of the start of insolvency proceedings on the behavior of the firm, its creditors, trading partners, and on the value of the firm

Answer:

As noted above, during the insolvency proceedings and the settlement of bankruptcy assets, the operation of the firm will be undertaken by the receiver.

As a practical matter, the value of the firm in insolvency is minimal than it is in a solvent condition.

L. *Respective incentives of managers and shareholders, various creditors, employees, and the government in facing the insolvency proceedings, including the incentives of some stakeholders to play protracted waiting games or wars of attrition.*

Answer:

There are no incentives to any party facing insolvency proceedings. However, the priority ranking of payments is available to certain ‘creditors’ and stakeholders, including payment of government taxes and employee severance.

M. *Industrial policy and other policy concerns of the government facing insolvent firms, the likelihood and the mode of the government’s intervention in insolvency proceedings*

Answer:

Following the enactment of the Bankruptcy Law there was only one Commercial Court, which was established within the domain of the Central Jakarta District Court. Until 18 August 1999, this Court tentatively operated for the whole territory of Indonesia until four additional commercial courts were established by the issuance of Presidential Decree No. 97 of 1999 in August 1999. The Commercial Court is the court in charge of hearing and deciding on petitions for bankruptcy adjudication.

In addition to hearing and deciding petitions for both bankruptcy and suspension of debt payments, the Commercial Court should also have jurisdiction to hear and decide other commercial cases.

The GOI has also passed Law No. 30 of 1999 on Arbitration and Dispute Settlement Alternatives on August 12, 1999 (“Law No. 30”). The regulations that were previously used as arbitration guidelines, found in the old civil procedure law (*Reglement op de Rechtverding* or “RV”), are no longer applicable. The RV did not address international contracts and their implementation.

Arbitration as regulated in Law No. 30 is a means of settlement outside the general judicial court system based on the written agreement of the disputing parties. However, not all disputes may be settled through arbitration, only

disputes regarding rights which according to the law are held by the disputing parties on the basis of their agreement.

Law No. 30 now sets forth the procedures for submitting cases to the arbitration committee. It also permits arbitrators to issue provisional decisions, stipulate impounds, order the safekeeping of goods or the sale of damaged goods, as well as to hear witnesses and expert witnesses.

In general terms, the arbitration body holds certain advantages over the judicial body. The former:

- a) guarantees the confidentiality of the parties and the proceedings;
- b) may avoid delays due to procedural and administrative matters;
- c) allows the parties to select those arbitrators they deem as honest and fair and having sufficient knowledge, experience and background regarding the matter in dispute;
- d) allows the parties to select which law to use to settle the matter as well as the process and place of arbitration; and
- e) makes the decision of the arbitrator binding on the parties through simple procedures or direct implementation.

Over time, arbitration in Indonesia should improve, but this will also depend on improvements within the judiciary.

The GOI has established the Steering Committee under the management of the Indonesian Supreme Court in 1998. This Steering Committee has made improvements such as the right to appoint ad hoc judges and to determine the court fee for bankruptcy proceedings. However, the functions, authorities, and administration of these ad hoc judges are still unclear. As far as we are aware, although ad hoc judges have been appointed, none have heard any cases.

V. Markets for Ailing Firms and Their Assets

A. *Markets for the Assets of Financially-Troubled Firms*

1. *How well developed are the markets for assets of firms to be liquidated? Are there any structural impediments to a smooth transaction of assets?*

Answer:

With regard to the liquidation proceeding, there is no specific requirement on selling the assets of a company-in-liquidation. During the process of settlement of the company's assets, the liquidator is authorized to settle the company's assets as far as possible by selling them to third parties. In selling the company's assets the liquidator may use either a private sale or a public auction.

Upon the liquidation decision either by a General Meeting of Shareholders or by a court order, the liquidator must carry out such acts as are necessary to settle the company's assets in the liquidation process, which acts cover:

- (i) the inventory and collection of the company's assets;
- (ii) the determination of procedures for asset distributions;
- (iii) the payments to the creditors;
- (iv) the distribution of the remaining assets in the liquidation to the shareholders; and
- (v) other actions necessary in settling the company's assets.

For the auction proceeding, there are some weaknesses concerning the rights of the winning bidder, particularly with regard to the sale of immovable assets. Upon the completion of the Auction Report (a report of the auction proceeding provided by government officials) the winning bidder in the auction proceeding cannot enjoy the sold collateral until he files a lawsuit with a district court. In practice, the court proceeding will take at least four months as of the date the lawsuit is submitted. ASBALI (the Association of Indonesian Auctioneers) proposes to do away with such procedures by changing the proceeding from a court decision on the lawsuit to a court affirmation. The reason for this proposal is that the Auction Report has executorial power equal to a court decision.

We note that although this lawsuit does not alter the auction proceeding itself, the winning bidder is still prevented from immediately enjoying the benefits of the collateral. Moreover, this situation hinders the development of the national auction institution, since selling by auction is more expensive and involves a more drawn-out procedure than a private sale.

A private auction institution can only be used for assets belonging to a private party, not State-owned assets or goods.

2. *Are there government agencies, state-owned enterprises or financial institutions specializing in the acquisition and sales of the assets of bankrupt firms?*

Answer:

It is not necessary for a bankrupt firm to sell its assets. A receiver may, however, decide to sell such assets, having obtained prior approval from the supervisory judge, if he believes such sale will result in greater revenue. The receiver has an option to sell the assets through either a private sale or an auction. There are two types of auction: government auctions and private auctions. Presidential Decree No. 21 of 1991 regarding the State Receivables and Auction Affairs Agency (Badan Urusan Piutang dan Lelang Negara or "BUPLN") stipulates the establishment of a government agency specializing in the acquisition and sale of the assets of a debtor to settle its unpaid debt. BUPLN is assigned to arrange auctions and the settlement of State receivables arising either from the enforcement of its duties or the enforcement of discretionary rules decided by the Minister of Finance and the prevailing laws. BUPLN is thus authorized to sell not only State-owned assets or goods, but also those belonging to private parties.

Established by Minister of Finance Decree No. 299/KMK.01/1997 regarding Auction Institutions, private auction institutions are authorized to carry out voluntary auctions of movable or immovable assets owned by individuals, the public or business entities, upon the request of the asset owner. Private auctions are permitted to accept, compile, register, classify, enhance the value of, store, appraise and market the assets or goods received from the owner. However, private auctions may not auction State-owned goods or assets, goods or assets acquired by the State, or goods or assets which are exempt from auction proceedings pursuant to the prevailing laws.

B. Markets for the assets and shares of firms during insolvency proceedings or reorganization

1. *How well developed are the markets for assets of firms in reorganization procedures? Are there any structural impediments to a smooth transaction of assets?*

Answer:

The reorganization of a company merely involves the organs of the company such as the general meeting of shareholders, the BOC, and the BOD of the company, as well as any external auditor. As above, if the company decides to sell its assets it will have two options, a private sale or an auction.

2. *Are there government agencies, state-owned enterprises or financial institutions specializing in the acquisition and sales of the assets of firms in reorganization procedures?*

Answer:

Yes, please see our answer above.

VI. Informal Insolvency Proceedings

A. Workouts

1. *Legal basis for workouts (e.g. statute/government policy/private agreement)*

Answer:

The legal basis for a workout is a private agreement. However, an institution has been established to facilitate restructuring, known as INDRA (the Indonesian Debt Restructuring Agency), under Presidential Decree No. 31 of 1999. For a particular State-owned company, the GOI will issue a regulation to establish a team to deal with the restructuring, such as the restructuring team for PT Perusahaan Listrik Negara (PLN) (under Presidential Decree No. 139 of 1998).

2. *Who initiates the process? What is the role of these organizations?*

- (i) Banks
- (ii) Government
- (iii) Financial supervision authorities
- (iv) Others

Answer:

Usually the debtor will initiate the workout process to settle its debts. The role of the organizations listed above is as follows:

- (i) Banks: For cases where a bank acts as the creditor, BI has issued guidelines on credit restructuring as referred to in BI Decree No. 31/150/Kep/Dir/1998 on Credit Restructuring (“Decree No. 31/150”). This regulation supports Decree No. 27/162, which requires banks to take an active role in monitoring credit and to take any measures required by Decree 31/150.
- (ii) Government: The role of the GOI with respect to private debt restructuring is as follows:
 - 1. Promulgating various rules to facilitate restructuring;
 - 2. Forming a team for problems concerning settlement of Indonesian private sector debt. This team will negotiate debt settlements with foreign creditors (Presidential Decree No. 4 of 1998);
 - 3. Setting up the JITF, one of whose duties is to facilitate negotiations by summoning the debtors and creditors to discuss debt settlements. The JITF also provides, free-of-charge, the consultants required in negotiations and debt settlements, such as accountants, lawyers, and so on;
 - 4. Establishing INDRA to help resolve the settlement of external foreign currency denominated debts of Indonesian corporations. INDRA takes over exchange rate risks but assumes no responsibility for commercial risks (Presidential Decree No. 94 of 1998)
 - 5. Establishment of IBRA to provide restructuring scheme for debtors of banks restructuring under IBRA’s supervision (Government Regulation No. 27 of 1998).
- (iii) Financial supervision authorities: Under Presidential Decree No. 56 of 1998, BI has taken an active role in private debt restructurings by listing all corporate debtors with foreign debts, to be used as input for the GOI. BI is also responsible for supervising and supporting the INDRA program.

- (iv) Other: The Indonesian Accountants Association has issued accounting standard (PSAK) No. 522 with respect to Foreign Currency Reporting, making it possible for a company to use a foreign currency (functional currency) in drawing up its reports, so long as certain criteria are met.

3. *Please draw a flow-chart of the workout process*

Please see **Exhibit I**.

4. *What are the criteria*

a. Selection of firms

Answer:

There are no specific criteria for the selection of firms, except that the workout must be to settle Indonesian private corporate debts. There is no discrimination between domestic and foreign creditors in the implementation of this program.

b. Plan formulation and agreement

Answer:

The following is the process for formulating and agreeing on the plan for workouts under the Jakarta Initiative:

a) Organization and Representation

- A Debtor should engage advisors experienced in corporate and debt restructuring.
- The restructuring process may be initiated by the debtor or its creditors.
- Creditors should form a single steering committee representative of creditors (the “Creditors’ Committee”).
- Unless otherwise agreed, the Creditors’ Committee should select a chairperson, financial advisor and legal advisor, each experienced in the process of corporate and debt restructuring.

- Costs will be borne by the debtor, unless otherwise agreed.
- b) Critical Role of Senior Management
- The debtor and the Creditors' Committee should appoint senior managers with demonstrable authority to participate in the debt and corporate restructuring.
- c) Standstill and Interim Financing
- The creditors should agree to a standstill for a reasonable and finite period.
 - The debtor and creditors should agree on what they can and cannot do during the standstill period.
 - The creditors should attempt to subordinate their claims to any funds advanced after the standstill commences.
 - The creditors should consider providing the working capital necessary to finance the debtor's operations during these negotiations or subordinating this task to others who are willing to provide such capital.
 - The debtor should provide creditors with access to information in order to permit an evaluation of a request for such interim financing.
 - The creditors and debtor should agree on permissible uses of, control over, conditions for disbursement of, and monitoring mechanisms for such interim financing.
- d) Access to the Information
- The Creditors' Committee members and their professional advisors should sign confidentiality agreements after which the debtor should provide them with up-to-date detailed financial information.
 - The actual information to be provided shall be determined on a case-by-case basis between the debtor and creditors.
- e) Company Restructuring Proposal
- The debtor should propose a restructuring plan to the Creditors' Committee, accompanied by the disclosure of information, as agreed.

- The proposal should be based on the debtor’s business plan and financial forecasts, the preparation of which should heed creditors’ contractual priorities, including their collateral positions.
- f) Creditors’ Committee’s Advisory Report
- The debtor should grant full and ongoing access to its Creditors’ Committee’s advisors to review the debtor’s business and financial status.
 - The Creditors’ Committee’s advisors will use this information to prepare an advisory report.
 - The advisory report should include a review and analysis of the debtor’s business operations, management and future prospects.
 - The report should contain recommendations and conclusions as to the viability of the company, group or any business thereunder, its ability to service its debt and its working capital needs for the future.
- g) Negotiation of a Restructuring Plan
- Using both the debtor’s restructuring proposal and the Creditors’ Committee’s advisory report, the parties should enter into negotiations to achieve a corporate and debt restructuring plan.
 - Expeditious negotiations are of the essence.
 - The agreed plan should respect and preserve creditors’ contractual positions, including creditors’ collateral rights and positions under subordination agreements.
 - No party should be forced to make any concessions, but commercial considerations should control each party’s decision-making process.
- h) Pre-Negotiated Bankruptcy Plans
- Best efforts should be made to present the agreed corporate and debt restructuring plan to creditors, except those whose rights will not be affected.

- Insofar as unanimity between all creditors may be elusive, the Bankruptcy Law may permit access to the commercial court for approval of the provisional “pre-negotiated” plan, provided that the pre-negotiated plan complies with the requirements of the Bankruptcy Law.

c. Execution

Answer:

As mentioned above, unanimity among creditors may be elusive; not all creditors might sign the settlement agreement. In the implementation of an agreement, the parties may use the INDRA scheme, which is a program for the purchase of foreign currency to facilitate corporate restructuring.

5. *Relationship between workouts and formal insolvency proceedings*

- a. Does or could this relationship preclude the use of formal insolvency proceedings, or does it offer another channel to resolve disputes before resorting to formal insolvency proceedings?

Answer:

Yes. The existence of informal settlements can preclude the use of formal insolvency. Further, according to the Bankruptcy Law, the debtor can request the suspension of payment to the Commercial Court to settle its debts, failure of which will cause the debtor to be declared bankrupt.

- b. What are the practical advantages for resorting to workout, from the efficiency perspective and also from the perspective of some stakeholders?

Answer:

Resorting to workouts is more likely to lead to the creditor obtaining full repayment. However, this process tends to take much longer for agreement to be reached than does a formal insolvency proceeding with its limited time period for a decision to be made.

- c. Statistics and cases, before and after the economic crisis.

Answer:

Since most of the informal workouts conducted before the economic crisis were not officially recorded, there is no qualified data on statistics and cases of workout. Since the start of the economic crisis in 1997, more than 250 workout cases have been registered to settle corporate debts through the JITF. Only 27 cases have been successfully completed.

Examples of some successful informal work-out cases without the JITF mediation:

PT Astra International Tbk. (AI), whose core business is the automotive industry: AI has successfully rescheduled payment of its debts with more than 200 creditors. The total debts of 979 million US\$ and 926 billion Rp. have been rescheduled for periods from three to seven and a half years until 2003.

PT Danareksa (mutual fund): Danareksa combined a buy-back scheme with its rescheduling. Danareksa bought back its debts, but received a discount. Creditors who did not wish to be restructured, walked out by selling their debts back to Danareksa. Danareksa benefited, gaining debt cut of the buy-back. Prior to the buy-back scheme, Danareksa's debt amounted to US\$370 million, owed to 53 creditors in 14 countries. Danareksa bought back debt in the amount of USD182 million or around 49% of the promissory notes which should be paid in the average price of 49.5% of the nominal price. This resulted in accounting profits for Danareksa of at least Rp. 750 billion.

B. *Composition Agreement*

1. *How often is this used by debtors?*

Answer:

Within the formal insolvency proceedings, the composition agreement was used by debtors and creditors in less than 25% of the total 112 cases.

2. *How do they secure the agreement?*

Answer:

They secure the agreement by inserting a bankruptcy clause or privilege rights in favor of the creditors.

C. *Other schemes employed to resolve systemic insolvency/non-payment*

Have schemes such as netting processes for enterprise debts or London club-style procedures for private bondholders in private companies of a specified nationality been employed in your country? Any other schemes worth mentioning?

Answer:

No to both questions.

VII. General Information on Bank Insolvency Regimes

A. *A general description of insolvency regimes for failing banks.*

Under Article 1 of the Bankruptcy Law, the petition for a declaration of bankruptcy may only be filed by BI in the event that the debtor is a bank.

Pursuant to Article 37 of Law No. 7 of 1992 on the Banking Law, as amended by Law No. 10 of 1998 jo. Government Regulation No. 25 of 1999 on the Revocation of Business Licenses, Dissolution and Liquidation of Banks, in the event a particular bank suffers difficulties which threaten its continued operation, BI may take necessary actions so that:

- a) the shareholders add capital;
- b) the shareholders replace the bank's commissioners and/or directors;
- c) the bank writes off bad credit or bad financing based on the Syariah (Islamic Law) Principle and calculates losses in relation to the bank's capital;
- d) the bank merges and consolidates with other banks;
- e) the bank is sold to buyers who are ready to take over all its liabilities;
- f) the bank hands over the management of all or part of its activities to other parties;
- g) the bank sells part of or all its assets and or liabilities to other banks or parties.

Further, if the above actions are still not sufficient to overcome the difficulties encountered by the bank; and/or if pursuant to its evaluation, BI considers the condition of the bank may endanger the banking system, then BI may revoke the bank's business license and order the directors of the bank to hold a general

meeting of shareholders promptly, in order to dissolve the bank as a legal entity and to establish a liquidation team.

If the bank's directors fail to hold a general meeting of shareholders to dissolve the bank within 60 days after the revocation of its business license, BI will ask the court to dissolve the bank as a legal entity and appoint a liquidation team to conduct the liquidation in compliance with the prevailing laws and regulations.

The liquidation of a bank can be conducted in two ways: (i) by selling the bank's assets and/or claiming the receivables from the debtors, followed by the payment of the bank's obligations to creditors; or (ii) by assigning all assets and obligations of the bank to another party approved by BI.

B. A brief summary of statistics on failing banks and how they have been taken care of.

Answer:

During 1992 to 1996, Bank Summa was the first bank to be liquidated, due to its bad property debts. The liquidation was carried out under Law No. 7 of 1992 on the Banking Law.

As mentioned above, in November 1997, 16 banks were closed down and liquidated by the GOI. Then, in April 1998, IBRA revoked the business license of 7 banks, leading to their liquidation.

In May 1998, Bank Central Asia, Indonesia's largest private bank, was placed under the IBRA restructuring program. It was taken over by the GOI three months later.

In August 1998, six banks (Bank Danamon, Bank Umum Nasional, Bank Tiara, Bank PDFCI, BDNI and Bank Modern) run by IBRA were declared insolvent. Eventually, three of these banks (BDNI, Bank Umum Nasional, and Bank Modern) were closed down by the GOI, while Bank PDFCI, Bank Danamon and Bank Tiara were taken over by the GOI.

In March 1999, the GOI closed down 38 more banks and took over a further seven. In April, the GOI took over Bank Niaga and Bank Bali when they failed to inject fresh funds for the recapitalization program. The other seven banks are still under the recapitalization program.

Banks which have been placed under IBRA restructuring are being supervised intensively. IBRA has restricted foreign exchange transactions and installed its officials to supervise these banks directly.

In the case of banks taken over by the GOI, IBRA immediately suspends shareholders' rights and replaces the bank's management. IBRA functions in place of the former shareholders and a governance contract is drawn up with a state-owned financial institution to provide new management with full control over the bank.

In cases where the operations of the banks have been frozen, their liabilities are transferred to a sound bank, shareholders' rights are suspended and the management replaced. IBRA functions in place of the former shareholders with full control over the bank. Usually, such action will be followed by the revocation of its business license by the GOI and then liquidation.

VIII. Problems, Future Tasks, and Trends

A. *What are the main problems with the current insolvency mechanisms, overall and specific, in terms of efficiency and fairness?*

In particular, how does the current system provide distorted incentives to some stakeholder that result in inefficient outcomes in both the static and dynamic sense.

Answer:

- (i) The main problem with the current insolvency mechanisms is the continuing perception that the judiciary does not operate fairly and professionally. The background of judges in many cases may not be appropriate for dealing with complicated international business transactions. Many of the bankruptcy petitions submitted involve modern and sophisticated transactions of derivatives, swaps, commercial papers, etc. When the judges presiding over a hearing lack a full understanding of the transactions, this leads to misinterpretations or narrow interpretations of the documents that are submitted as evidence by the parties. The main problem, however, is the overall perception that Indonesian courts are subject to corrupting influences.
- (ii) Some problems have arisen in practice due to the unclear provisions in the Bankruptcy Law, particularly on procedural

matters. In practice, the procedural law used in bankruptcy trials still refers to the Indonesian Civil Procedural Law. The definition of debt in the Bankruptcy Law has been interpreted in two different ways. One side argues that the legal term “debts” in the Bankruptcy Law refers to the law of obligations in the ICC. Under the ICC, obligations or debts can arise either out of contract or out of law. There are obligations to provide something, and obligations to do or not to do something. A creditor is entitled to expect the performance of the obligation by the debtor, which obligation the debtor is obliged to perform. In contrast, the Supreme Court appears to have a totally different opinion about the meaning of the legal term “debts”. The Supreme Court effectively narrowed the meaning of this term in its judgement in certain cases. In these cases, the Supreme Court decided that a debt consists of the principal debt plus interest. Consequently, only loans would qualify as debts under the Bankruptcy Law.

B. Are there other elements other than insolvency proceedings themselves that have critical deficiencies, such as the governance problem of banks and other financial institutions in Indonesia?

Answer:

Yes, there are. Under the BI Decision No. 27/162 jo. BI Decision No. 31/147/Kep/Dir/1998 on the Quality of Productive Assets, commercial banks are obligated to determine their credit policies in writing. These credit policies should regulate at least the following fundamental matters: (i) the principle of prudence in credit affairs; (ii) the organization and management of credit affairs; (iii) credit approval policies; (iv) the documentation and administration of credits; and (v) the settlement of credit problems.

The problems with the lending practices of domestic banks are essentially as follows:

- a. there is an issue of “moral hazard” of bankers and debtors;
- b. there is inadequate law enforcement for violations of banking regulations;
- c. there is a lack of effective supervision by the central bank, BI;
- d. the technical ability of bank officers to understand their customers’ business is still weak; and
- e. there has been a practice of high-ranking government officials abusing their power.

The above matters should be addressed and resolved first prior to addressing technical matters. To overcome the moral hazard of bankers, BI conducts a “fit and proper test”, which should entail an evaluation of the competence and integrity of the controlling shareholders, as well as the competence, integrity, and independence of the Directors and the Commissioners in controlling the operational activities of commercial banks³. While BI has provided guidance and provisions on lending practice, further efforts are needed to implement these matters seriously and properly. The role of BI in enforcing the banking regulations is crucial to educate Indonesian bankers to become more professional.

There have been no court trials for violations of the banking provisions, indicating lack of effective law enforcement in the banking sector.

However, in practice, only a few banks have complied with Decision 27/162. Such lack of compliance may be responsible in part for the large percentage of non-performing loans in commercial banks.

In these cases, the owners of the banks were likely to force the management of banks to channel funds into companies within their own group. Even though the banking provisions regulate the legal lending limit and include penalties for violations, the central bank appears to have been ineffective in upholding the law and imposing appropriate penalties.

We note that not all violations of the legal lending limit are deliberate. Some violations have been due to US Dollar exposure and exchange rate fluctuations. Aside from this foreign exchange exposure, it is clear that almost all banks that have group credit are in category C (with CARs of minus 25% or below). Although the capital of these banks is negative, many owners have still obtained loans from them.

C. *What needs to be done to improve the effectiveness and efficiency of overall as well as the individual insolvency proceedings?*

Answer:

The following are some practical solutions to those problems:

- (i) The salaries of judges and other government law enforcement officials should be substantially increased. The salary levels of judges are too low to sustain them, thus encouraging corruption.

- (ii) Strongest judicial oversight should be put into effect. Judges who render poor decisions should be trained; incompetent judges should be dismissed; corrupt judges should be prosecuted. If the Supreme Court is itself reformed, it can undertake these steps without jeopardizing judicial independence. The Government should prioritize the reform of the judiciary to accomplish the above.
- (iii) Lawyers who engage in corruption should be subject to disciplinary proceedings and prosecution. The creation of a single, mandatory, state-centered bar may assist in this effort. Greater exposure to either courses and issues may assist.
- (iv) Decisions should be published and so be subject to review and criticism by the mass media and academics.

D. What changes have been made since the onset of the crisis? How do you evaluate their results?

Answer:

A number of regulations have been issued by the GOI. Some of the regulations issued, which relate to insolvency law reform, corporate governance and secured transactions, follow:

- 6. Government Regulation No. 64 of 1999 Regarding the Amendment of Government Regulation No. 24 of 1998 on Annual Corporate Financial Reports: This regulation deals with elements of legal certainty, transparency and access to financial information. It requires most types of companies to submit their annual financial reports to the Department of Industry and Trade.
- 7. Law No. 23 of 1999 on BI (“Law No. 23”): This is the new central bank law and it replaces and revokes Law No. 13 of 1968. It provides that BI is the Government’s treasurer and an independent state institution free from government intervention. Its key functions are threefold: to determine and implement monetary policy; to regulate and maintain an efficient payment system; and to regulate and supervise banks.
- 8. Law No. 23 is intended to guarantee the independence of BI, bearing in mind that the weaknesses of BI were partly due to its subordination to the GOI and its vaguely stated purposes. Law No. 23 is expected to become the legal basis for the central bank to effectively undertake its responsibilities by focusing on a single

objective and operating without any interference from the Government or other parties.

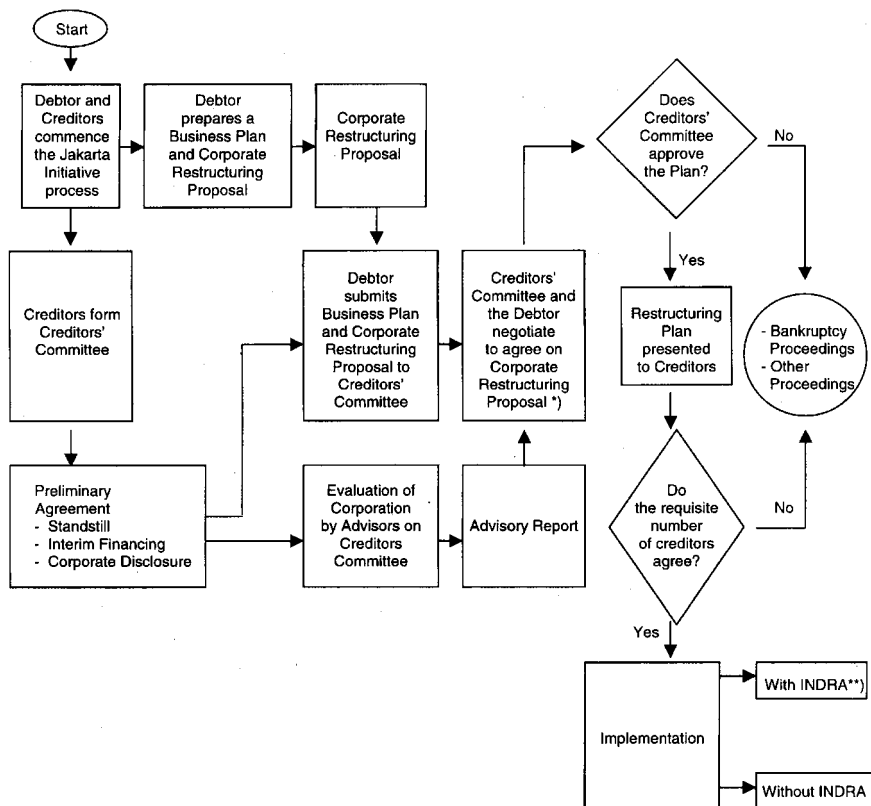
9. Government Regulation No. 17 of 1999 on IBRA: This regulation appointed IBRA as the special institution in charge of handling the Indonesian banking restructuring program referred to in Law No. 10 of 1998 on the amendment to the Banking Law, Law No. 7 of 1992.
10. Law No. 42 of 1999 on Fiduciary Transfers: For the first time in Indonesia, fiduciary transfers have now been legislated on. It has, however, come into use as a type of “common law” security device due to the commercial necessity for a financing device for movable property.

E. What are the current activities in this area, and what are the likely directions for the insolvency proceedings for the future?

Answer:

The GOI has been working on a bill to amend the Bankruptcy Law, as well as another bill on debt restructuring and company reorganization; to accommodate the needs of companies in financial difficulties and financial providers for a fairer and more just judicial system. In addition, the Parliament has also raised the issue of evaluating and examining the skills and accountability of Supreme Court judges.

Exhibit I The Jakarta Initiative Scheme



Notes:

*) Insofar as unanimity among all creditors may be elusive, the newly amended bankruptcy law allows access to the commercial court for approval of the pre-negotiated plan (making it binding on all creditors, even those who do not consent to it), provided that the pre-negotiated plan complies with the requirements of the newly amended bankruptcy law.

**) INDRA (Indonesian Debt Restructuring Agency) is a program designed to guard against foreign exchange rate fluctuations in order to facilitate corporate restructuring.

NOTES

1. Business News, May 1, 1999
2. Other relevant insolvency procedural regulations are:
 - The Company Law, Law No. 1 of 1995;
 - Law No. 2 of 1992 regarding Insurance;
 - Government Regulation No. 80 of 1998 on the Calculation of Creditors' Voting Rights;
 - Government Regulation No. 26 of 1999 on Tariffs on Non-Tax State Revenues Applicable at the Department of Justice;
 - Minister of Justice Decision No. M.02.UM.01.06-1993 on the Determination of Fees for Legal Services Provided by the Probate Court of the Department of Justice;
 - Minister for Development Planning/Chairman of the National Development Planning Agency Decision No. Kep.216/6/1998 on the Steering Committee for the Operation of Commercial Courts;
 - Minister of Justice Decision No. M.08-HT.05.10-1998 on the Procedures and Requirements for Registration of receivers and administrators;
 - Minister of Justice Decision No. M.09-HT.05.10-1998 on Guidelines for the Amount of Service Fees for receivers and administrators;
 - Supreme Court Decision No. KMA/022/SK/VIII/1998 regarding the Appointment of Judges for the Commercial Court;
 - Supreme Court Decision No. KMA/048/SK/X/1998, which amended Supreme Court Decision No. KMA/028/SK/IX/1998 regarding the Fees for Commercial Civil Cases Petitioned for Cassation and Civil Review;
 - Central Jakarta District Court/Commercial Court ("Commercial Court") Decision No. W7.Dc.HT.07/VIII/ 1998.01 on the Compositions of the Panels of Judges and supervisory judges of the Commercial Court;
 - Commercial Court Decision No. W7.Dc.HT.08/VIII/1998.01 on Registration Fees at the Registrar's Office of the Commercial Court for Bankruptcy Cases.
3. The Fit and Proper Test is regulated under Article 5 of Joint Decree of Minister of Finance and Governor of BI No. 53/KMK.07/1999 and No. 31/12/Kep/GBI on the Realization of the Recapitalization Program for Commercial Banks. This test was originally intended for Category B banks with CARs of (-25% to +4%) as a condition for inclusion in the Recapitalization Program, but it is also needed for other banks.

COUNTRY REPORT FOR KOREA

by

Il Chong Nam*, Soogeun Oh** and Joon-Kyung Kim*

I. Overall Economic Conditions and Extent of the Debt Crisis

I-1. Overview

Although Korea's financial crisis was triggered by a foreign currency shortage in financial institutions, there is little doubt that the financial troubles of debt-ridden firms, particularly *chaebols*, were at the epicenter of the crisis. The financial weakness of *chaebols* can be easily seen from their high debt leverage. As of the end of 1997, the average debt/equity ratio of the 30 largest *chaebols* reached 519 percent, about 130 percentage points higher than a year earlier (see Table I-1). In particular, the debt/equity ratios of those *chaebols* that later became bankrupt and/or subject to court receivership were at an unsustainable level at the time of the crisis. For instance, New Core's ratio was at 1,784 percent, while Haitai is reached 1,501 percent. Some *chaebols*, most notably Halla and Jinro, lost all their equity and fell into situations where their debts were greater than asset values.

Upon the onset of the crisis, a drastic rise in interest rates, coupled with a severe credit crunch, caused massive corporate bankruptcies. During the first quarter of 1998, the monthly average number of corporate bankruptcies exceeded 3,000, representing about a 200 percent increase compared to the same period of the previous year (see Table I-2). Massive corporate bankruptcies directly translated into a dramatic increase in non-performing loans (NPLs), seriously undermining the soundness of the financial system as a whole. As of the end of March 1999, the total amount of NPLs of all financial institutions had increased to 65.3

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trillion won (11.4 percent of total loans) from 43.6 trillion won (6.7 percent of total loans) at the end of 1997.¹

The Korean economy has successfully overcome the immediate liquidity crisis thanks to financial assistance from the IMF, World Bank and ADB, and the dramatic turnaround in current account balances. Accordingly, the won has stabilized greatly, holding steady at around the 1,200 level *vis-a-vis* the US dollar, down from 1,950 in December 1997. Currency stability has also led domestic interest rates to drop significantly.

Having achieved such positive results, the government has pursued financial restructuring. As of June 1999, 217 financial institutions have had their operations suspended or have been closed down. As part of the restructuring program, the government injected 40.9 trillion won (10 percent of GDP) in fiscal resources to rehabilitate the financial system between late 1997 and the end of 1998. First, KAMCO purchased 44.1 trillion won (book values) in non-performing assets from financial institutions at a cost of 19.9 trillion won. Second, the Korea Deposit Insurance Corporation provided a total of 21 trillion won for recapitalization, loss coverage for merging or acquiring institutions, and deposit repayments for closed institutions. The apportionment was 6.3 trillion won, 6.9 trillion won, and 7.8 trillion won, respectively. The government used an additional 23.1 trillion won at the end of 1999 to lay a solid foundation for a “clean bank” environment. As a result, most Korean banks obtained BIS capital adequacy ratios of 10-13 percent. Such improvement in the capital structure, coupled with the stabilization of interest rates, contributed significantly to the alleviation of the credit crunch. Indeed in 1998, the monthly figures for corporate bankruptcies fell from more than 3,000 in the first quarter to about 900 in the fourth quarter (see Table I-2).

However, the declining number of business failures seems to be more largely attributable to the bailout policy for troubled firms. In fact, creditor banks have not only provided co-financing loans to several distressed *chaebols* since the end of 1997, but also entered into corporate workout programs which have been applied to large-scale troubled borrowers (the top 6-64 *chaebols* and large, non-*chaebol* corporations).² As a result, despite the severe economic contraction, the number of large corporate bankruptcies declined dramatically to a total of 39 for all of 1998 as compared to 36 during the last two months alone of 1997. Considering the overlaid subcontracting structures, such a decline in large corporate bankruptcies reduced the incidence of chain bankruptcies among small- and medium-sized companies’ (SMC) subcontractors, thereby contributing to the reduction of overall business failures.

Table I-1 Top 30 *Chaebols*' Debt/Equity Ratio
(Unit: %)

1995		1996		1997		1998	
<i>Chaebols</i>	Debt/ Equity Ratio	<i>Chaebols</i>	Debt/ Equity Ratio	<i>Chaebols</i>	Debt/ Equity Ratio	<i>Chaebols</i>	Debt/ Equity Ratio
1. Hyundai	376.4	1. Hyundai	436.7	1. Hyundai	578.7	1. Hyundai	316.0
2. Samsung	205.8	2. Samsung	267.2	2. Samsung	370.9	2. Samsung	355.0
3. LG	312.8	3. LG	346.5	3. Daewoo	472.0	3. Daewoo	252.1
4. Daewoo	336.5	4. Daewoo	337.5	4. LG	505.8	4. LG	315.6
5. Sunkyung	343.3	5. Sunkyung	383.6	5. SK	468.0	5. Hanjin	458.3
6. Ssangyong	297.7	6. Ssangyong	409.4	6. Hanjin	907.8	6. SK	249.8
7. Hanjin	621.7	7. Hanjin	556.6	7. Ssangyong	399.7	7. Ssangyong	1,402.8
8. Kia	416.7	8. Kia	516.9	8. Hanwha	1,214.7	8. Kohap	impaired capital
9. Hanwha	620.4	9. Hanwha	751.4	9. Kumho	944.1	9. Hanwha	327.1
10. Lotte	175.5	10. Lotte	192.1	10. DongAh	359.9	10. Kumho	558.0
11. Kumho	464.4	11. Kumho	477.6	11. Lotte	216.5	11. DongAh	625.4
12. Doosan	622.1	12. Halla	2,065.7	12. Halla	impaired capital	12. Hyosung	281.2
13. Daelim	385.1	13. DongAh	354.7	13. Daelim	513.6	13. Daelim	335.8
14. Hanbo	674.9	14. Doosan	688.2	14. Doosan	590.3	14. Anam	8,550.7
15. DongAh	321.5	15. Daelim	423.2	15. Hansol	399.9	15. Dongkuk	198.8
Construction		16. Hansol	292.0	16. Hyosung	465.1	Steel	
16. Halla	2,855.3	17. Hyosung	370.0	17. Kohab	472.1	16. Doosan	331.7
17. Hyosung	315.1					17. Shinho	impaired capital

1995		1996		1997		1998	
<i>Chaebols</i>	Debt/ Equity Ratio	<i>Chaebols</i>	Debt/ Equity Ratio	<i>Chaebols</i>	Debt/ Equity Ratio	<i>Chaebols</i>	Debt/ Equity Ratio
18. Dongkuk Steel	190.2	18. Dongkuk Steel	218.5	18. Kolon	433.5	18. Hansol	458.7
19. Jinro	2,441.2	19. Jinro	3,764.6	19. Dongkuk Steel	323.8	19. Kabul	impaired capital
20. Kolon	328.1	20. Kolon	317.8	20. Dongbu	338.4	20. Dongbu	267.5
21. Tongyang	278.8	21. Kohab	590.5	21. Anam	1,498.5	21. Kolon	334.6
22. Hansol	313.3	22. Dongbu	261.8	22. Jinro	impaired capital	22. Jindo	impaired capital
23. Dongbu	328.3	23. Tongyang	307.8	23. Tongyang	404.3	23. Tongkook Co.	impaired capital
24. Kohab	572.0	24. Haitai	658.5	24. Haitai	1,501.3	24. Haitai	impaired capital
25. Haitai	506.1	25. New Core	1,225.6	25. Shinho	676.8	25. Woobang	impaired capital
26. Sammi	3,244.6	26. Anam	478.5	26. Daesang	647.9	26. Tongyang	306.0
27. Hanil	936.2	27. Hanil	576.8	27. New Core	1,784.1	27. Saehan	276.7
28. Kukdong Construction	471.2	28. Keopyong	347.6	28. Keopyong	438.1	28. Byucsan	655.4
29. New Core	924.0	29. Miwon	416.9	29. Kangwon	375.0	29. Shinwon	impaired capital
30. Byucksan	486.0	30. Shinho	490.9	Industrial		30. Kangwon Industrial	441.6
30. Saehan					419.3		
Total	347.5		386.5		519.0		369.1

Source: Fair Trade Commission.

Table I-2 **Bankruptcies**
(unit: number of firms)

	Large firm	SMCs	Unincorporated	Total
1996 (yearly)	7	5,150	6,432	11,589
1997 (yearly)	58	8,160	8,942	17,168
11	17	697	755	1,469
12	19	1,540	1,638	3,197
1998 (yearly)	39	10,497	12,292	22,828
1-3	16	4,275	5,158	9,449
4-6	8	2,847	3,502	6,357
7-9	8	2,031	2,182	4,221
10-12	7	1,344	1,450	2,801
1999. 1-9	7	2,486	2,578	5,071
1-3	2	925	1,005	1,932
4-6	3	801	858	1,662
7-9	2	760	715	1,477

Source: Bank of Korea.

I-2. Financial Landscape of Corporate Sector Before and After the Crisis

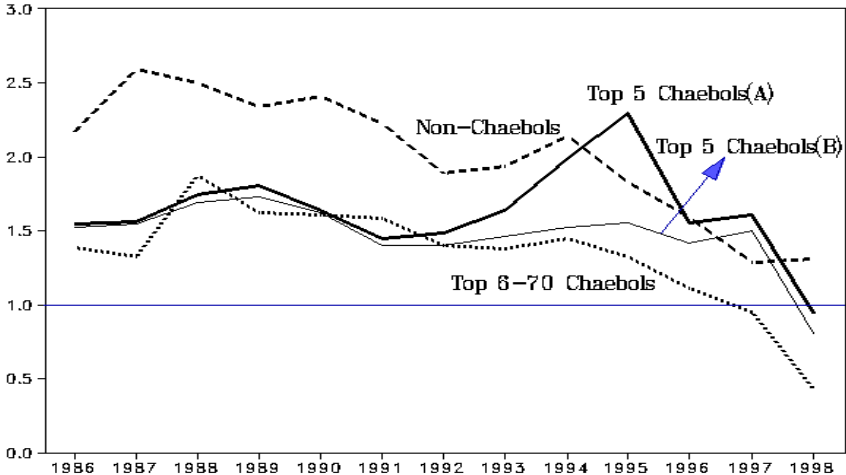
In order to investigate the role the weak financial structure of the corporate sector played in the financial crisis, it would be helpful to document the financial landscape of the corporate sector, particularly the *chaebols*, in more detail. To this end, the financial data of 6,116 non-financial firms, which are subject to external auditing requirements, are analyzed. The full sample is classified into three categories: affiliates of the top 5 *chaebols*, affiliates of the top 6-70 *chaebols*, and non-*chaebol* independent companies.

Given the high debt leverage of the corporate sector, a large share of operating earnings went to servicing their debts. Chart I-1 shows the time profile of the interest payment coverage ratio (IPCR), constructed as the ratio of operating earnings over interest expenses.¹ Notable features of Chart I-1 are that 1) the top 6-70 *chaebols* have been most vulnerable in terms of debt servicing capacity, and 2) the IPCRs of all three categories have been on a decreasing trend, despite short-term ups and downs.² At the time of the crisis in 1997, the IPCR of the top 6-70 *chaebols* was merely 0.95, far below the level of the top 5 *chaebols* (1.6) and non-*chaebol* companies (1.3). Such financial vulnerability of the top 6-70 *chaebols* has been attributed to prolonged poor business performance and high debt leverage.

Depending on the progress in restructuring, the financial landscape of the corporate sector varies across the three categories. *Chaebols* have experienced a substantial decrease in operating earnings mainly due to the combined effect of a sharp fall in sales revenue and capital loss related to exchange rate depreciation. This was particularly so for the top 6-70 *chaebols*. Despite the somewhat reduced debt levels, the debt servicing capacity of the *chaebols* deteriorated significantly after the crisis. The IPCRs of the top 5 *chaebols* declined to 0.94 in 1998, down from 1.60 in 1997. The decline in the IPCR is most pronounced in the top 6-70 *chaebols* as it fell to 0.43 from 0.95 in just a year. In contrast, the IPCRs of non-*chaebol* independent corporations rose slightly to 1.31 in 1998.

At this juncture, it should be noted that factor costs have stabilized considerably since the second half of 1998. Not only have interest rates dropped significantly, but nominal wages have also fallen as firms struggled to survive and workers preferred pay cuts to reductions in employment. Such reductions in factor costs are significantly improving firms' balance sheets and increasing IPCRs. These developments will contribute to the reduction of the corporate default risk. Nonetheless, considering the heavy debt service burden of *chaebols*, the potential of large business failures cannot be ruled out as can be seen recently by the serious credit risks posed by the Daewoo Group.

Chart I-1 Interest Payment Coverage Ratios
(unit: times)



Note: 1) (A) includes all subsidiaries of the top 5 *chaebols*, (B) excludes semiconductor-producing companies among the top 5 *chaebols*.
Data Source: National Information and Credit Evaluation Inc.

II. Debtor-Creditor Relationships

II-1. *Historical Background*

Given the fact that the corporate sector in Korea has relied heavily on indirect financing, lending institutions have been primarily responsible for corporate monitoring. However, the reality has been that the financial institutions have neglected monitoring and oversight. This has been due to the distorted incentive structure that was largely affected by a policy environment characterized by prolonged state control in the financial sector as well as lax financial supervision.

A. *Banking Sector: Prolonged State Control*

In Korea, unhealthy links between the government and banks were a legacy of government-led economic development. Since the early 1960s, policy loans were extensively utilized as an important instrument for industrial policies. The Korean government directly owned all major banks in 1961, and directed policy loans to priority sectors such as the exporting sector and heavy and chemical industries (HCIs). Policy loans were indeed substantial during the HCI drive in the 1970s: they constituted about 63 percent of the total loans extended by deposit money banks.³ Most banks were privatized in the early 1980s, but the state influence over the banking sector remained substantial until recently.

The provision of policy loans combined with interest rate control contributed to investment resource mobilization and rapid industrialization. At the same time, however, such a policy resulted in heavy corporate leverage, particularly for *chaebols*, as well as the underdevelopment of the banking industry in terms of risk management and credit evaluation. The debt-ridden *chaebols* became vulnerable to business fluctuations, and corporate failures posed systemic risks at the time of recession. Given the tight linkage between the banking and corporate sector, corporate failures had an immediate impact on the soundness and viability of banks.

For these reasons, the government undertook major corporate bailout exercises on numerous occasions, including the August 3rd measure of 1972⁴, industrial restructuring of major HCIs in the early 1980s, and industrial rationalization measures in depressed industries such as shipping and overseas construction during the mid-1980s. The government also provided financial support to creditor banks in order to prevent systemic risks.

The government-led bailouts exacerbated the already weak market discipline and caused serious moral hazard problems. Excessive corporate leverage based

on implicit risk-sharing by the government created the so-called "too-big-to-fail" hypothesis, which worked as an important exit barrier and often overshadowed the voices calling for financial market liberalization. Given the implicit state guarantees on bank lending, banks had little incentive to monitor client firms' investment decisions. Strict prudential regulation and supervision were rarely applied to banks given the fact that the government and banks were in the same boat in the sense that both acted as a risk-sharing partner of business firms. Indeed, in the course of bailouts, the management of rescued financial institutions and corporations was not replaced, further undermining incentives for prudent behavior. Such recurrent corporate bailouts resulted in a vicious cycle of reckless lending and investment and pervasive moral hazard problems.

In the meantime, the social concern about the strong economic influence of *chaebols* translated into strict restrictions on the bank ownership structure. Indeed, in 1982, when the privatization of the banking sector was pursued, a ceiling of 8 percent⁵ was imposed on individual ownership of nationwide commercial banks. As of the end of 1996, the average number of shareholders who owned more than 1 percent of the total voting stocks was 10 for the nationwide banks. Their combined shares accounted for 39.3 percent of the total. This figure indicates that the ownership distribution of Korean banks was no less concentrated than in the case of advanced countries, such as the United States. Despite a bank ownership structure comparable to that of advanced countries, large shareholders of most Korean banks remained passive in exercising their voting rights and monitoring bank management. Government intervention in the appointment of CEOs of banks prevented bank management from pursuing shareholders' interests. To make matters worse, the board of directors of banks were not in a position to check the management in an independent manner. Typically, the nomination of directors was controlled by inside management. Although a certain number of non-executive directors existed in the case of large nationwide banks, they were not assigned a clearly defined role, nor provided with necessary information for monitoring. Accordingly, the internal governance of banks remained ineffective and poor.

B. *NBFIs: Cash Vault of Chaebols in the Absence of Financial Supervision*⁶

Unlike banks, non-banking financial institutions (NBFIs), except for life insurance companies and investment trust companies (ITCs), were free of ownership restrictions. As a result, many NBFIs are currently owned or actually controlled by *chaebols*. As of 1997, the 70 largest *chaebols* owned a total of 114 financial affiliates. Although many NBFIs are owned by *chaebols*, financial supervision on NBFIs has been almost absent. Such combination was a disaster in waiting, as can be seen from the fact that the financial trouble of Merchant

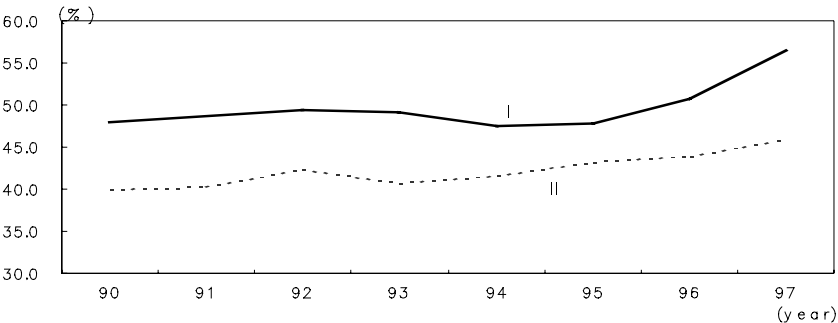
Banking Companies (MBCs) acted as a trigger point for the financial crisis in 1997. The close links between NBFIs and *chaebols* have created scope for conflict of interests. In fact, it appears that the *chaebols* have exploited their affiliated NBFIs as a financing arm to support and favor other subsidiaries within their group in various ways.

1) Corporate Leverage and Ownership of NBFIs

In order to analyze the linkage between *chaebols'* debt leverage and their ownership of NBFIs, more than 5,000 firms in the sample were divided into two groups: Group I covers those firms that own NBFIs, while Group II includes firms without any ownership in NBFIs. If one or more subsidiary companies of a *chaebol* own NBFIs, then all non-financial affiliated companies of the same *chaebol* are treated as belonging to the first group.

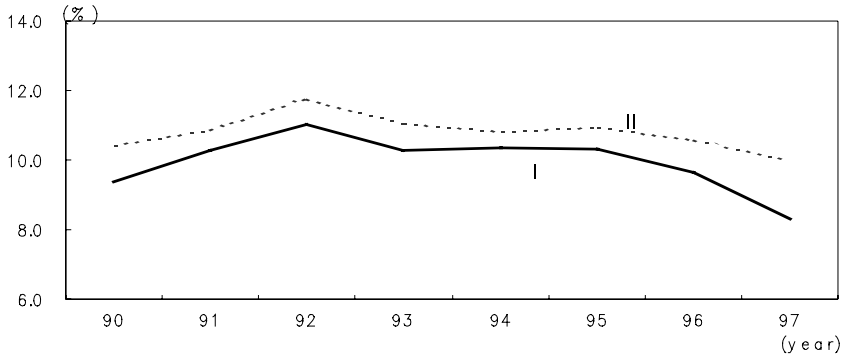
Chart II-1 presents the ratio of total borrowings to total assets for each group. It can be easily seen that Group I showed consistently higher debt leverage than Group II, and that the gap between the two groups became more pronounced in 1997 when Korea's credit situation was particularly tenuous due to fears regarding the financial crisis. In addition, Group I has been favored in terms of interest costs as shown by Chart II-2, and the gap between the two groups was also widened at the time of crisis in 1997. These findings imply that *chaebol*-owned NBFIs have been functioning as a cash vault for their affiliated subsidiaries. Particularly, the widened gap between the two groups in terms of debt leverage and interest costs at the time of the crisis can be taken as crude evidence of how financial support was provided to troubled subsidiaries at favorable terms.

Chart II-1 Total Borrowings to Total Assets for Non-Financial Firms



Note: 1) I: Non-financial firms that own NBFIs.
 II: Non-financial firms without any ownership in NBFIs.
 Source: National Information and Credit Evaluation Inc.

Chart II-2 Interest Costs to Total Borrowings for non-financial Firms



Note: 1) I: Non-financial firms that own NBFIs.

II: Non-financial firms without any ownership in NBFIs.

Source: National Information and Credit Evaluation Inc.

2) Profitability and Soundness of NBFIs

We also attempt to identify whether the financial support provided by *chaebol*-owned NBFIs to their affiliates proved profitable or not. To this end, we compare the profitability of NBFIs over two subgroups: *chaebol*-affiliated and non-*chaebol* independent NBFIs. Table II-1 shows that during 1995-97, the average rate of return on asset (ROA) of *chaebol*-affiliated NBFIs was lower than that of independent institutions by 0.1 to 1.0 percentage points.⁷

Table II-1 ROAs of NBFIs (Weighted average)

	<i>Chaebol</i> -affiliated	Non- <i>Chaebol</i>
1995	0.27%	1.00%
1996	-0.68%	-0.10%
1997	-0.47%	-0.37%

Source: National Information and Credit Evaluation Inc.

Chaebols' ownership of NBFIs turned out to affect not only the profitability of the NBFIs in question but also their soundness. In the case of securities companies and MBCs, *chaebol*-owned institutions show relatively poor capital adequacy compared to independent institutions. Specifically, as of the end of March 1998, the average BIS ratio of *chaebol*-affiliated MBCs was 5.4 percent,

while that of independent institutions was 6.3 percent. Furthermore, the net operating capital ratios of securities companies also show a similar pattern: 165 percent for *chaebol*-affiliated institutions versus 234 percent for independent institutions.

In conclusion, the apparently poor performance of *chaebol*-owned NBFIs in terms of both profitability and soundness seems to be a reflection of a serious conflict of interests. The external governance by these NBFIs on their debtors has been neither adequate nor efficient. These institutions have acted as a private cash vault of affiliated *chaebols* under their strong influence, and thus have not worked towards maximizing profits with a commercial orientation.

II-2. Policy Responses to the Crisis: Financial Sector Governance System

Since the onset of the financial crisis, various measures have been undertaken to improve the financial sector's governance structure. Since January 1998, under the Act Concerning the Structural Improvement of the Financial Industry, the supervisory authority has been able to order the write off of equities of the shareholders deemed responsible for the insolvency of banks. In February 1998, in order to encourage shareholders and internal auditors to assume management roles with respect to monitoring, the required conditions for exercising minority shareholders' right to initiate a class action were eased. The Financial Supervisory Commission (FSC) has also established and executed an efficient sanction system in which the FSC, if necessary, can impose civil and criminal liabilities on the directors.

Besides these measures, much has been done to improve the prudential regulation of financial institutions: 1) a prompt corrective action system was introduced, 2) in April 1998, the FSC expanded the number of regular disclosure items to the scope dictated by the International Accounting Standards (IAS) in order to strengthen banks' disclosure system, and 3) in July 1998, loan classification standards as well as provisioning requirements were strengthened in accordance with international practices. Also, forward-looking asset quality classification standards were introduced at the end of 1999.

The closure of insolvent financial institutions opened a new chapter in Korea's financial history, in that no single commercial bank had been closed previously. As of June 1999, five banks, sixteen MBCs, three securities companies, one ITC, and four insurance companies were permanently closed (see Table II-2). In addition, one ITC and three securities companies were suspended. If mutual savings, finance companies, and credit unions are included, the total number of financial institutions that were either closed or suspended is 74. Another 143 financial institutions have merged or broken off.

Table II-2 Financial Institutions Closed or Suspended
(As of June 1999)

	Total No. of Institutions (end-1997)	License Revoked	Suspended	Merger/ Dissolution	Sub-total
Banks	33	5	-	4	9
Merchant Banks	30	16	1	1	18
Securities Companies	37	3	3	-	6
Insurance Companies	50	4	-	1	5
Investment Trust Companies	6	1	1	-	2
Mutual Savings and Finance Companies	230	25	14	2	41
Credit Unions	1,666	1	-	130 ^{d)}	131
Leasing Companies	25	-	-	5	5
Total	2,077	55	19	143	217

Note: 1) includes bankruptcy and dissolution

Source: Financial Supervisory Commission

II-3. Future Challenges

In principle, the potential for government control over banks has increased significantly since the crisis, as three troubled nationwide banks were nationalized in the course of restructuring. Indeed, the ownership structure of nationwide banks has become much more concentrated since the crisis (see Table II-3). Under these circumstances, it is difficult to expect to see an improvement in the expertise and capacity of banks with respect to credit evaluation, assuming that the government continues to intervene in bank management by exploiting increased ownership, with the end result being a delay in the privatization of banks. This concern is valid even though Korean banks have been restructured to show some degree of restored soundness and profitability, because the ultimate source of the bank competitiveness will come from expanded human capital and upgraded lending practices.

The intrinsic deficiencies in NBFIs also continue to exist, and are likely to become more marked in that the *chaebols'* influence on NBFIs has been increasing even more rapidly since the onset of the crisis. In particular, the ITCs under the control of *chaebols* have expanded in terms of their shares in the ITC business. Specifically, Hyundai Group and Samsung Insurance took over three troubled ITCs, one of which was ranked third in terms of assets. As a result, the market share of the ITCs affiliated with the top 5 *chaebols* had jumped to 31.9 percent as of the end of 1998, up from a mere 2.8 percent at the end of 1997.

Table II-3 Large Shareholders' Ownership of Banks
(As of the end of 1998)

Classification	Large Shareholders Over 1%		Large Shareholders Over 4%	
	Number	Ownership Share (%)	Number	Ownership Share (%)
Chohung	8 (3)	19.8 (7.3)	1 (1)	4.5 (4.5)
Hanvit*	2 (0)	97.0 (0.0)	1 (0)	94.8 (0.0)
Korea First*	2 (0)	93.8 (0.0)	2 (0)	93.8 (0.0)
Seoul*	2 (0)	93.8 (0.0)	2 (0)	93.8 (0.0)
Korea Exchange	4 (1)	68.2 (1.2)	2 (0)	66.0 (0.0)
Kookmin	12 (3)	36.3 (6.0)	3 (0)	20.5 (0.0)
Housing & Commercial	6 (1)	36.5 (4.5)	3 (1)	30.5 (4.5)
Shinhan	7 (3)	11.6 (5.2)	0 (0)	0.0 (0.0)
KorAm	13 (5)	68.4 (41.0)	3 (2)	53.5 (33.7)
Hana	16 (9)	55.7 (34.4)	8 (5)	43.4 (27.4)
Peace	16 (4)	43.1 (10.4)	1 (0)	5.0 (0.0)
Nationwide average	Banks, 8 (3)	56.7 (10.0)	2 (1)	46.0 (6.4)
Daegu	4 (1)	15.9 (12.1)	1 (1)	9.1 (9.1)
Pusan	3 (2)	21.1 (17.3)	1 (1)	15.1 (15.1)
Kwangju	6 (4)	21.1 (16.4)	1 (1)	11.4 (11.4)
Cheju	4 (2)	61.5 (58.4)	1 (1)	57.3 (57.3)
Jeonbook	11(6)	54.4 (30.9)	6 (3)	41.7 (22.5)
Kangwon	7 (1)	33.0 (12.9)	3 (1)	24.4 (12.9)
Kyungnam	9 (4)	24.3 (16.6)	2 (2)	10.9 (10.9)
Chungbuk	10 (4)	38.4 (23.2)	3 (2)	27.0 (19.7)
Local Banks, average	7 (3)	34.0 (23.5)	2 (2)	24.6 (19.9)
Commercial Banks, average	12 (3)	47.0 (19.8)	3 (1)	36.9 (12.1)

Note: Figures in parentheses indicate the number and ownership share by private industrial capital (including affiliated financial institutions).

* The government owns 46.88 percent of Korea First Bank, 46.88 percent of Seoul Bank, KDIC owns 94.75 percent of Hanvit Bank and 6.88 percent of Korea First Bank and Seoul Bank respectively.

Source: Bank Supervisory Board.

Despite these developments, firewalls designed to prevent insider trading and excessive exposure have been unsatisfactory. In particular, given the fact that the market share of the NBFIs is much larger than that of the banking sector, the increasing influence of *chaebols* on NBFIs poses increased systemic risks.

Currently, the share of NBFIs in the domestic deposit market is about 70 percent. Therefore, the structural deficiencies and weakness of the financial sector will continue to undermine financial soundness and stability unless an advanced regulatory and supervision framework is established and effectively enforced.

II-4. Regimes for Property Rights Protection

Each creditor has his or her own priorities under the Civil Code and other relevant statutes. Secured claims are paid before unsecured claims. However, wage claims, rental down payments, and taxes have priority over secured claims. There is no single rule on priority that applies to all cases. Claims holding the same priority are to be paid on a pro rata basis.

The trustee in the corporate reorganization procedure and the administrator in the composition procedure have the authority to bypass those transactions that are harmful to the creditors. The reorganization plan should treat each category of creditors and shareholders fairly and equitably according to the priority of the claims.

There is always the possibility that debtors and creditors play games that can destroy the value of the financially distressed company under the corporate reorganization or composition procedure by holding out without consenting to the proposed restructuring plan. The laws limit this in two ways: the time limitation in each process and cram down.

III. Formal Insolvency Mechanisms

III-1. Introduction

A. Overview

Korea has three statutes on insolvency: the Bankruptcy Act, the Composition Act, and the Corporate Reorganization Act. The Bankruptcy Act deals with the liquidation of individuals and companies. The Composition Act provides composition (arrangement) proceedings for individuals and companies. The Corporate Reorganization Act covers the reorganization process of joint stock corporations. Since the enactment of these statutes in 1962, there had been no significant amendments until 1998.

While the majority of insolvent companies were liquidated on a non-judicial basis, the government saved some financially troubled companies in the name of rationalization measures. The government, which had control over financial institutions in a practical sense, took every possible measure to enforce or induce restructuring. The rationalization measures by the government eliminated opportunities for the court to deliberate insolvency cases. The rationalization measures are explained in more detail in the next section.

The general assessment of the reorganization process has been negative, with critics pointing to problems such as outside political influence, abuse of the proceedings to evade criminal punishments, ambiguity of the rules, delays in the process, insufficient recovery of claims by creditors, and the low rate of successful reorganization.

Aware of these criticisms, the Supreme Court tightened the process by enacting the Rule on Corporate Reorganization Procedure in 1992 (“1992 Rule”), which provided detailed requirements for initiating the reorganization process and for approving reorganization plans. The 1992 Rule established three requirements for the corporate process: high social value, financial distress and possibility of rehabilitation. It also enumerated detailed factors to be considered for each requirement.

The second bankruptcy of the Non-No corporation in a reorganization process led the Corporate Reorganization Act to face public criticism again. The owner/CEO of Non-No Corp. fled abroad after having issued many bounced checks. Primarily as a result of this case, in 1996 the Supreme Court amended the 1992 Rule to enforce the monitoring function of the court on corporations in a reorganization process. The 1996 Rule mandated the courts to wipe out shares owned by controlling shareholders responsible for mismanagement of the company. It also excluded the incumbent management from the reorganization process.

The 1996 Rule, however, had an unexpected effect. Since it essentially removed any incentive for the incumbent controlling shareholders and management to reorganize the company, insolvent companies avoided the reorganization procedure and looked for other procedures that would keep the corporate insiders' shares and control of the company intact. Savvy lawyers were able to find such means in the composition procedure and filed for the procedure in major *bodo* cases, such as Kia Motors Corp. in 1997, even though the composition procedure was originally intended for independent businesspersons and small companies. While Kia Motors withdrew the petition and eventually filed for the reorganization procedure, a flood of companies followed suit as seen in <Table III-1>.

Table III-1 Number of cases under the bankruptcy-related laws

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
<i>Boodo*</i>	U/A	U/A	4,107	6,159	10,769	9,502	11,255	13,992	11,589	17,168	22,828
Bankruptcy	21	37	27	16	14	26	18	12	18	38	467
Composition	-	2	-	-	-	-	-	13	9	322	728
Reorganiza- tion	26	27	15	64	87	45	68	79	52	132	148

*Number of companies which could not pay checks or notes

Source: Court Administration Agency (1999), Bank of Korea (1999)

B. Comparison and Transferability between Proceedings

As the corporate reorganization process and the composition process aim at rehabilitation of a debtor, these two processes cannot be engaged while insolvency proceedings are undertaken. In the case whereby the court dismisses, disapproves or discontinues the composition process, the court shall declare the debtor bankrupt (Composition Act, Art. 9•). A judge does not usually render the disapproval, discontinuance or dismissal decision offhand; but rather generally recommends that the defunct composition plan proceed to the bankruptcy process.

In the case of the corporate reorganization process, it is not mandatory for the court to declare bankruptcy. Art. 23 of the Corporate Reorganization Act authorizes the court to declare bankruptcy in cases where the reorganization process has been dismissed, disapproved or discontinued. The court may allow the application for composition proceedings for rendering bankruptcy.

There is no barrier between the reorganization and the composition. Thus, the debtor can file a petition of the composition after the application for the corporate reorganization is dismissed, and vice versa. The following <Table III-2> shows the organization of the three processes.

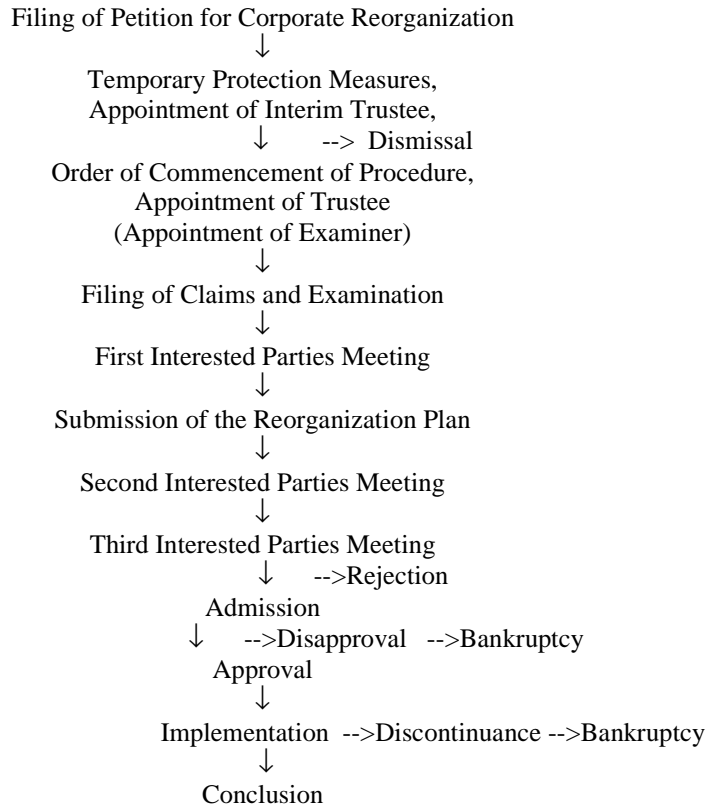
Table III-2 Comparison of Three Insolvency Processes

	Bankruptcy	Composition	Corporate Reorganization
Eligibility for Proceeding	Individual, corporate and other legal persons	Individual, corporate and other legal persons (certain large-size joint stock companies may not be eligible)	Joint stock company
Applicant	Debtor, creditor	Debtor	Debtor, qualified creditor(s), qualified shareholder(s)
Business Operation and Disposal of Assets	Receiver (no interim receiver is recognized)	Debtor (under the supervision of interim administrator and administrator)	Interim trustee, Trustee
Qualification of Trustee/Administrator	Individual	Individual	Individual or financial institution
Foreclosure of Mortgages and Other Security Interest	Foreclosure is not Stayed	Foreclosure may not be stayed	Foreclosure is stayed once the proceeding is commenced
Execution of Judgment	Stayed	Stayed	Stayed
Compulsory Redemption of Shares without Compensation	Not applicable	Redemption of shares is not required	Redemption of all or part of outstanding shares without compensation is mandatory in certain cases
Filing of Proof of Claims	Mandatory	Not mandatory (if not filed, the creditor loses only voting rights)	Mandatory
Suspension of Litigation	Suspended	Not suspended (diversity of opinion in practice)	Suspended
Submission of Plan	Not applicable	Composition condition should be submitted at the time of petition for commencement of proceedings (but the plan may be changed)	Plan is submitted after the commencement of the proceeding
Repayment Period	Not applicable	No restriction (usually, 4-8 years)	Up to 10 years from the approval of the plan
Court's Involvement	Until the completion of distribution	Until the approval of the condition	Until successful implementation or dismissal of the case

Source: Chiyong Rim

III-2. *Proceedings under the Corporate Reorganization Act*⁸

A. *Flowchart*



B. *Filing*

The corporate reorganization procedures are normally initiated with a petition for the commencement to the relevant court by the insolvent corporation. This process is for joint stock corporations only. The petition may also be filed by at least one of the creditors whose claims against the company are no less than 10 percent of the company's equity capital, or by shareholders who hold no less than 10 percent of the issued shares of the company (Art. 30). The court that has venue on the main office of a corporation has exclusive venue on a corporate reorganization case (Art. 6).

The Act does not penalize a late filing. This means a debtor company does not have a legal obligation to file a corporate reorganization petition under the Act. Members of the board of directors, however, have a duty of care or fiduciary duty in a general sense under the Commercial Code, which provides on corporate matters. Thus they have to compensate for any damages that come about if a filing is late as a result of negligence of duties.

As the Corporate Reorganization Act does not allow automatic stay, the applicant simultaneously files a petition for issuing a provisional protection order, whereby an interim trustee is appointed; the disposal of assets and repayment of debt by the insolvent company are prohibited; and/or other enforcement procedures are stopped (Art. 37, 39). Without this provisional protection order, the reorganization proceedings cannot be effective because most creditors are eager to collect their claims individually. The court issues a provisional protection order after reviewing petition documents and interviewing applicants. The court shall hear the opinion of the management committee in issuing the order.

If the court turns down or dismisses the application for the provisional protection order, it also dismisses the application for the commencement of the corporate reorganization process. When the court renders the provisional protection order it also nominates an interim trustee (*bojunkwanriin*).

The interim trustee acts as the legal representative of the insolvent company and performs the daily functions of the company (Art. 39-3, 53). In other words, the incumbent members of the board of directors lose their functions. As the interim trustee's authority is almost the same as that of the incumbent trustee, most provisions for the latter are applied to the interim trustee. Commercial banks, merchant banks and trust companies as well as individuals may be appointed as the interim trustee. The interim trustee must obtain the approval of the court to perform certain actions specified by the court, such as disposing of the company's assets.

Before the 1999 Amendment was made, the court deliberated whether to render the order of the commencement of the reorganization process while the interim trustee took charge of the applicant company. The court rejected any petition for the commencement of proceedings where one of the prescribed negative requirements was met. The most meaningful factor among these negative requirements was the comparison between liquidation value and going concern value. The court-appointed examiner performed due diligence and appreciation of liquidation value and going concern value. It took several months for the court to decide the commencement upon the opinion of the examiner.

The 1999 Amendment, however, changed the requirements and the process. The court dismisses the petition in cases where it is clear that liquidation value is greater than going concern value. The court does not appoint the examiner. Moreover, the Act mandates that the court shall decide the order of commencement within one month from the petition (Art. 45-2). It seems that the Act's intention here is to ensure that the decision of the commencement shall be made based on formal review instead of deliberation on merit.

The estate is not created in the corporate reorganization procedure, unlike the bankruptcy procedure. The provisional protection order and the ensuing order of commencement protect the assets of the applying company from the enforcement of creditors or arbitrary payment by the debtor.

C. *Commencement*

1) Trustee

When ordering the commencement of the reorganization proceedings, the court also appoints one or more trustees (*kwanriin*) and fixes the period for the filing of claims, the date of the first meeting of interested parties, and the date for examining the claims. The trustee has full authority to manage the corporation, as is the case with the interim trustee. He or she has to report to the court and the management committee prescribed information, including the comparison between liquidation value and going concern value.

The court may appoint the examiner (*josawewon*) to hear opinions on the evaluation of corporate assets, financial statements, and suitability as to the requirements of the proceedings. As the court usually appoints accountants as examiners, the opinion of the examiner is critical with regard to the comparison of the liquidation value and going concern value. The Act does not prescribe any specific method for calculating those values. The Supreme Court Rule on Corporate Reorganization, however, suggests one possible method: for liquidation value, to sum up the discounted price of individual assets on a balance sheet, and for going concern value, to evaluate the present value of future cash flow in addition to the value of not-for-business assets. Other reasonable methods are permissible, but the practice generally follows the suggested method.

2) Claims

All creditors are required to file their claims with the court within the period fixed by the court, which should not be less than two weeks and not more than four months. The court together with the chairman of the board of directors and the trustee will then examine each of the filed claims. If claims are established after the filing period, they shall be filed within one month from the origin.

Without filing claims, creditors cannot exercise their voting power, they are excluded in the distribution under the reorganization plan, and finally, they lose their claims. Contrary to this, the failure to file claims in the composition process does not result in the loss of claims.

Under the reorganization proceedings, creditors are classified into three categories according to their priority: (i) claims of common benefit claims, (ii) secured claims, and (iii) unsecured claims. Common benefit claims are to be repaid irrespective of the reorganization plan and have priority over secured claims and unsecured claims. Art. 208 describes common benefit claims to include administrative fees for the procedure, employees' salary and retirement allowance, and claims which occur after the commencement under the approval of the court. Unsecured claims and secured claims, however, are subject to the corporate reorganization plan except when the court approves separate payments.

The trustee under the reorganization proceedings has the authority to set aside such transactions that would cause harm to its creditors (Art. 78). The trustee also has the authority to decide whether to perform or terminate any executory contract under which there remain obligations to be performed by the counterparty. This means that the trustee has the power to either terminate or seek action on an executory contract. He or she may exercise this power in such a manner as to allow contracts that are advantageous to the insolvent company and terminate those unfavorable to the company, which is generally known as cherry picking. The Corporate Reorganization Act does not have any provisions particularly mentioning derivatives. Thus derivatives are handled in the realm of executory contracts.

Creditors are entitled to set off debt owed to the company against their claim to the company except the cases prescribed in Art. 163. The creditor's right to set off under reorganization proceedings, however, must be exercised on or before the last day of the period specified for filing the claims of creditors.

The act of insolvency is not criminal behavior and the managers of insolvent companies are not considered criminals. Neither the Corporate Reorganization Act nor the Criminal Code orders any criminal investigation upon the

commencement of the corporate reorganization procedure. Criminal charges against corporate directors are unusual in Korea even in a bankruptcy situation. But the conflicts between creditors and the management of a debtor company sometimes reveal evidence of embezzlement or breach of trust, so that the prosecutor may bring an indictment against the managers. The situation in insolvency proceedings is almost the same as in the normal business process as far as criminal matters are concerned.

Directors are to be sued by their own company if they act against their duty or law and cause damages to the company (Commercial Code, Art. 399). Derivative suits may be brought by the shareholder(s) with 3 percent or more of issued shares (0.01 percent for listed corporations) if the company does not exercise its claim. The Corporate Reorganization Act stipulates a summary procedure, named “assessment”, against the director who is liable for the damages of the corporation (Art. 72). When the court discovers any damage caused by the director to the corporation, the court orders the director to pay the damages to the corporation, bypassing much of the time and expense involved in a regular damage recovery suit.

Civil and criminal charges against directors have not often been exercised. This has been particularly so in the case of large companies, including listed companies. But the crisis in 1997 changed the situation to some extent. The rights of minority shareholders have become an important agenda item in citizen activism. An activist group brought a derivative action against the former president and directors of Korea First Bank. The local court ordered them to pay compensation of US\$ 33 million for the damages incurred by them to the Bank. The case was reported as the first derivative suit against a listed company in Korea’s economic history. It is doubtful whether the accused directors can pay the damages because they do not have liability insurance or sufficient property to use as recompense. However, legal actions with respect to the responsibilities of directors are expected to increase, as shareholder activism has grown more prevalent after the crisis.

Korean law confines the liability of each legal entity to itself and does not extend to other legal entities without any statutory provisions. The liabilities of a business corporation do not extend to its shareholders and/or directors. Shareholders and directors are not liable for the debts of the corporation. The only possibility whereby shareholders may be liable for the debts of the corporation is when the principle of piercing the corporate veil is applied. The Korean courts have applied the principle only in a few cases, and in these, extended the liability of the corporation to the shareholders.

There has been much criticism that the information on an applicant corporation does not flow effectively among interested parties and a reorganization process,

including the creditors, the trustee, the corporation and the court. To improve the situation, the 1998 Amendments established the creditors conference.

Within a week of receiving the notice of the commencement of the corporate reorganization process, the management committee (or the court) organizes the creditors conference. The creditors conference consists of up to ten major creditors. The conference is a channel between the court and creditors. It may render creditors' opinion on major processes, including appointing trustees, payment approval, or other matters requested by the court. The court also provides information to the conference for all creditors.

The trustee is another bridge between the court and the corporation. The court obtains the information on the applicant corporation mainly through the documents that the trustee submits. In addition, the court may question the trustee on any issues. The examiner also provides basic financial information to the court before the reorganization procedure starts. The district court can allow creditors to have access to the information necessary to determine whether the corporation is appropriate for the corporate reorganization procedure.

D. Reorganization Plan

Based upon the confirmed claims and the result of due diligence, the trustee makes the draft of the Reorganization Plan ("the plan"). The plan shall be presented to the court within the period prescribed by the court. The period shall not exceed four months from the last day of the period for filing claims. The prescribed period may be extended within two months. For small- and medium-sized companies, the extension shall not exceed one month. The Act entitles the corporation's creditors and shareholders to submit the plan. However, no case has yet been reported in which the plan was drafted by any one other than the trustee.

In the past, creditors, usually banks and other financial institutions, were not prone to cut off their claims even in the reorganization procedure. The officers of banks did not have the authority or ability, in certain situations, to decide the cut-off on a commercial basis under the government-led corporate structure in banking institutions. They did not have ample knowledge and skill to handle non-performing loans and hesitated to decide on anything that might incur suspicion.

Debt-for-equity swaps were seen and treated in a similar manner as debt cut-offs. Moreover, banks did not want to be a major shareholder because they did not want to take any responsibilities for the management of troubled corporations. As financial markets were underdeveloped in the past, the bad

debts or equities of reorganized corporations had no place to be traded. For these reasons, the only methods used in the plan were to postpone the due dates and/or reduce the interest rates. Banks preferred to maintain the amounts of loans in the accounting statements even though they were non-performing.

The financial crisis of late 1997 changed this practice. Non-performing loans had grown so big that creditor banks were almost destroyed under their pressure. Banks have slowly begun to prefer cash to unreduced amounts in accounting statements. Banks have agreed to cut down or cut off their claims in return for collecting some parts of their claims in cash. Debt-for-equity swaps have also been adopted as a method of restructuring. Banks now hope to collect their claims by selling their shares of the newly restructured company in the near future.

Shareholders' rights are usually restricted during the corporate reorganization procedure, with their voting rights frozen. Art. 221 authorizes the court to amortize over one-half of the outstanding shares in cases where the total amount of debt exceeds that of the assets. The court is authorized to amortize over two-thirds of the stocks in cases where the owners are responsible for mismanagement.

In the normal debt collection process, the claimants with junior priority are not entitled to get anything at all before those with senior priority are fully paid. In the corporate reorganization process, the highest priority is given to wage claims, the second is to secured claims, the third is to unsecured claims, and the last is to shareholders. So in the normal judicial enforcement process, the shareholders take nothing before the unsecured creditors are fully paid. Priority among creditors and shareholders is strictly observed in the normal judicial enforcement process. The plan, however, usually allows junior claimants to be paid even if senior claimants have not acquired full payment. The common means for discrimination between secured creditors and unsecured creditors are interest rates and duration of payment.

It is useful to note that under the same category there are several sub-categories: 1) primary financial institution creditors, such as commercial banks versus the secondary financial institution creditors, including investment banks; 2) principle creditors versus surety creditors; and 3) commercial creditors versus financial creditors. The payment schedule might be slightly different from one subcategory to another. The plan is usually drafted reflecting inflation, so it normally adds expected inflation rates to the estimated growth rate of sales.

The plan is to be deliberated on and admitted to by creditors and shareholders at the interested parties meeting. There is usually a series of three meetings. The first meeting is for presentation of the trustee's report on the company's financial

condition and examination of the filed claims. The second meeting is for deliberation of a draft reorganization plan. The third meeting is for the resolution of the draft reorganization plan. Usually the second and third meetings are held at the same time. Admission of the plan requires consent of over two-thirds of general creditors, three-quarters of secured creditors, and a majority of shareholders.

Once a draft reorganization plan has been consented to at the meeting of interested parties, the court determines whether or not to approve it. The consent of the employees is not required for the approval of the plan by the court. Public interests are not a factor to be considered either. Instead, the court shall examine whether the draft reorganization plan satisfies all the statutory requirements (Art. 233).

Most frequently visited requirements are fairness and equality. In recent rulings, the Supreme Court found these requirements lacking in the reorganization plan, and thus reversed an appellate court's decision with respect to the plan's different payment schedule for damage claimants.⁹ The Supreme Court made a similar reversal with respect to unfair and inequitable early payments and higher interest rates as applied to a state-owned bank.¹⁰

The Corporate Reorganization Act has a provision authorizing the court to approve the plan even though any category of claimants fails to reach an agreement on the proposed reorganization plan, but only under the condition that the court determines the necessary clauses to protect the rights of interested parties. Though Art. 234 provides the basis and method of cram-down, cram-downs have not been utilized in insolvency practice. The reason is not clear. The court may not have found any cases where the cram-down was needed, or the reorganization practice itself may not have evolved enough so as to require it.

Absolute priority rule is not stated in the Act nor accepted in practice. The normal reorganization plan allows junior claimants to be paid even if some of the senior claimants have not been fully paid. Conjectures can be made as to why senior creditors agree to such plan. In most cases, secured creditors have unsecured claims too. Their concern is to maximize the total amount of collection regardless of a claim's priority. There should be some compromises between interested parties to prevent a holdout. No case has been filed yet in which the plaintiff complains that the reorganization plan violates the absolute priority rule.

The best interest test is used in the United States as a tool to protect the dissenting creditors, with the result that they are essentially put in the same category as those who agree to the plan. This means that the dissenting

claimants are guaranteed to receive the amount that they might get in liquidation. The Corporate Reorganization Act does not provide this rule explicitly. However, the liquidation value will be preserved in practice because the total value distributed in the reorganization process shall be bigger than the liquidation value if the distribution is fair.

The feasibility test can be applied throughout the whole process from the filing of the petition to the successful conclusion of the plan. If the court discovers that there is no possibility of rehabilitation before issuing the provisional protection order or commencement order, it shall dismiss the petition. Even before a reorganization plan is adopted at the interested parties meeting, the court shall discontinue the process if the court recognizes that there is no possibility of rehabilitation (Art. 272). Feasibility is one requirement for the approval of the plan by the court (Art. 233). Even after the implementation of the plan, the court shall discontinue the procedure unless the plan is feasible (Art. 273, 276).

E. Post-confirmation Procedures

Once a corporate reorganization proceeding begins, the authority to manage the operation and assets of the company is vested exclusively with the trustee, subject to court supervision. Although formally the Act did not exclude the incumbent management or major shareholders as a trustee in the reorganization process, the 1992 Rule clearly stated that the former owner should be blocked from any attempt to regain control of the firm. The Rule reflected public sentiment that someone should be held responsible for the failure of the corporation. Retired officers of financial institutions were often appointed trustees because the creditors' opinion was receptive to the court. The problem is they do not know the business and the firm in the reorganization process.

The 1998 Rule repealed the provisions and recommended that the court appoint the trustee, with due consideration given to the opinions of the corporation, the management committee and creditors conference. Though it does not exclude the former manager from being a candidate for trustee, it is still so cautious as to suggest that a co-trustee recommended by the creditors conference be appointed in cases where the incumbent manager is named as the trustee.

In addition to the regular salary, the court may allow the trustee a special bonus or stock option for the compensation of his/her achievements. According to the Seoul District Court's internal guidelines, the total of the special bonus can amount to up to one hundred million Korean won.

The trustee has no fixed term in a normal reorganization plan. The court supervises the trustee in a general sense. The trustee shall manage the firm with the care of a good manager. He is liable for any damages that he causes by neglecting his duty of care (Art. 101, 43). The court is entitled to dismiss the trustee in cases of serious cause (Art. 101, 44). It is generally understood that serious cause means bribery or false reporting.

The 1998 Amendments introduced the creditors conference as a communication channel between creditors and the corporation. As the trustee is responsible to the court, not to the creditors, the creditors did not have an appropriate way to communicate with the court and the trustee. The creditors conference, composed of up to 10 major creditors, disseminates information among creditors and submits the opinion of the creditors to the court. In addition to the presentation of their opinion to the court, creditors can file a formal petition in some instances, including discontinuance of the procedure and the exercise of avoidance power. As to the application of these two petitions, actual practice to date has not been as successful as expected.

Once the court approves the reorganization plan, the trustee implements the plan under the court's supervision. If the plan has been implemented completely or if it is deemed certain that the plan will be successfully implemented, the court may conclude the reorganization proceeding. As reorganization plans are usually organized within a 10 year span, it takes several years to implement it completely. A merger and acquisition (M&A) would be the common cause for an early conclusion of the plan. Upon the conclusion of the process, the authority of managing the company reverts to the company's directors.

If, on the other hand, it becomes apparent, either before or after the approval of the reorganization plan, that the company cannot be rehabilitated, the court may decide to discontinue the reorganization proceeding. In this case, the court shall declare the corporation bankrupt as in the case of disapproval of the plan (Art. 23). Even with the cessation of the procedure, the change of claims or discharge according to the plan will be still effective. The cessation of the procedure does not have a retroactive effect.

III-3. Proceedings under the Composition Act

A. Flowchart

The process of the composition procedure is similar to that of the corporate reorganization, as shown in the following flowchart. Differences from the corporate reorganization procedure are highlighted.

Filing of Petition with the Condition of Composition



Temporary Protection Measures,
Appointment of Interim Administrator



Appointment of Examiner

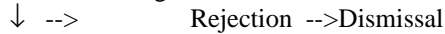


Order of Commencement
Appointment of Administrator

Filing of Claims



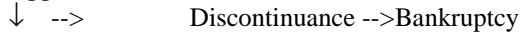
Creditors' Meeting



Admission



Approval



Implementation

B. *The Stage of Filing*

Only the debtor is eligible for the composition petition. An individual as well as a legal person can be a petitioner. If the debtor is a legal person, the consent of the board members is required. However, the court may dismiss the petition in cases where the amount of assets and debts is huge and the number of interested parties is large (Art. 19-2). Composition has been considered for individuals or relatively small enterprises. A petition for commencement of composition should state the terms and conditions of a composition ("the condition of composition") such as the method of payment and the provision of collateral (The Composition Act, Art. 13). The condition of composition can be modified under the approval of the court. The petitioner shall also submit to the court a detailed statement of the assets and the list of creditors and debtors.

Automatic stay is not allowed in the composition procedure either. Before deciding on a petition for commencement of composition, the court may issue a temporary protection order appointing an interim administrator and/or prohibiting the disposal of assets and repayment of debt by the debtor (Art. 20). An order to stop other enforcement procedures is not allowed in the composition procedure by interpretation.

An interim administrator (*bojun kwanjaein*) can be appointed at the time when the court issues the temporary protection measures. This interim administrator has virtually the same powers as those granted to the administrator who is

appointed following commencement and who is entitled to monitor the activities of the debtor.

The court appoints an examiner to prepare a report on the appropriateness of commencing with a composition proceeding. On the basis of such a report, which shall be submitted within 2 months after the appointment, the court will decide whether to approve the petition for commencement.

The Composition Act stipulates negative requirements with which the court shall dismiss the petition (Act. 18, 19 and 19-2). The court may order the debtor company to provide personal or material security, including the shares of major shareholders, as collateral to the creditors as a precondition to the commencement of the composition procedure. Commencement shall be decided within three months from the filing with the possibility of a one-month extension.

Upon issuing the order of the commencement of composition, the court sets the period for filing claims and the date for the creditors meeting. It also appoints an administrator. All such information regarding the commencement of the composition shall be made public. The known creditors and other concerned parties are notified.

The filing of claims in the composition process has a different meaning from that in the corporate reorganization process. Creditors file their claims in order to exercise their voting rights at the creditors conference. If a debtor does not file its claims by the fixed date and the claims are not included in the list of debts, the debtor does not lose its claims. The filing is just for the participation in the creditors meeting and for exercising voting rights. There is no process for the confirmation of claims. The list of claims is not deemed to the title of debts. Priority claims that are superior to general claims are not subject to composition proceedings. Thus, secured claims are out of the scope of the composition procedure.

An administrator (*kwanjaein*) in the composition procedure does not have full authority such as the trustee in the corporate reorganization procedure. The appointment of an administrator in the composition procedure does, however, affect the power of the debtor to manage and dispose of assets. The administrator has authority to monitor the activities of a debtor. Transactions outside the scope of the ordinary course of business are subject to the consent of the administrator, and even transactions falling within the scope of the ordinary course of business may not be undertaken if the administrator raises an objection (Art. 31, 32).

C. *The Condition of Composition*

The creditors meet on a date fixed by the court and review the reports and opinions of the administrator and the examiner on the condition of composition. The creditors then vote on the proposed condition of composition. The consent of the condition of composition requires affirmative votes by a majority (in number) of the creditors present representing three-fourths or more of the total amount of claims filed (Art. 53: Bankruptcy Act. Art. 278).

The condition of composition consented to at the creditors meeting will be examined by the court to see if it satisfies all the legal requirements. Art. 55 lists occasions where the court may disapprove the composition. Those negative requirements include where the composition procedure or consent does not conform with the provisions of the Act, where the consent was done in an illegitimate manner, and where the consent goes against the general interests of the composition creditors. If the condition is found satisfactory, the court will approve the plan. The court may decide to discontinue composition proceedings if the debtor wishes to do so before the creditors vote on a plan, or if it is not affirmatively voted on within two months of the first creditors meeting.

Creditors with priority claims are not subject to the approved composition. A creditor with secured claims, for example, may foreclose his collateral at any time. For this reason, a debtor usually tries to involve priority creditors in the composition plan.

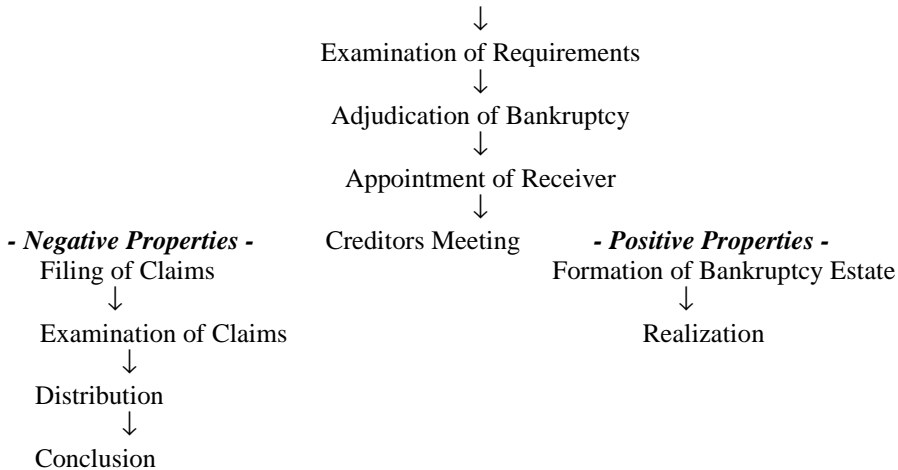
D. *Post-confirmation Procedures*

The debtor runs the business without any interference by the court after the approval of the composition. The implementation of the condition is laid in the hands of the debtor. Following approval of the composition, the debtor company must report to the court every six months with respect to its payment under the plan. The court has discretion to discontinue the composition proceedings if it finds that the debtor has not met, or may not be able to meet in the future, repayment obligations according to the condition. In case of discontinuance, disapproval or cancellation of the composition, the court shall, *ex officio*, adjudicate the bankruptcy of a debtor (Art. 9).

III-4. Proceedings under the Bankruptcy Act

A. Flowchart

Filing of Bankruptcy



B. The Filing Stage

Bankruptcy proceedings aim at the collection of debtors' assets and distribution of realized assets to creditors in the event of the insolvency of a debtor in a collective manner. The debtor may be any form of legal entity, including individuals and legal persons. In general cases, bankruptcy shows the debtor's inability to pay debts. A suspension by the debtor of overdue payments is presumed to demonstrate inability to pay (Art. 116). A corporation may be declared bankrupt when its liabilities exceed its assets (Art. 117).

A petition for bankruptcy may be filed by a debtor, by the debtor's creditor, or by a third party. In the case of a corporation, a corporate director may also file the petition. When a petition for bankruptcy is not filed by a debtor or by all directors of an incorporated body, the applicant shall establish *prima facie* evidence of valid grounds for bankruptcy (Art. 122-128).

When such a petition is filed, the court may issue an order temporarily suspending the disposition of the debtor's assets except as permitted by law or

by the court. Upon review of a petition for bankruptcy, the court adjudicates the debtor bankrupt if it determines that grounds for bankruptcy exist based on the information included in the petition and further examination by the court. Otherwise, the court will dismiss the petition.

C. *The Commencement Stage*

At the time of adjudication of bankruptcy, the court appoints a receiver (*pasankwanjaein*) with the consultation of the administration committee (Art. 147). It also sets the period for the filing of claims, the date of the first meeting of creditors, and the date of the examination of claims (Art. 132). All such information regarding an adjudication of bankruptcy shall be made public, and the creditors, debtors and other concerned parties are notified (Art. 133).

The court shall notify the appropriate government office or agency, where relevant, of the adjudication of bankruptcy, as well as the public prosecutor. Anyone having a legal interest may appeal the court's decision adjudicating bankruptcy within 14 days of the date of public notice of bankruptcy.

Upon the court's adjudication of bankruptcy, the bankruptcy estate (*pasanjaedan*) is established with all properties of the debtor (Art. 6). The right to manage and dispose of the bankruptcy estate is vested exclusively with the receiver, subject to court supervision (Art. 7). The receiver, immediately upon assuming office, shall take possession of and manage the bankruptcy estate (Art. 175). The receiver shall have all properties in the bankruptcy estate appraised in the presence of the court clerk, bailiff or notary public, make the list of inventory and a balance sheet, and submit them to the court. Interested parties have the right to inspect such documents (Art. 178, 179).

The Bankruptcy Act authorizes the receiver to set aside transactions in bankruptcy proceedings. Art. 64, which enumerates the avoidable transactions, is very similar in substance to Art. 78 of the Corporate Reorganization Act. The receiver's power to terminate the executory contracts (Art. 50) is the same as the trustee's power to terminate executory contracts under the Corporate Reorganization Act (Art. 103).

All creditors are required to file their claims with the court within the period fixed by the court, which shall be not less than two weeks and not more than four months. The hierarchy among creditors can be summarized as follows.

a. Secured claims: Secured creditors can proceed against their security on the same terms as would be available if a debtor were not bankrupt.

b. Estate claims (jaedanchaekwon): Estate claims are senior to all unsecured claims and can be paid by the receiver at any time regardless of the bankruptcy procedure (Art. 40, 41). Estate claims constitute, in nature, administrative costs for the bankruptcy procedure. Art. 38 enumerates estate claims, among which are costs of judicial proceedings incurred for the common benefit of creditors; expenses incurred in the management, liquidation, or distribution of the bankruptcy estate; claims resulting from the acts of the receiver in managing the bankruptcy estate; and reimbursement claims resulting from a termination of a bilateral contract.

c. Claims with preference: The most significant example of such claims is claims for unpaid wages to employees, which are superior to any bankruptcy claims.

d. Bankruptcy claims (pasanchaekwon): Bankruptcy claims are the credits against the bankrupt incurred before the adjudication of bankruptcy which are not included in other categories (Art. 14). These claims cannot be exercised outside of the bankruptcy procedure.

e. Subordinated claims: Subordinated claims are inferior to bankruptcy claims. They include interest accrued after the adjudication of bankruptcy, damages and penalties resulting from a failure of performance after adjudication of bankruptcy, and costs of participating in the bankruptcy proceedings (Art. 37).

As is similar in the case of creditors in corporate reorganization, the creditors have the right to set off their debt to the insolvent company under the Bankruptcy Act (Art. 89-95). One procedural difference between the two cases, however, is that the creditor's right to set off under the Corporate Reorganization Act must be exercised on or before the last day of the period specified for filing the claims of all creditors, whereas there is no such time limit in the case of the creditor's right to set off under the Bankruptcy Act.

D. Claims and Distribution

At the first creditors meeting, the receiver reports on the circumstances that led to the adjudication of bankruptcy, interim developments, and the present status of the bankrupt and the bankruptcy estate (Art. 183). The validity of claims filed by creditors can be examined at the first creditors meeting. If the receiver or any creditor does not object to a filed claim, it will become conclusive (Art. 217). If the receiver or any creditor oppose a filed claim, the holder of the claim may bring action to obtain a court judgement.

A resolution at the creditors meeting requires that the majority of the creditors present votes for the resolution, and the claims of the creditors voting for the resolution must exceed 50 percent of the amount of the claims of all creditors present at the meeting (Art. 163). If the resolution adopted at the creditors meeting goes contrary to the general interests of the creditors, the court may prohibit implementation of the resolution (Art. 168).

Immediately after the general examination of claims, the receiver shall perform the distribution whenever he or she recognizes any money appropriate for the distribution (Art. 228). The receiver distributes the proceeds from the bankruptcy estate to the creditors in proportion to their claims according to the distribution schedule prepared by him or her, and inspected by creditors (Art. 229-231). Permission from the court is required for the final distribution.

E. Conclusion

A bankruptcy proceeding is concluded with a court decision after the receiver has made the final distribution and presented a report at the creditors meeting. The court may also discontinue a bankruptcy proceeding in the following cases: (i) when the bankrupt applies for the discontinuance under the agreement of creditors, and (ii) when the court acknowledges that the value of the bankrupt estate is smaller than the amount of the expenses for the bankruptcy proceeding.

IV. Effect of Insolvency Proceedings on the Efficiency and Welfare of Creditors and Debtors

A. Criteria for the Reorganization Decision

The reorganization decision is made at two levels. The first level is when the court issues the order of commencement. The economic test, i.e. the comparison between liquidation value and going concern value, is the main criterion at the first level. To obtain the order of commencement from the court, the firm should pass the economic test successfully. In cases where the economic test was passed successfully but the major creditors explicitly disagree with the reorganization, the court tends to follow the creditors' opinion.

The second level is when the court approves the reorganization plan. The plan should meet the requirements listed in the Act. The major criteria at the second level are legitimacy, fairness, equity and feasibility.

B. *Process of Drawing up the Reorganization Plan*

According to the Act, the reorganization plan can be proposed by the corporation, creditors or shareholders as well as the trustee. Most plans, however, are submitted to the court in the name of the trustee. The logical order for drafting the plan is as follows: 1) estimate future sales and profits, 2) calculate maximum payments to creditors with available funds, and 3) negotiate the payment schedule with creditors based on the above mentioned figures.

An empirical study, however, reveals a different story. In most cases, not the trustee but rather the applicant firm prepares the plan. The officers of the debtor corporation begin by speaking with major creditors to get the minimum level of payment that can be accepted by them. In most cases, the interest rates are the main issue. After the firm decides the fundamental figures, including interest rates and duration of payment, it calculates the necessary funds and future sales, and then completes the table.¹¹

As a result, the payment conditions are rather similar to each other regardless of the differences between firms. Hence, the most critical point in the reorganization procedure is at the point when each creditor takes a position on whether to stand for or against the process.

C. *Corporate Governance*

In the bankruptcy procedure, the receiver takes charge of business operations and the disposal of assets. In the corporate reorganization procedure, the trustee has the full authority of management and representation of the firm. The receiver and the trustee are appointed by the court and under the supervision of the court. In contrast, the debtor still runs the business in the composition procedure.

The receiver in the bankruptcy procedure and the trustee in the reorganization procedure are only responsible to the law and the court. In a sense, business performance is not the primary concern. The debtor/manager in the composition procedure is mainly responsible to creditors and shareholders although the (interim) administrator monitors him.

D. *Quantum*

The draft reorganization plan is adopted with the required consent of each group of interested parties: two thirds of the creditors of general claims, three-quarters of the creditors of secured claims (four-fifths or unanimous voting in special

situations), and one-half of the shareholders. Shareholders have no voting rights if the total amount of the debt exceeds that of the assets at the time of commencement of the procedure.

The composition plan is adopted by the consent of three-quarters or more of the total filed claims. As the secured creditors can exercise their security interests regardless of the condition of composition, the consent of secured creditors is not required in the composition procedure.

E. Cram down

The Corporate Reorganization Act has a provision authorizing the court to approve the plan even if any category of claimants fails to reach an agreement on the proposed reorganization plan, but only under the condition that the court determines the clauses to protect the rights of the interested parties. The Act enumerates the possible methods for protecting the rights of interested parties in Art. 234.

F. Division of Economic Value

Under the reorganization plan or the condition of composition, every economic value is distributed to creditors until they are fully paid according to the plan. Shareholders can get dividends after the plan is fulfilled. In the bankruptcy procedure, the distribution of economic value is strictly executed according to the distribution schedule.

G. Stakeholder

The insolvency laws do not take any stakeholder into consideration except when they are creditors or shareholders. Employees have special priority for their wage claims over secured creditors, as provided by the Labor Standard Act. The Corporate Reorganization Act classifies the wage claims into claims of common benefits that are to be paid irrespective of the reorganization plan.

H. Duration of Procedure

The decision on the commencement of composition shall be made within three months from the petition. This period may be extended for up to one month. In the corporate reorganization procedure, the provisional protection order shall be issued within two weeks after the petition. The order of commencement for

small- and medium-sized companies shall be decided within three months after the petition. The trustee shall submit the reorganization plan within four months after the last date of filing claims. The reorganization plan shall be adopted at the interested parties meeting within one year after the commencement of the reorganization procedure. This period can be extended up to six months. If the plan is not submitted or adopted within the prescribed period of time, the court shall discontinue the process *ex officio*.

Table IV-1 Duration from the order of commencement to the conclusion in cases where the reorganization process was concluded in the last 5 years

	Number of Cases	In 3 years	In 5 years	In 7 years	In 10 years	In 15 years	In 20 years
1993	4	0	1	1	2	0	0
1994	9	0	0	1	4	4	0
1995	5	1	0	0	0	3	1
1996	8	0	0	1	1	5	1
1997	5	3	0	0	1	1	0
1998	2	1	0	0	0	1	0
Total	33	5	1	3	8	14	2

TableIV-2 Duration from the order of commencement to the discontinuance in cases where the reorganization process was discontinued in the last 5 years

	Number of Cases	In 3 years	In 5 years	In 7 years	In 10 years	In 15 years	In 20 years
1993	12	6	2	2	2	0	0
1994	16	6	2	1	6	1	0
1995	24	5	8	7	0	4	0
1996	18	5	6	3	0	4	0
1997	15	5	5	0	3	2	0
1998	6	3	1	1	0	1	0
Total	91	30	24	14	11	12	0

Table IV-3 Payment period in recent cases (1996.1.1. -1998.3.31.)

Claims	In 5 years	In 7 years	In 10 years	In 15 years	In 20 years	Total
General	6 (13%)	1 (2%)	19 (41%)	9 (19%)	11 (24%)	46
Secured	5 (11%)	4 (9%)	20 (43%)	10 (22%)	7 (15%)	46

Table IV-4 Payment ratio in recent cases (1996.1.1. - 1998.3.31.)

() % Unsecured creditors	Up to 10%	Up to 30%	Up to 50%	Up to 75%	Up to 100%
Financial Institution	3 (7.9%)	0	1 (2.5%)	2 (5%)	33 (84.6%)
Commercial Transactions	5 (18%)			2 (7%)	21 (75%)

I. Non-adoption of the Plan

When the condition of composition is not adopted, the court shall discontinue the process and transfer it to the bankruptcy procedure. In contrast, on the occasion of discontinuance of the corporate reorganization, the transfer to the bankruptcy procedure is not mandatory. The firm would be liquidated privately in most cases.

J. Sales of Assets and Businesses

Assets, operations, or the corporation itself may be sold during the reorganization process. Prospective buyers prefer to purchase the company after debts are restructured. Thus, in some cases, a potential purchaser plays an important role in drawing up the reorganization plan. After the court approves the plan, the new owner may take control of the firm which by then has a sound financial structure.

K. Impact of the Start of the Proceedings

After the provisional protection order is issued, most business transactions are performed on a cash basis, so the extent of business activities is reduced.

V. Markets for Ailing Firms and Their Assets

V-1. *Korea Asset Management Corporation (KAMCO)*

KAMCO is the government agency mandated to acquire and dispose of non-performing loans (NPLs) in Korea's financial sector. KAMCO was established in April 1962 as a subsidiary of the Korea Development Bank to dispose of assets that financial institutions acquired from their insolvent debtors. In the wake of the financial crisis in late 1997, KAMCO was mandated to acquire and dispose of non-performing loans in the financial sector.

The Non-performing Assets Management Fund of 33.5 trillion won was set aside to acquire NPLs of distressed financial institutions, as shown in the following table. The fund plays a crucial role in enhancing liquidity and restoring stability in the financial sector. A major portion of the fund came from the issuance of KAMCO bonds. KAMCO is authorized by the National Assembly to issue up to 32.5 trillion won worth of bonds. As of the end of June 1999, KAMCO had issued bonds worth over 19 trillion won.

Table V-1 **Funding Sources of KAMCO as of June 30, 1999**
(unit: billion won)

Funding Sources	Authorized Amount	Disbursed Amount
Contribution from Financial Institutions	573.4	573.4
Borrowing from KDB	500	500
KAMCO bonds issuance	32,500	19,359
Total	33,573.4	20,432.4

Source: KAMCO

Since being reestablished in November 1997, KAMCO has purchased about 46 trillion won of non-performing loans from 71 financial institutions. Approximately 80 percent of the NPLs acquired came from the banking sector. The remainder was from other financial institutions, including merchant banks, insurance companies, and securities companies.

Table V-2 Status of NPLs Purchased as of June 1999
(Unit: billion won)

Date	Designated institution	Loans Purchased	Acquired price
Nov. 26 1997	Cheil Bank, Seoul Bank	43,943	29,103
Nov. 28 1997	30 Merchant Banks	26,988	17,555
Dec. 15 1997	30 Banks	39,510	24,743
	Sub Total ('97)	110,441	71,401
Feb. 19 1998	2 Insurance Companies	28,166	4,121
Jul. 23 1998	Seoul Bank	10,400	4,989
Jul. 31 1998	Cheil Bank	11,335	6,066
Sept. 29 1998	23 Banks, 2 Insurance Companies	230,136	90,850
Nov. 6 1998	Kwangju Bank, Cheunju Bank, etc	4,969	2,616
Dec. 29 1998	5 Special Banks	45,308	19,030
	Sub Total ('98)	330,314	127,672
Feb. 12 1999	Chohung Bank	876	428
Mar. 31 1999	Chungbok Bank	78	25
May 19 1999	P.B.O bonds of 5 Banks	17,514	2,804
June 30 1999	Hanmi Bank, 50 Mutual Credit Associations	2,110	1,134
	Subtotal ('99)	20,578	4,391
	Total	461,333	203,464

Note: P.B.O indicates Put Back Option

Source: KAMCO

KAMCO has been disposing of its assets through various methods, such as individual REO property sales, foreclosure auctions, portfolio sales, equity partnerships and ABS issuance. KAMCO disposed of NPLs worth 3.4 trillion won as of July 1999.

Table V-3 NPLs Disposition
(Unit: Billion Won)

Category		Face Value	Sale Value
Liquidation Of Asset	98-1 (Distribute Residential Interest)	207.5	25.4
	98-2 (Equity Partnership)	541.2	201.2
	99-1 (Outright Sales)	772.4	123.8
	ABS 99-1 (Domestic ABS issues)	300.7	320.0
	Secured NPL 99-1 (Outright Sales)	1,038.8	524.9
Sub Total		2,860.6	1,195.3
Asset Sale	Foreclosure Action	1,878.0	953.7
	Public Sale	261.1	119.3
	Sub Total	2,139.1	1,073.0
Voluntary Repayment		1,143.9	1,121.3
Total ¹		6,143.6	3,389.6

Note: 1. Estimated price

Source: KAMCO

V-2. *Vulture Funds*

The market for the assets of insolvent firms has recently risen in prominence, as restructuring in the corporate and financial sectors has made the management of insolvent assets a major issue. Previously, vulture funds (companies specializing in corporate restructuring) were not fully utilized in Korea; rather, they generally only entered the domestic market to purchase the insolvent assets owned by banks or merchant banks. For example, the Commercial Bank of Korea sold the insolvent assets of the Canadian branch corporation of Sammi Atlas for US\$ 20.69 million to Merrill Lynch, an American investment bank. However, Korean firms' inexperience in managing insolvent assets has led them to evaluate their assets much differently from foreign buyers, resulting in bargaining failures in most cases.

The Industrial Development Act allowed the establishment of vulture funds as of February 2, 1999. As of September 1999, eleven vulture funds and one association had set up establishments in Korea. The market for insolvent assets seems to grow based on domestic capital. The main tasks of a vulture fund is to acquire¹² those firms in need of restructuring through a stock-purchase, merger, or transfer of operation, and to sell them again after normalization.¹³ In addition to this, a vulture fund can buy assets of financially - troubled firms, such as real estate, that the firms are willing to sell in order to reduce their debts. A fund can also buy insolvent assets owned by financial institutions or the Korea Asset

Management Corporation, mediate M&As between firms, and conduct agency business of reorganization, composition, and bankruptcy procedures.

Firms considered in need of restructuring¹⁴ are those that went into bankruptcy more than once in the past three years, filed for reorganization, composition, or bankruptcy in court, or were declared in need of management normalization by the council of creditor financial institutions.

At the same time, a vulture fund can set up an association with other investors to finance restructuring. Mandatory investment of the vulture fund is required here to prevent conflicts of interest between the vulture fund and the association.¹⁵ Such an association is defined as a legal entity under the Civil Code. The Civil Code applies to this organization except for cases as specified in the Industry Development Act. In September 1999, the First Komet M&A Ltd. was enrolled as an association for corporate restructuring.

VI. Informal Insolvency Proceedings

VI-1. Workouts

A. Legal basis for workouts

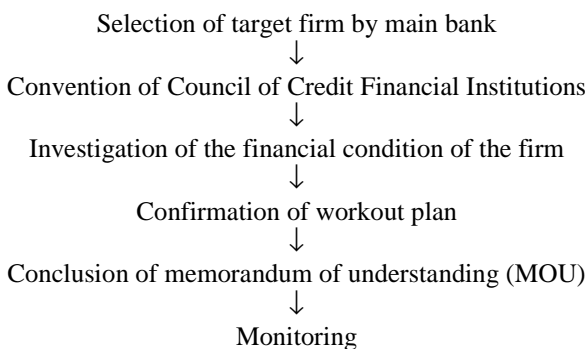
The workout program is based on the Financial Institutions Agreement for Promotion of Corporate Restructuring ("Corporate Restructuring Agreement") signed on June 25, 1998 by creditor financial institutions, including commercial banks, investment trust corporations, and merchant banks. It was supposedly modeled after the London Approach, in which the central bank plays an arbitrator's role in the voluntary negotiations between debtor companies and their banks. But the Korean program differs in a number of ways in its implementation. First, every financial institution was urged to participate in this agreement, including insurance companies and security brokerage companies, unlike the case of the failed Anti-Bankruptcy Agreement of 1997, which was signed only by commercial banks. Second, the Financial Supervisory Commission (FSC) has in effect assumed a central role in the process since it is in charge of both corporate and financial sector restructuring, even though the Corporate Restructuring Committee is the official arbitrator according to the agreement. Third, the government retains another way to directly influence the process, as it is the majority shareholder of many of the largest commercial banks. The government became the absolute majority shareholder of many commercial banks as a result of the restructuring.

The workout program was an attempt to prevent a systemic corporate bankruptcy amid mounting non-performing loans in the aftermath of the

economic crisis, and was conceived partly out of the concern that the existing formal insolvency procedures were not fully developed and efficient enough to handle such a large number of firms in financial distress at the same time.

The workout program is implemented according to the following flow chart.

Flow Chart of Workout



B. Process of Workout

1) Selection of target firms

The workout procedure is first initiated when the main bank of a debtor company, or financial institutions having loans amounting to more than 25 percent of the company's total credit, select a targeted firm and call for a council of credit financial institutions. The targeted firms mainly consist of firms that are economically viable but are temporarily suffering from financial distress. The workout procedure should provide a more reasonable loan call rate than what a legal procedure such as composition and reorganization would entail. But selection of the targeted firms is largely dependent on the main bank's discretion.

2) Council of credit financial institutions and decisions on workout procedure

When the main bank selects the targeted firm and notifies the credit financial institutions, the council of financial institutions is convened and decides on the workout procedure. When the council of financial institutions is convened, debt collection by the financial institutions on loans is immediately suspended for a maximum of six months.

The council then decides whether or not the workout procedure will begin. The approval of the proposed workout plan requires at minimum a 75 percent majority vote by the creditors, otherwise the firm is excluded from the workout procedure. In the event where neither a 75 percent agreement nor 75 percent objection is reached, the agenda is rolled over to the second or third convention of the council. If the second and third convention of the council cannot decide on the workout procedure, the main bank may request arbitration by the Committee of Corporate Restructuring. In addition, the council of credit financial institutions also selects the institution that will examine the situation of the targeted firm during the standstill.

3) Investigation of target firms

The purpose of assessing the condition of the firm is mainly to verify its real liquidation value from a conservative perspective. The subjects of investigation are the company's assets, liabilities, future going concern and liquidation value, and other liabilities such as those not listed in the books or contingent liabilities. Based on the results of the investigation, each creditor knows the minimum value of what he or she can collect, and compares the various alternatives provided by the main bank with that basic information. During the investigation, the main bank prepares a workout plan with the assistance of an external advisory group.

4) Confirmation of workout plans

A workout plan prepared by the main bank is negotiated in the council of creditors. The plan can include a wide range of restructuring measures: debt rescheduling, interest reductions, additional financing, dissolution of cross-loan guarantees in the case of conglomerates, debt-equity swaps and capital reduction, asset and business sales, injection of fresh capital from foreign investors, and the appointment of a manager. After the workout plan is established, the council of financial institutions approves the workout plan with the approval of 75 percent or more of the total of those holding the company's debts.

5) Conclusion of Memorandum of Understanding (MOU)

Once the plan is approved, the main bank concludes a Memorandum of Understanding on corporate restructuring with the targeted firm. The workout procedure principally requires the shareholder, manager and other employees to be equally responsible for the losses suffered by the creditors. Thus, the MOU must include and specify elements of self-rescue, reduction of capital and adjustment of personnel. In concluding the MOU, the main bank must specify

the management target measurable with quantitative and qualitative measures and the time schedule to carry out the target to protect the credit financial institutions and fulfil the workout procedure correctly.

6) Monitoring

After conclusion of the MOU, the main bank establishes and dispatches a management team to the targeted firm for monitoring. In addition, the main bank may construct a regular reporting system, appoint and dispatch an independent director, and construct a committee to assess the management and monitor the process of executing the MOU.

C. Scope of Workouts

As of October 1999, 93 companies were under the workout procedure, 81 of which have an approved workout plan. The total amount of loans of those 81 companies subject to the workout plan is 38.4 trillion won. (Table VI-1, VI-2)

Table VI-1 Workout Programs in Progress as of October 1999
(Unit: Companies)

	Selected	Unqualified	Resolved	Applied	Plan Fixed	List of Unqualified Companies
Firms Affiliated with 6 th to 64 th <i>chaebols</i>	59	5	-	54	43	Tongil Heavy Industries Co., Ilsung Construction Co., Ilshin Stone Co., Hankook Titanium Industry Co., Anam Electronics Co.
Firms Not Affiliated with <i>chaebols</i>	44	4	1	39	38	Kyunggi Chemical Industrial Co., Daljay Chemical Co. Korea Leasing CO., Samhyup Development
	103	9	1	93	81	

Table VI-2 Confirmed Results of Workout Plan
Unit: billion won, one hundred million dollars

List	No. of affiliates	Main Bank	Fixed Plan	Amount of Loans			Debt Restructuring							New Loans	Trade Financing	
				Loans	Cross Loan Guarantees	Total	Interest rate cuts	Interest Release	Debt / Equity Swaps	CB Conversion	Loan Release	Repayment of Loans	Etc.			
Dongah Construction Ind., Co.	1	Seoul	980911	44,758	8,229	52,987	43,928	8,257	802						1,600	
Keopyung	3	Chohung	981014	3,822	4,862	8,584		824	748	111	3,048	578	3,375			
Sepoong	2	Chohung	981017	4,605	92	4,697	4,605	92							59	6.9
Kabool	2	Hanvit	981017	13,780	2,655	16,435	10,357	1,890	163	3,260	765					50.0
Kohap	4	Hanvit	981021	47,775	3,553	51,328	42,819	4,751	1,450	2,308					3,260	194.0
Shinho	3	Cheil	981024	12,441	2,717	15,158	7,541	4,720	494	2,403					700	70.0
Peeres Cosmetics	1	Hanvit	981027	590	123	713	540	58		50	65					
Shin Won	3	Korea Exchange	981028	9,544	4,060	13,604	4,854	2,739	1,540	3,150	1,321				540	30.0
Jindo	3	Seoul	981106	10,739	3,202	13,941	6,718	4,273	908	2,042						86.0
Kangwon Industries	4	Chohung	981112	17,208	575	17,783	17,208	575							1,239	12.0
Woo Bang	1	Seoul	981116	8,398	734	9,132	5,838	1,242	419	1,633					1,200	
Korea Computer Inc.	1	Shinhan	981117	1,083	70	1,153	1,083	70								8.8
Byucksan	3	Hanvit	981126	9,054	2,356	11,410	7,454	2,356	100	1,500					500	
Taegu Depart. Store Co.	2	Daegu	981127	3,352	683	4,035	3,152	261		200	422					
Samil Kongsan	1	Korea Development	981204	488	28	516	488	28								9.0
Seshin	1	Busan	981204	536	45	581	581									

List	No. of affiliates	Main Bank	Fixed Plan	Amount of Loans			Debt Restructuring							New Loans	Trade Financing
				Loans	Cross Loan Guarantees	Total	Interest rate cuts	Interest Release	Debt / Equity Swaps	CB Conversion	Loan Release	Repayment of Loans	Etc.		
Dae Kyung Special Steel Co.	1	Korea Development	981210	739	0	739	739								
Dongwha	3	Chohung	990920	1,675	2,939	4,614	1,458	2,943	110				103	76	47.6
Young Chang Akki Co.	1	Korea Exchange	981216	1,661	321	1,982	321	1,982	1,661	321				210	9.0
Sung Chang Enterprise Co.	1	Hanvit	981223	2,001		2,001		2,001	2,001					88	5.0
ShinWoo	3	Hanvit	981223	2,875	2,499	2,475	2,499	5,374	2,475	2,499	29	371		152	10.0
XETEX Co.	1	Hanvit	981228	895	838	895	838	1,733	895	838					
Dong Bo Construction	2	Housing Commercial	981229	1,244	1,022	1,244	1,022	2,266	1,244	1,022				318	

List	No. of affiliates	Main Bank	Fixed Plan	Amount of Loans			Debt Restructuring							New Loans	Trade Financing
				Loans	Cross Loan Guarantees	Total	Interest rate cuts	Interest Release	Debt / Equity Swaps	CB Conversion	Loan Release	Repayment of Loans	Etc.		
Dongbang	3	Cuohung	981230	3,625	236	3,861	1,767	236	147	181			1,530	90	14.0
Namsun Aluminum Co.	1	Korea Development	990105	1,863	58	1,921	1,413	58	60	390				80	8.8
Muhak Co.	1	Kyungnam	990109	255	650	905							905		
Il-dong Pharmaceutical Co.	2	Cheil	990123	4,012	190	4,202	3,662	176	79	250	35			117	50.0
Hanchang	4	Busan	990123	3,906	500	4,406	3,906	500							11.0
Choong Nam Spinning Co.	2	Chohung	990128	2,759	645	3,404	447	645					2,312	80	17.0
Seo Han	1	Daegu	990203	2,081	35	2,116	1,731	35		350				350	
Hwa Sung Industrial Co.	1	Daegu	990209	4,941	256	5,197	4,641	256		300				590	

List	No. of affiliates	Main Bank	Fixed Plan	Amount of Loans			Debt Restructuring							New Loans	Trade Financing
				Loans	Cross Loan Guarantees	Total	Interest rate cuts	Interest Release	Debt / Equity Swaps	CB Conversion	Loan Release	Repayment of Loans	Etc.		
Tongkook Corporation	3	Cheil	990213	12,507	5,975	18,482	11,107	6,191	338	846				856	80.0
Ssangyong	2	Chohung	990302	16,741	946	17,687	8,929	862	5,636				2,260		
Anam	2	Chohung	990307	22,441	6,313	28,754	10,747	6,313	1,419	1,081			9,194	500	
Shin Song Food Co.	2	Korea Exchange	990329	515	0	515	515							20	
Miju	4	Seoul	990419	2,113	397	2,510	1,415		72	360			663	241	5.9
Korea Industry Co.	1	Busan	990624	942	412	1,354	730						624		1.0
Korea Development Leasing Co.	1	Hanvit	990729	38,536	2,380	40,916	31,344	4,156	3,036						
Shin Dong-Bang	4	Hanvit	990826	6,180	1,016	7,196	3,180	1,615	721	1,680				200	67.0
Total	81			322,680	61,612	384,292	253,173	60,802	18,271	22,466	5,656	578	20,966	13,066	792.0

- Note:
1. Cross-loan guarantees mean guarantees for non-objective affiliates of workout companies.
 2. Total Amount = interest rate cut + interest release + debt/equity swaps + CB conversion + Loan Release + Repayment of loans + etc.
 3. Etc. includes the sustained interest rates and so forth.
 4. Interest rate cut and interest release are the objectives of deferred payment.
 5. New loans unit: billion won, Trade Financing unit: one hundred million dollars

Source: Financial Supervisory Commission

Several obstacles to a better workout outcome have been pointed out, including the following: 1) lack of experience and commercial knowledge among bank personnel involved in the process; 2) reluctance to supply new money to the debtor firm by any financial institutions except the main bank; 3) ineffectiveness of the formal procedure and the threat it poses to the creditors and the debtor firm in the event the informal procedure fails; and 4) the lack of effective corporate governance within the institutional creditors. Banks may not provide strong enough incentives to their employees to strive actively for a successful workout. Given the nature of the Corporate Restructuring Agreement as a private contract, the last two obstacles may in particular give the current controlling shareholders of a debtor company some incentive to hold out in the hopes of exacting a bigger concession from the creditor.

VI-2. *Other Schemes*

A. *Rationalization Measures of the 1970s and 1980s*

At the outset, it is helpful to look at the institutional arrangements dealing with insolvency problems in Korea from a historic perspective. Before the modernization drive began in the 1960s, there were few firms in Korea to talk about. Relatively large-sized firms appeared as a result of the rapid industrialization policy of the Park Chung Hee government, which pushed for the development of many industries that the president believed were necessary for Korea.

Faced with either the lack of a well-developed financial market that could channel the savings of the general public to projects that he wanted, or the dearth of private financiers who had money to finance those projects, President Park resorted to quite a unique form of capitalism. He took over the financial market and ran banks and most of the other NBFIs virtually as government businesses while using them as a means to channel the savings of the general public to his favorite projects. He forced financial intermediaries to lend money to the firms in those industries he sought to develop. Lending by banks owned and operated by the government, such as the Korea Development Bank, to such projects was not uncommon either.

Such heavy involvement in the financial market by the government naturally led the government to consider corporate bankruptcy in its industrial policies. It is also important to remember that at the time, the Park Chung Hee government had near absolute power in Korea, enabling it to implement a wide range of actions at will, unchallenged by anyone. Thus, the government tackled the

insolvency of large firms by using a set of measures generally called "rationalization" rather than formal proceedings supervised by the court.

The Park government implemented rationalization policies in two waves. During the period 1969-1971, a total of 112 firms were designated as failing firms and became targets of rationalization policies. The Korea Development Bank, a state-owned bank, handled the cases along with some of the commercial banks that were major creditors of the target firms. The measures consisted of debt reductions, forced sale of firms and their assets, and liquidation in some cases.

The second wave of rationalization came in 1972. In the 8.3 measure of 1972, so called because it was announced on August 3, the Park administration introduced a wide range of measures for a total of 61 industries that included the steel, shipbuilding, electronics, PVC, chemical fertilizer, and other industries that were important to the Korean economy at the time. In addition to the measures that are similar to the ones used in the first wave of rationalization, the 8.3 measures included tax benefits for target firms, and forced specialization of some firms. Further, Park's emergency decree nullified all existing debt contracts, except in the cases of small amounts, and in their place substituted contracts that were much more favorable to the debtors. The 8.3 measure was an all-out response by the Park administration to an economic crisis in which many of the firms that had been created as a result of industrial policies aimed at rapid industrialization, became insolvent.

Overall, rationalization measures more closely resembled restructuring of financially troubled firms and debt restructuring necessary to keep the firm in operation than they did liquidation, which was rarely used. However, it is also important to note that rationalization went beyond restructuring of individual firms as it aimed at restructuring the target industry and entailed significant changes in the industrial organization of the industry. Nullification of existing loan contracts between private parties by the presidential decree was clearly inconsistent with fairness and long-term efficiency in the capital market and violated the spirit of the Constitution, if not the Constitution itself.

The government's command of the financial sector continued under Park's successors, although the industrial policies aimed at developing target industries lost much of their steam in the 1980s. Rationalization measures continued to be employed by the Chun Doo Hwan government as a major response to the insolvency problems of large firms. There were three waves of rationalization under the Chun administration. The set of measures called the "Adjustment of Investment in Heavy Industries" implemented in 1982 targeted electricity-generating facilities, manufacturing, construction, heavy equipment,

automobiles, electronic equipment, diesel engines, and copper refining industries.

The second wave of rationalization measures of 1984-1985, called "Rationalization of Depressed Industries," targeted marine transportation and the overseas construction business. During 1986-1987, 57 financially troubled firms were reorganized while 21 of them were liquidated in this last wave of rationalization by the Chun administration. The measures used were similar to the ones used by the Park administration.

It is noteworthy that under the Park and Chun administrations, the rationalization measures were taken unilaterally by the administrative branch of the government and often lacked firm legal grounds or legally adequate procedures. All of the key decisions were made by the government, including those regarding whether to liquidate or restructure the firm, and the terms of restructuring or mergers when mergers were a part of the package. In fact, there were no principles or guidelines that governed the rationalization measures. Naturally, there was little transparency.

On the surface, banks were the biggest losers as they were forced to absorb most of the losses involved. But since the banks virtually operated as a government business and their losses were eventually covered by the public's money, it was the general public who ultimately paid for the losses. In fact, the Bank of Korea, the central bank in Korea, frequently provided special loans at favorable conditions to the banks whose financial health was seriously undermined by the massive writing-off of loans made to the firms targeted by rationalization measures.

Rationalization policies became more formal after 1986 as the Industrial Development Act was introduced. The Act specified the conditions under which the rationalization measures were to be applied and the types of measures that could be employed. The key cases to which the Act was applied involved automobiles, heavy construction equipment, diesel engine, and electronics industries during the 1986-1989 period. Compared with the rationalization measures of the Park and Chun administrations, the rationalization policies under the Industrial Development Act put more emphasis on limiting competition in the industries to which target firms belonged. Measures such as forced specialization of firms, preferential treatment in procurement, and bans on additional capacities, as well as the scrapping of existing capacities were employed in order to limit competition in target industries and thereby improve the profitability of target firms.

Rationalization policies based on the Industrial Development Act became insignificant in the 1990s as successive administrations put less emphasis on the

kind of industrial policies aimed at developing target industries that had been so fervently pursued by the Park government. However, as a result of the rapid industrialization policies of Park and the policies of the successive administrations on financial markets, most large firms were heavily indebted and highly exposed to the risk of becoming insolvent even in the 1990s. This, combined with the continued domination of the financial market by the government, left the door wide open for government intervention in the event that large firms became insolvent.

B. *"Big Deals" of 1998*

In 1998, the government announced plans for mergers by large firms in several industries, called "Big Deals," as a part of the emergency measures introduced at the height of the economic crisis. The plan was based on agreements by the firms involved and did not officially involve the government. However, some believe that the government played some role in setting up the "Big Deals." Table VI-3 summarizes the "Big Deal" plan announced on October 7, 1998. The industries covered by the plan share the common characteristic that they require a large amount of initial investment to start a business, and that a large proportion of initial investment becomes a sunk cost once the investment is made.

Assuming that the Korean government implicitly had interest in seeing some of the proposed big deals go through, one is naturally led to ask why a government would be interested in successful mergers and acquisitions between firms with sizable market shares. Normally, a government would be interested in deterring mergers and acquisitions that would significantly harm competition. Are the big deals motivated by industrial policy concerns aimed at making the Korean firms in target industries competitive in the world market?

Another crucial question relevant to the arguments concerning big deals is why we have not observed efforts by the firms involved or their management to merge before big deals were proposed. The most common criticism directed at big deals is that they would severely reduce competition in the relevant industries. If big deals indeed reduce competition severely and increase the combined value of the firms to be merged, the firms must have an incentive to merge. However, mergers are rare in Korea.

Table VI-3 “Big Deal” Plan

Business line	Plan of the Deal	Controlling Body
Semiconductor	Samsung Electronics Co. →	Samsung Electronics Co. Hyundai Electronics Ind. (Decided in March 1999)
	Hyundai Electronics Ind. →	
	LG Semiconductor Co. → Merger	
Power-Generation Equipment	Hyundai Heavy Industries Co. →	Korea Heavy Industries & Construction Co.
	Korea Heavy Industries & Construction Co. →	
	Samsung Heavy Industries Co. → Merger	
Petro-Chemicals	SK, LG, Daelim, Lotte, Hanwha →	SK, LG, Daelim, Lotte, Hanwha Sole corporation establishment
	Hyundai Petro-chemical Co. →	
	Samsung General Chemical Co. → Merger	
Aircraft Manufacturing	Korea Air Line Co. →	Korea Air Line Co. Sole corporation establishment
	Samsung Aerospace Industries Co. →	
	Daewoo Heavy Industries Co. →	
	Hyundai Space & Aircraft Co. → Merger	
Railway Vehicles	Hyundai Precision & Ind. Co. →	Sole corporation establishment (Share ownership ratio: 4:4:2)
	Daewoo Heavy Industries Co. →	
	Hanjin Heavy Industries Co. → Merger	
Ship Engines	Hyundai Heavy Industries Co. →	Hyundai Heavy Industries Co. Korea Heavy Industries & Construction Co.
	Korea Heavy Industries & Construction Co. →	
	Samsung Heavy Industries Co. → Merger	
Oil Refining	SK, LG, Ssangyong →	SK, LG, Ssangyong Hyundai Oil Co.
	Hyundai Oil Co. →	
	Hanwha Energy Co. → Merger	

Note: On December 7, 1998, the swap between Samsung Motors and Daewoo Electronics was announced as an additional Big Deal plan.

Source: Financial Supervisory Commission. 1998.12.

The main reason why the Korean government may be interested in big deals is that the firms in question are heavily indebted and cannot pay back their debts. As the dominant shareholder of several banks, some of which have recently been effectively nationalized in the course of restructuring since the onset of the crisis, the government was and still is keenly interested in minimizing the losses of the banks. In other words, the government could have reason to hope for mergers between ailing firms with huge amounts of debt if the merger increases the combined profit streams as a way to minimize the losses to the banks.

However, such a merger would require a *chaebol* family to relinquish its ownership and control of a large firm which it has controlled with little of its own at stake. Further, in cases where the net value of the firms after the debts are negligible or negative, the controlling *chaebol* family would have no incentive to hand over the shares under its control because it would receive little in return for giving up control over huge amounts of assets. Under such circumstances, it would be difficult for the management of the firms to agree on conditions for a merger. In fact, big deals have not been proceeding smoothly precisely for this reason.

Even if a big deal goes through, as has been the case with semiconductors, there remains the question of whether the benefits from the merger more than offset the loss of efficiency from the reduced competition. In the case of the semiconductor industry, there seem to be few experts who believe that the merger would substantially reduce competition in the market because the relevant market is the world market.

Our final comment on big deals is that the Korean government could have followed an alternative path in coping with the firms that were included in the proposal for big deals, namely workouts. A more standard way of dealing with large ailing firms has been workouts, in which creditors give up some of the loans that they made to the firms in return for the shares of the firms. Had the government chosen this path, the creditors of the firms that were targets of big deals would have become new owners. The new owners of the firms then could voluntarily decide whether to merge their firms and negotiate the terms of the merger. If they were to agree on a merger, it should then be up to the Fair Trade Commission (FTC) to determine whether to allow the merger based upon efficiency criteria.

VII. Bank Insolvency Regimes

The relevant law in Korea is the Act Concerning Structural Improvement of a Financial Industry. Originally known as the Act on Merger and Transfer of Financial Institutions in 1991, this law underwent comprehensive revision in 1996 with a different title to encourage healthy financial institutions to merge and weak institutions to exit. Although there were several financial institutions with serious problems, and despite growing concern regarding the poor business practices of Korea's banking industry, this Act was never used to restructure or liquidate any financial institutions. Most of the problems were not exposed publicly or dealt with judicially. Some financial institutions were merged or acquired by other institutions under the guidance of the Ministry of Finance.

The financial crisis finally provided an opportunity to apply this Act openly. The law gives the Financial Supervisory Commission (FSC) the authority to order management improvement measures, including the amortization of stocks, suspension of directors, appointment of a trustee, transfer of businesses, and third party acquisitions. The FSC may also suspend a bank's business for a stipulated period and ask the Minister of Finance to cancel the bank's license.

On December 22, 1997, the FSC issued a management improvement order to Seoul Bank and Cheil Bank, two of the five largest banks. Two months later, the FSC issued management improvement orders to twelve banks that did not meet the BIS ratio. After reviewing management normalization plans and performing on-the-spot examination of assets, the FSC announced the liquidation of five banks and their acquisitions. Seven other banks have been restructured through mergers, new investment of foreign capital, and trimmed business operations.

The application of the Act Concerning Structural Improvement of a Financial Industry raised controversy over the legitimacy of some of its provisions. The Act provides that through an agreement between two parties, and with the public notice appearing in newspapers, all assets and debts of an insolvent bank are transferred collectively to the acquiring bank. This provision has been criticized for lacking creditor protection measures that are generally provided under the Civil Code and Commercial Code. Another point of contention involves allowing the transfers to take place without a special resolution at a general meeting of shareholders, which is required by the Commercial Code in the event a company transfers all or a major part of its business. The issue of constitutionality has also been raised regarding the provision that the FSC solely determines the take-over bank. These criticisms, however, have not stood in the way of continuous implementation of the Act. Statistics on the closed or suspended financial institution are shown in <Table II-2>.

NOTES

1. By the end of March 1999, the Korea Asset Management Corporation (KAMCO) had purchased 44.1 trillion won in NPLs from all financial institutions.
2. Moreover, the scope of the workout programs has been expanded to include small and medium sized companies (SMCs). Creditor banks had evaluated the financial status of more than 37,000 SMCs by the end of March 1999.
1. The operating earnings used in this paper are EBITDA (Earnings Before Interest payment and Taxes plus Depreciation and Amortization). This definition implies that those firms with a ratio of less than 1 are at risk of going bankrupt at any time and pose serious credit risks to their creditors.
2. One exception is the IPCR of the top 5 *chaebols* over the period from 1994 to 1995. Such a blip in the IPCRs of the top 5 *chaebols* is largely due to the unprecedented boom in the semiconductor industry.
3. Y.J. Cho and J.K. Kim (1995).
4. It included an immediate moratorium on the payment of all corporate debt to the curb lenders and extensive rescheduling of bank loans. All corporate loans from the curb market were converted to long-term loans, at a maximum interest rate of 16.2 percent, when the prevailing curb-market rate was over 40 percent per annum. About 30 percent of the short-term bank loans to businesses was converted into long-term loans at a reduced interest rate. This conversion was ultimately backed by the central bank, which accepted the special debentures issued by the commercial banks (Y.J. Cho and J.K. Kim 1995).
5. The ceiling was further lowered to 4 percent in 1994, as financial liberalization made progress.
6. J.K. Kim (1999) provides more details on this section.

7. Indeed, the null hypothesis that both *chaebol*-affiliated and independent institutions carry an equal ROA was rejected at a 5 percent significance level.
8. Three insolvency statutes were amended again on Dec. 31, 1999. The amended provisions became effective on April 1, 2000. This paper reflects the new provisions.
9. In re Korea Takoma, 92Kue10, 1992.6.15
10. In re Samik, 98Kue11, 1998.8.28
11. Soogeun Oh, “ A Critical Analysis on the Payment Schedule in the Reorganization Plan”, *Korean Journal of Commercial Law*, vol. 18, no. 2(1999).
12. The acquisition of firms related to the vulture fund such as subsidiaries is banned. (Clause 3 of Article 10 in the enforcement ordinance of the Stock Exchange Act)
13. The obligation of selling off acquired firms within five years of the acquisition is imposed on a vulture fund. A delay is allowed for no longer than one year. (Article 17 of the Industrial Development Act)
14. A vulture fund can conduct restructuring operations for only those “firms to be restructured” specified in article 14 of the Industrial Development Act.
15. The minimum size of the restructuring is 10 percent of the association’s total investment fund.

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COUNTRY REPORT FOR MALAYSIA

by
Philip T.N. Koh

I. A Summary of General Economic Context'

A. *A Review of the Malaysian Economy Before and After the Asian Crisis*

At the outbreak of the Asian financial crisis in mid 1997, the Malaysian economy had been registering high growth for a decade of 8.5% per annum (p.a.). There was full employment, with the unemployment rate at 2.6% (versus 8.8% in 1986) and with continued upward pressure on wage rates (and this in spite of the huge pool of foreign labor). Some sectors of the economy were over-invested with a massive over-supply in properties and infrastructure facilities. This had exposed the economy to the risk of a boom-bust cycle. The inflation rate was around 2.5% p.a. (and under 4% for the ten year period). The external current account deficit had been persistently high throughout the 1990s (above 6% of nominal GNP with a high of 10% in 1995). The service sector was over-regulated and over-protected causing its GDP share to be still below 45%². The economy had become more open with international trade at twice the size of GNP whereas it had been about the size of GNP in the early 1980s. The exchange rate in US dollar (USD) terms had appreciated from the 2.70 Malaysian ringgit (RM) level in the late 1980s to the RM 2.50 level in the mid 1990s.

At the outbreak of the crisis the government was running a fiscal surplus (and the stance of fiscal policy had been prudent from the late 1980s). But the stance of monetary and exchange rate policy in the mid 1990s was in fact unsound (with a near-pegged exchange rate regime and excessive growth in money supply and credit). Growth was generally prioritized over distribution. But over-reliance on privatization to achieve a distributional goal undermined efficiency and increased macroeconomic vulnerabilities.

Excessive risk-taking had also caused the regional financial crisis. Asia, including Malaysia, had taken too much credit risk. There were also huge mismatches between the assets and liabilities of the banks which had led them to assume excessive liquidity risk, interest rate risk or currency risk. This excessive risk-taking was caused partly because the Asians loved to take risk and partly because there were not enough opportunities to hedge risk. Given the love of Asians to take risk the problem should have been addressed by requiring mandatory disclosures to forewarn investors and depositors but the disclosure regime was underdeveloped. To provide adequate opportunities to price and hedge risk, active and liquid markets are necessary but markets were not allowed to develop because of over-regulation and over-protection of the banking industry.³

The initial response to the crisis was to tighten the stance of macro policies to restore market confidence. And judging by the stringent credit control introduced, this led to an overkill. These policies and the contagion plunged the economy into a deep recession. Anti-market pronouncements and an unwillingness to consider a market solution aggravated the crisis. These policies were replaced by a new regime of capital controls in September 1998 and a limited easing in macro policies. Before we end this sub-section by a quick review of how the economy has performed since then, it is useful to look at the state of the economy and the stance of policy at the time of the imposition of the new regime.

The economy was then in deep recession with rising unemployment⁴ and a deterioration in government finances into negative territory⁵. But inflation had peaked (though still in single digit) and was moderating. And there was a rapid build-up in external current account surplus. The interest rate was high but falling (with the 3 month inter-bank rate declining to 9.5%). The Malaysian ringgit was weak, trading between RM 4.00 and RM 4.20 against the USD, but the stock market composite index had slipped below 300. There was a banking crisis with mounting non-performing loans (NPLs) with the optimists projecting it at 15% and the pessimists at 30% by the end of 1999. There was also a corporate crisis with many businessmen (and in particular several prominent Malay businessmen) driven into bankruptcy. But there were more bankrupt controlling shareholders than companies. The economy was still facing a liquidity crisis and was falling into the grip of a credit crunch.⁶

The stance of policy at the imposition of capital controls was mildly reflationary from mid-1998, but the stance of monetary policy was still contractionary. The government was prepared to liberalize and deregulate the economy, but only within limits. It was not prepared to open up the service sector which may have provided for a more efficient utilization of surplus capacity (especially in property and infrastructure sectors).

For 1998 as a whole the Malaysian economy contracted by 6.7%, inflation registered at 5.3%, the unemployment rate climbed marginally to 3.9%, the 3 month inter-bank rate declined to 6.5% and the external current account recorded a surplus of 13.7% in terms of GNP. The stance of fiscal policy was mildly expansionary, with the federal government running a deficit of -1.9% as a percentage of GNP in 1998 compared to the surplus of 2.5% in 1997. The stance of monetary policy was contractionary with the growth rate in broad money (i.e. M3) declining from 18.5% in 1997 to 2.7% in 1998. Credit growth registered an equally steep decline from 26.5% in 1997 to 1.8% in 1998. And the exchange rate was pegged at RM 3.80 to the USD and has remained at that level from September 1998.

With the aggressive buying of NPLs by the asset management company Danaharta and the prompt recapitalization of financial institutions by the bank recapitalization agency Danamodal, the threat of a credit crunch from the lack of bank capital has been significantly reduced in Malaysia. However, the continued slow growth in credit suggests that bankers are still suffering from risk aversion, or loan demand is weak, or the stance of monetary policy is still tight as may have been the case until recently. Corporate restructuring, however, is painfully slow; this is in part due to it being not entirely market-driven.

Many observers had expected the imposition of the new regime of capital control to be accompanied by an aggressive easing in macro policies. If this had happened and had continued for any length of time it could have bankrupted the economy. This has not happened. The out-turn of macro policies have continued to be tight, partly because of the anti-inflation bias of policy makers in the conduct of monetary policy and partly because the government machinery was not geared up to cope with the increased spending that had been envisaged in the 1999 Budget as unfolded in October 1998.

The increased domestic liquidity from the imposition of capital controls as well as weak demand has led to significantly lower interest rates as well as a marked uptake in activity in the stock market and, to an extent, in the property market. The perception that the exchange rate is undervalued and that capital controls are temporary (fostered at least partly by the country's history and the flexible manner in which the controls have been imposed) have not led to any serious flight in capital through such activities as re-invoicing. However, this is not likely to remain so if there is a risk of capital controls becoming more permanent or if re-pegging of the currency or unexpected shocks cause the currency to become over-valued.

B. An Overview of Financial System and Development of Markets

Malaysia boasted the largest debt market and the largest equity market in ASEAN in the mid 1990s. Nonetheless, banks in Malaysia have become even more dominant. The share of domestic debt of the banking system increased from 62% in 1986 to 75% in 1997 whereas that of the debt market decreased from 38% to 25% over the same period.

To gauge the reliance of firms on the debt and equity markets, the only data that is available is on the supply of funds. In terms of net funds raised, the share of the banking system increased from 50% to 58% between 1986 and 1997, the share of the domestic debt market declined from 33% to 11%, the share of the equity market increased from 13% to 14% and the share of external borrowings increased from 3% to 16%.

The over-dependence on banks in Asia has been caused by the over-protection of banks (in particular of locally owned banks) and the over-regulation of capital markets. This has led to the under-development of non-bank financial institutions, capital markets, risk management products, risk intermediaries as well as of trading and market making.

An over-dependence on banks can become catastrophic when the high-risk banking industry operates under a regime of pegged exchange rate and open capital flows or under inconsistent macro-economic policies. Asia's experience during the 1990s provides ample evidence to substantiate this conclusion.

The high-risk nature of banking (versus, for instance, the fund management industry) arises from implicit government guarantee of bank deposits. Consequently its high gearing and massive asset-liability mismatches create an incentive for risky or imprudent banking.

C. Dynamics of the Equity Market

The ratio of market capitalization (of the Malaysian equity market) to money GDP was 2.59 in 1995, 3.23 in 1996 whereas it was only 1.36 in 1997. On the other hand the ratio of total market turnover to market capitalization was 0.59 in 1996 and 1.13 in 1997.⁷

The listing requirements for an IPO include minimum thresholds regarding the number of shareholders and the value and volume of public shares, earnings and balance sheet criteria over a number of years; an assessment of the potential of the firm and industry it belongs to; qualitative criteria regarding corporate governance; and credible documentation of compliance with the above criteria.

From the mid 1990s, a disclosure-based regulatory regime has been gradually replacing a merit-based system in deciding which companies are to be permitted for listing. Merit reviews are judgements made by regulatory bodies on IPOs, not on the quality of the disclosure, but on the merit of the prospective investment. Under a merit system, the regulatory authorities replace investors in the investment decisions. Merit type systems usually also include a strong role for the regulatory institution in setting prices and allocating rights for IPOs. Under the phased implementation of the disclosure-based regime, the pricing of corporate offers in Malaysia was to be fully determined by market forces from the beginning of 1998. As a result of the regional financial crisis, there has been a shift of the target date to 1 January 2001.

The requirements for continued listing are not clearly spelt out in Malaysia. The authorities are now working on the criteria for a company to qualify for continued listing with reference to such considerations as the adequacy of its scale of operations, the satisfaction of its financial condition, the public shareholding spread as well as its corporate governance practices.

Unlike the Anglo-Saxon world, there is concentration in ownership in Malaysia (as elsewhere in Asia). For instance, the three largest shareholders owned some 54% of the shares of the ten largest non-financial private firms and 46% of the shares of the ten largest firms in Malaysia. The average for the Asian countries (i.e. India, Indonesia, Malaysia, Pakistan, Philippines, Sri Lanka and Thailand) was 50% and 46% respectively.

The concentration of shareholding in Malaysia imposes a severe constraint on the market for corporate control. Thus there is little or no role for hostile takeovers to play a disciplinary role on insiders who are not working towards the maximization of shareholder value. However, share price movements exercised through the exit route or a sell-down of shares do provide an avenue for disenchanted or aggrieved shareholders to discipline errant insiders.

D. Credit Market Dynamics

Banking is relationship-based and not transaction-driven. But governance is exercised by large shareholders and not large creditors and banks are prohibited from lending to related parties. Under the current law, creditors have been able to pursue their rights without serious handicaps or bias, but in recent years the courts have become slower in resolving disputes between creditors and debtors.

The prevalent Government view is that economic and corporate hardships have been caused by currency speculators and stock market raiders have enabled the problem borrowers to bargain for more time from their bankers to settle their

loans. The relaxation of rules with respect to recognition of interest income and loan provisioning has encouraged this tendency. There is no evidence that more loans are being pumped in (on an indiscriminate or imprudent basis) to “rescue” financially weak borrowers. However, loan restructuring is being permitted a little more liberally. Under the old rules, even if the borrower services the restructured loan without default, it will continue to be classified as a non-performing loan for a period of 12 months before being reclassified. It appears that now a more liberal approach has been adopted and the period for reclassification has been reduced to 6 months.

There has been a great deal of talk on the need to introduce US-equivalent Chapter 11 provisions in Malaysia. Apparently, such provisions are in a bill that is being reconsidered by the Government.

Under the current law, creditors have a variety of legal protections, including the right to grab assets that serve as collateral for the loans, the right to liquidate the company when it does not pay its debts, the right to vote in the decision to reorganize the company, and the right to remove managers in reorganization.

If Chapter 11 is introduced, it will allow companies unimpeded petition for reorganization, give companies the right of automatic stay of creditors, and let managers keep their jobs in reorganization, thus keeping creditors at bay even after having defaulted, as in the US, which is deemed as one of the most anti-creditor common law countries. Protection of creditor rights is necessary for ensuring a steady flow of external finance in the form of bank and other credit to businesses and households. More complete bankruptcy laws are necessary in countries such as Malaysia where courts may not be as reliable as in the developed countries. Monitoring by large creditors may encourage minority shareholders to invest even in companies with concentrated shareholding.

E. Relationship between Banks, Big Companies and the Government

Foreign-owned banks have a 20% market share. Government-owned or controlled banks, which include the largest bank in the country, a public limited company (PLC), account for 30% of the market share. Many of the leading locally-owned banks are PLCs, but each with a dominant shareholder, either a government institution or a private family interest. All the other local banks are not PLCs and are directly or indirectly controlled by private family interests.

Of the 37 commercial banks, only a few are part of a conglomerate. But prohibition on loans to related parties and its stringent enforcement by the central bank has greatly reduced opportunities for business groups to avail themselves of easy loans through their tie-ups with banks.

The relationship between firms, government and banks cannot be described as cozy as in certain other Asian countries. There was no overt “policy of directed lending” to big firms and to that extent one cannot say that the financial constraints on big firms were weak.

Nonetheless, there were certain discernible weaknesses. The government’s commitment to a high growth policy based on a high ratio of investments to GDP led eventually to the promotion and support of certain mega projects, implicit assumption by lenders that the government would not let these projects fail, and to lending decisions by bankers based on collaterals and implied government support and not just on project cashflows. Such over-investment led to aggregate demand outstripping aggregate supply and to mounting or persistent external deficit. It also led to lower returns and poorer cashflows and to more problem loans.

The government’s active pursuit of privatisation during the 1980s and 1990s enabled Malaysia to emerge as a leader in privatisation within the developing world with some brilliant success stories. Privatisation reduced the role of government and increased reliance on markets. But the apparent use of privatisation to attain certain non-economic goals (e.g. the promotion of bumiputra businessmen) has caused problems. This led to more reliance on negotiated tenders and hence to lower efficiency. The desire to control output prices and to minimize subsidies led, in some cases, to government support of privatisation deals via approvals for special property development projects. This has and can lead to an over-supply of properties. And reliance on management or leveraged-buyouts to attain the government’s distribution goal biased government policy towards supporting the stock market. Hence, it compromised conduct of monetary policy. It also made the stock market as well as the banking industry, with its over-exposure to share financing, vulnerable to the regional financial crisis.

II. Corporate Casualties⁸

The recession hit Malaysia’s corporate sector hard. High interest rates, sluggish demand and poor cashflows caused many companies to default on their loans and seek court protection from creditors. An estimate of RM3.0 billion loans turned non-performing in the first few months of the recession, which was equivalent to about 0.7% of the banking system’s outstanding loans. In Malaysia, loans are classified as non-performing after three months in default. The concern laid in “cross-default” clauses that were found in most loans, which would trigger a default and immediate repayment of all loans with all financial institutions once a loan at any bank is defaulted upon. This essentially

suggests all loans within these companies risk turning non-performing once a single loan repayment is not serviced.

Companies which have defaulted on debts or sought court protection as at 14 July 1998

	No.	Amount defaulted (RMm)	Total bank borrowing (RMm)
Main board	26	2,622.8	14,250.8
Second board	14	331.8	1,389.6
Companies qualified by auditors	3	na	2,313.5
Total	43	2,954.6	17,954.0

The majority of the non-performing loans belonged to companies which were listed on the main board of the stock exchange. The relatively low default rate of second board companies mask the fact that many of these companies' controlling shareholders are highly geared due to the slew of takeover activities over the past two years. Since its peak in March 1996, the second board's market capitalization has dropped by RM60 billion or 81% to RM13.6 billion.

In the worst case scenario, the ratio of non-performing loans to total loans was estimated at 22.6%. At this level, the banking system would have required RM21.1b in recapitalization costs and would deplete as much as 76% of most financial institutions shareholders' funds, excluding that of Maybank, Public Bank and the foreign banks. Furthermore, there was a possibility that NPLs may revisit the 30% range seen in the mid-1980s recession should economic conditions deteriorate further.

A notable feature of the non-performing loans is the concentration of debt in companies belonging to former high-flying corporate personalities. Another interesting observation is the high concentration of bad debts in certain financial institutions. For instance, from the list of non-performing loans as at 14 July

1998, MBf Finance accounted for 20.3% of the defaulted loans, the RHB group 18.2% and the Sime Bank group 14.0%.

A. *Loan Growth*

Credit extended by the banking system as a whole declined by RM7.6 billion (-1.8%) in 1998. This was due mainly to the removal of loans by Danaharta in 1998 which amounted to RM13 billion (not including loans sold by the Malaysian banks' overseas branches, which amounted to RM1.4 billion). Taking into account the removal of loans by Danaharta, the banking system as a whole registered a marginal growth of RM5.5 billion or 1.3% in 1998. Higher loan repayments, which increased by 5.5%, and lower turnover in loan disbursements, which declined by 26.6%, also contributed to the slowdown in growth momentum. Only the commercial banks as a whole managed to show a positive growth of 3.3% (7.1% if loans removed by Danaharta are taken into account), while both finance companies and merchant banks showed negative growth in 1998. If banks that do not have the capacity to lend due to capital adequacy problems are excluded, the loan growth of the remaining commercial banks was even higher at 8% in 1998. The positive credit growth exhibited by the commercial banks and the negative growth by the finance companies were partly due to the absorption of several finance companies by their respective parent banks.

Table 1.1 Banking System : Outstanding Gross Loans

	1997	As at end 1998			
		Excluding loans sold to Danaharta	Annual Change (%)	Including loans sold to Danaharta	Annual Change (%)
	RM million	RM Million		RM million	
Commercial banks	289,756.7	299,257.8	3.3	310,405.2	7.1
Finance companies	108,389.2	92,182.1	-15.0	93,072.1	-14.1
Merchant banks	23,056.6	22,198.3	-3.7	23,200.1	0.6
Banking system	421,202.5	413,638.1	-1.8	426,677.3	1.3

As the regional financial turmoil became prolonged during 1998, banking institutions faced with economic uncertainties became cautious in extending credit. Tight and uneven distribution of liquidity further heightened the problem. Consequently, only RM38.2 billion of new loans were approved during the first three quarters of 1998, an average of RM4.2 billion a month. Several measures were introduced to inject greater liquidity, reduce interest rates and remove barriers to the supply of new financing, including the setting up of Danaharta to buy NPLs and the formation of Danamodal to recapitalize banking institutions.

The more conducive business environment brought about by the reduction in interest rates, greater liquidity, the removal of the twin distraction of rising NPLs and erosion of capital as well as rising consumer confidence, resulted in a significant rise in new loans approved during the fourth quarter of 1998. New loans approved amounted to RM24 billion during the last quarter of 1998, or an average of RM8 billion a month, nearly two-fold increase over the preceding nine months. For 1998 as a whole, manufacturing and end-financing for purchase of residential properties were the largest recipients of new loans approved. Loans for the purchase of residential properties costing RM150,000 and below accounted for more than 60% of the new loans approved to the residential property sector.

B. *Asset Quality*

The asset quality of the banking system was adversely affected during 1998. In an environment where interest rates were high and economic activities had contracted, the ability of borrowers to service their debt was invariably affected. This was evident in the sharp increase in NPLs in the banking system in 1998.

The actual NPLs of the banking system increased by RM34.2 billion or 8.3% of total loans in 1998, whilst on the 3-month classification basis, NPLs grew by RM48.8 billion. On a net basis, the actual NPL ratio of the banking system increased from 4.1% as at end-December 1997 to 9% as at end-December 1998. As at end-December 1998, 57 banking institutions have reverted to the 6-month classification policy of NPL and they account for 54% of total loans of the banking system. Based on the 3-month classification policy, the net NPL ratio of the banking system increased from 4.7% as at end-December 1997 to 13.2% as at end-December 1998. Excluding the NPLs of three banking institutions that were most affected, the net NPL ratio for the industry as a whole was 12.2% as at end-December 1998. For the commercial bank industry, their net NPL ratio remained below 10% as at end-December 1998.

Although NPLs had increased during the year, the rate of increase has in fact moderated during the fourth quarter of 1998. The average monthly increase in NPLs from October to December 1998 slowed to 6.2% (after taking into account loans sold to Danaharta), as compared with the average monthly increase of 11.3% in the first nine months of 1998. In December 1998 alone, the monthly rate of growth in NPLs moderated to 2.7%. Loan loss coverage ratio of the banking system declined slightly with total provisions (interest-in-suspense, specific provisions and general provisions) set aside by the banking system amounting to 55.7% of NPLs. Including the value of collateral, the total loan loss coverage of the banking system amounted to 143.3% of NPLs as at end-December 1998.

In terms of NPLs by sector, as at end-December 1998, loans to the broad property sector accounted for 35.3% of total loans and gross NPLs to the broad property sector accounted for 35.1% of total NPLs as at end-December 1998. A major proportion of NPLs to the broad property sector came from the construction and real estate sectors, which accounted for 61.6% of total broad property sector NPLs (52% as at end-1997). NPLs for the purchase of residential properties remained relatively low at 11%.

The sharp decline in the stock market has also adversely affected the quality of loans extended for the purchase of securities. The NPL ratio for the purchase of securities increase from 6.5% as at end-1997 to 23.2% as at 31 December 1998. However, given the relatively low exposure of the banking system to share financing at 7.9% as at end-1998, the high levels of NPLs for share financing remained manageable.

The increase in NPLs was mainly concentrated in the construction, real estate and commercial sectors and for the purchase of shares which together accounted for RM15.5 billion or 45.2% of the total increase in NPLs in 1998. Recognising the vulnerabilities of these sectors, BNM has prohibited banking institutions from extending bridging financing for the development of properties above RM250,000. Although the limit on loans extended for the purchase of shares was increased from 15% to 20% of total loans in September 1998, this was aimed at providing share financing for genuine long-term investment and not for short-term speculative purposes.

C. *Corporate Winding Ups*

The total number of local companies that were dissolved during 1998 showed an increase when compared to the previous year. During 1998, 5039 local companies and 38 foreign companies were dissolved. Thus, when compared to 1997 the total number of local companies dissolved rose by 137%.

During 1998, the total number of companies which began the process of winding up voluntarily was 1039. However, in 1997 it was only 732. Thus there was a percentage increase of 42%. Companies that went into voluntary liquidation were companies which were able to meet their liabilities and did not wish to continue business. These companies were required to obtain clearance from creditors and the Income Tax Department to enable them to complete the process of voluntary liquidation. The total number of companies which completed the process of voluntary liquidation during the year 1998 rose by 14% i.e. from 679 in 1997 to 771 in 1998.

In 1998 the Dissolution Unit issued a guideline entitled “Garis Panduan Mengenai Pembatalan Nama Syarikat Tidak Beroperasi Dibawah Seksyen 308 Akta Syarikat 1965” (Guideline for Striking off the Names of Companies Which Are Not In Operation Under Section 308 of the Companies Act 1965). These guidelines were circulated to professional bodies, secretarial firms and members of the public. Among the conditions for striking off the name of a company as stated in these guidelines is that the company should not be in operation, have no assets and liabilities and is not placed under receivership. These guidelines enable companies to apply for their names to de-registered from the register more easily and effectively without any cost to the company.

The above statistics show that the total number of companies which began dissolution under section 308, whether through the initiative of the Register of Companies (ROC) or applications received from companies, had increased by 9% as compared to 1997. Companies that had completed the process of striking off under section 308 rose by 198% i.e. from 1427 in 1997 to 4249 in 1998.

In accordance with Section 219 of the Companies Act 1965, the process of the winding up of a company compulsorily begins with the presentation of the petition for winding up. During 1998, the total number of companies which were petitioned for winding up rose tremendously by 72% to 1509.

Court orders issued for compulsory winding up also rose by 24% i.e. from 382 during the year 1997 to 474 in 1998. Since the process of compulsory winding up takes a longer period and is more tedious, it is not surprising that the number of companies wound up dissolved was only 19 for the year 1998.

III. Restructuring the Banking Sector⁹

A. Background

To ensure that the Malaysian banking system was well-placed to meet the challenges arising from the changing environment, Bank Negara Malaysia (BNM) initiated policies directed at:

- creating a core of domestic banking institutions which are well managed and highly capitalized;
- broadening and deepening the financial markets as well as strengthening the financial infrastructure;
- improving the overall level of efficiency and competitiveness of the sector; and
- accelerating the development of the bond market.

Over this decade, the legislative framework for the supervision of the banking institutions has been further strengthened. The Banking and Financial Institutions Act 1989 (BAFIA), which came into effect in October 1989, provided a framework for an integrated supervision of the Malaysian financial system. In addition, the Government has adopted measures designed to increase the efficiency and soundness of the financial system, including measures to achieve credit growth that is in line with the overall macroeconomic growth, while at the same time reducing excessive exposure of banking institutions to the vulnerable sectors of the economy. Other prudential measures introduced include refining the capital adequacy framework, greater information disclosure and improving the risk management of banking institutions. The supervisory and regulatory framework has also constantly been structured to be consistent with international standards and best practices. Compliance with the Basle Committee's "Core Principles for Effective Banking Supervision" was already at an advanced stage before the onset of the crisis.

With the measures in place to achieve the long-term objectives, the banking system was in a position of strength at the onset of the financial crisis. The regional crisis, however, exerted pressures on the currency and stock markets, causing the ringgit to depreciate and the Kuala Lumpur Composite Index to drop by about 35.1% and 44.8% respectively in the second half of 1997. As the financial crisis persisted, the effects on the economy and the financial system began to be felt. While policies had already been put in place to strengthen

economic fundamentals as well as to stabilize the financial system, it was recognized that pre-emptive action was necessary to deal with the vulnerabilities of the banking sector. While some banking institutions were facing difficulties, the banking system as a whole remained sound.

Structural weaknesses in the financial system also became more evident. Strong loan growth between 1994-1997, which averaged about 25% per annum, had led to the high loan exposure of the banking system. In addition, the underdeveloped bond market has also resulted in the banking sector providing a significant portion of the private sector financing, thereby increasing the concentration of risk in the banking sector.

In this environment of prolonged volatility in the financial markets, the finance companies became vulnerable given the highly fragmented nature of the industry (39 companies) and the nature of their business, which focused mainly on hire-purchase financing and consumption credit, which was adversely affected by the rising interest rates and slowdown in the economy.

The prolonged financial crisis and subsequent contraction of the economy led to some deterioration in the quality of the asset portfolio of the banking institutions, with the net NPL to total loans ratio increasing to 8.9% as at end-June 1998. Banking institutions became increasingly preoccupied with managing their existing asset portfolio, self-imposing a credit squeeze mentality in their lending activities. The reluctance of the banking institutions to lend combined with higher interest rates caused severe difficulties for individuals and businesses, including viable businesses to obtain financing. At the same time, the rising level of NPLs also eroded the capital base of a number of banking institutions. While the risk-weighted capital ratio (RWCR) for the banking system as a whole remained well above the minimum of 8%, a number of banking institutions required recapitalization.

In order to restore confidence in the financial markets and the banking sector, the Government implemented a series of measures designed to promote economic recovery, including reducing interest rates, injecting greater liquidity into the banking sector and formulating a comprehensive plan to restructure the banking sector.

B. Banking Sector Restructuring

The Malaysian Government adopted a four-pronged approach to strengthen the resilience of the banking sector through a merger programme; the setting up of an asset management company, Pengurusan Danaharta Nasional Berhad

(Danaharta); a special purpose vehicle, Danamodal Nasional Berhad (Danamodal); and the Corporate Debt Restructuring Committee (CDRC).

As the crisis had exposed the vulnerability of the finance companies, a merger programme for the finance companies was announced in January 1998 to consolidate and rationalise the industry. This programme was intended to create a core of domestic banking institutions to meet the challenges of increased liberalisation and increase the resilience of the finance companies to withstand risks arising from the economic slowdown. On completion of the exercise in 1999, the number of finance companies would be reduced by more than half from the original 39.

In view of the NPL problem in the banking sector, the Government established Danaharta, an asset management company, to purchase NPLs from banking institutions and manage these NPLs in order to maximise their recovery value. Danaharta, which is modelled after the other asset management companies in the world, operated within the broad concepts of rehabilitation, restructuring and maximising recovery value of the assets.

While Danaharta would not purchase the entire NPL portfolio from the banking system, it would ensure that the residual NPLs in the banking sector remain at manageable levels at all times. To ensure that banking institutions utilise Danaharta to remove their NPLs, banking institutions with gross NPL ration exceeding 10% are required to sell all their eligible NPLs to Danaharta, otherwise they would have to write down the value of these loans and restructure them. Banking institutions that required recapitalisation from Danamodal are also required to sell their eligible NPLs to Danaharta. The acquisition of NPLs by Danaharta would enable Danaharta to rehabilitate these loans in the most effective and efficient manner.

Danaharta would also assist the restructuring of the corporate sector. Once banking institutions have sold their NPLs to Danaharta, Danaharta would then be able to impose conditions on the borrowers which may include, amongst others, the reconstruction or rehabilitation of the underlying assets and identified cash flows. Danaharta also has the powers to appoint Special Administrators into viable companies that faced temporary cash flow problems. With the assistance from Danaharta and Danamodal, both the banking institutions and corporate sector could then be restructured.

Once the banking institutions are relieved of the burden to manage their NPL portfolios, they would be in a better position to resume their lending activities. However, the sale of NPLs to Danaharta would usually result in banking institutions incurring losses as Danaharta would purchase the NPLs at fair market value. Hence, recapitalization of certain of these banking institutions

became necessary to enable banking institutions to undertake additional businesses and risks and to encourage these banking institutions to resume their lending activities. The recapitalization, under normal times, would usually be achieved through the effort of the banking institution's own shareholders. Given the current economic environment, the ability of shareholders of banking institutions to raise capital on their own was not expected to be very forthcoming. Hence, to facilitate the recapitalization exercise of banking institutions, a special purpose vehicle, Danamodal, was established to address the constraints faced by the shareholders to recapitalize the banking institutions to healthy levels.

Danamodal would only inject capital into viable banking institutions on commercially viable terms and market principles. Due diligence reviews would be conducted by international investment bankers to determine the viability of the banking institutions and recapitalization requirements. In all its capital injection exercises, Danamodal would adhere strictly to the "first-loss" principle where the existing shareholders would be required to bear all losses before the recapitalization by Danamodal. The "undercapitalised" banking institutions would also have to sell all their eligible NPLs to Danaharta and comply with a comprehensive set of performance indicators.

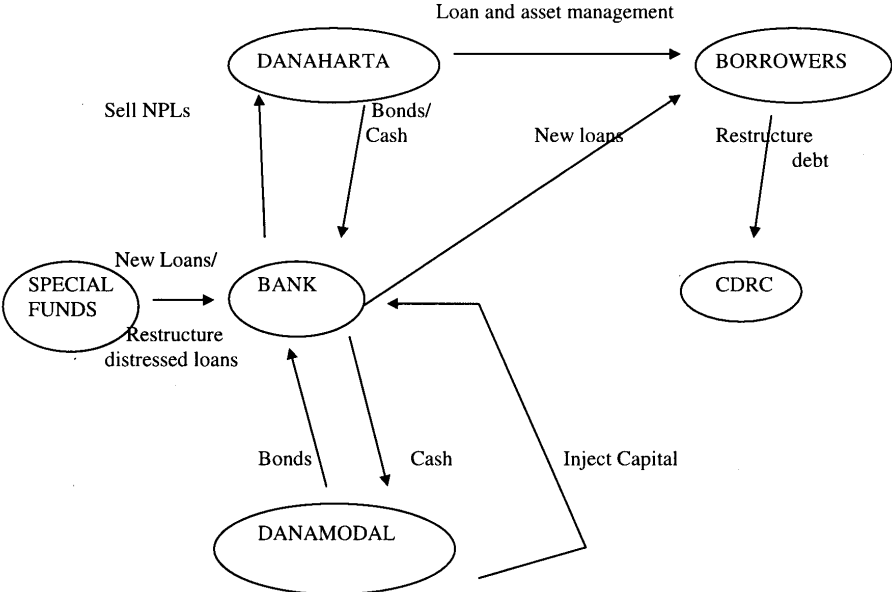
As a strategic shareholder in these recapitalized banking institutions, Danamodal would then be able to institute micro reforms through its nominees appointed on the respective Boards of these banking institutions. Such reforms would include, amongst others, sound risk management practices and credit culture, good corporate governance and higher operational efficiencies. Danamodal, in its role as a strategic shareholder, may also facilitate mergers in line with BNM's objective to consolidate and rationalise the banking sector.

To facilitate the restructuring of corporate debt, a Corporate Debt Restructuring Committee (CDRC) was set up to provide a platform for both the borrowers and the creditors to work out feasible debt restructuring schemes without having to resort to legal proceedings. An increasing number of borrowers in financial difficulties had initially sought legal protection under Section 176 the Companies Act 1965 rather than negotiate for loan restructuring. With the creation of CDRC, borrowers would be able to direct their debt restructuring to CDRC. Under the CDRC debt restructuring framework, creditor committees comprising banking institutions would be formed to work out the debt restructuring. These restructuring efforts would be conducted based on market-driven principles to ensure that there would be a win-win situation for both the borrowers and the creditor banking institutions. The restructuring of the corporate sector debts would expedite the recovery of the corporate sector which would in turn strengthen the health of the banking institutions. If the process under CDRC could not obtain consensus among the banking institution,

Danaharta would assist by buying over these NPLs from the dissenting banking institutions, thereby facilitating the restructuring process.

Danaharta, Danamodal and CDRC are interdependent and complementary, representing a comprehensive and coherent plan towards strengthening the banking sector. The complementary nature of these measures is illustrated in the chart below.

Overview of Danaharta, Danamodal & CDRC



Given that the measures were interdependent, it was critical that the functions of Danaharta, Danamodal and CDRC were co-ordinated to ensure that these institutions operated in cohesive and structured manner to achieve the desired objectives. In this regard, a Steering Committee, chaired by the Governor of Bank Negara Malaysia, was established to oversee and monitor the policies, operations and progress of Danaharta, Danamodal and CDRC. The Committee, which meets fortnightly, ensures that the operations of these institutions are well co-ordinated and complement each other, and monitors progress. In addition, mechanisms are also in place to ensure that the activities of Danaharta, Danamodal and CDRC are appropriately sequenced.

In addition to Danaharta, Danamodal and CDRC, the Government has also established several special funds to provide funds at reasonable cost to promote

investment in the priority sectors. These special funds include the Fund for Small and Medium Industries (RM1.5 billion), the Special Scheme for Low and Medium Cost Houses (RM2 billion) and Rehabilitation Fund for Small and Medium Industries (RM750 million). The Rehabilitation Fund for Small and Medium Industries was established to provide financial assistance to viable small - and medium-sized industries that are facing NPLs and temporary cash flow problems.

C. *The Malaysian Asset Management Corporation: Pengurusan Danaharta Nasional Berhad*¹⁰

Pengurusan Danaharta Nasional Berhad (Danaharta) was established on 20 June 1998 to NPLs from financial institutions to enable them to resume their lending activities to viable economic sectors in order to accelerate the overall economic recovery process. Danaharta was incorporated under the Companies Act 1965 but was given statutory backing to enable it to perform its duties expeditiously. This provides Danaharta with greater flexibility regarding its financing and commercial operations, whilst having special powers to perform its function effectively.

To enable Danaharta to perform its duties in an efficient and economical manner, the Pengurusan Danaharta Nasional Berhad Act 1998 was gazetted and came into force on 1 September 1998. This Act encompasses two main principles:

1. Ability to acquire loans via statutory vesting, whereby Danaharta is allowed to take clear titles to the loans and step into the shoes of the selling institution. Assets can also be transferred without the borrower's consent.
2. Ability to manage the borrowers through the appointment of Special Administrators (SAs) with the consent of the Oversight Committee. Danaharta also has the powers to impose a 12-month moratorium on all claims to allow the SAs to work out their restructuring proposals.

Danaharta adopts a market-based approach and incorporates international best practices in its operations. To maintain transparency, Danaharta publishes details of its acquisitions in its accounts, including amount of NPLs acquired from individual financial institutions and average accounts applied, on a half-yearly basis.

Danaharta is governed by a Board of Directors, which consists of a Chairman, the Managing Director of Danaharta, two non-executive directors from the

Malaysian Government, three non-executive directors from the Malaysian community and two non-executive directors from the international community.

Danaharta's acquisition process is divided into three stages - secured loans, unsecured loans and other credit facilities such as foreign currency loans and off-balance sheet facilities. Danaharta accords priority to weaker financial institutions, including those institutions seeking recapitalization from Danamodal Nasional Berhad before proceeding to acquired non-performing loans from other financial institutions.

Danaharta also manages, on behalf on Bank Negara Malaysia and the Malaysian Government, loans of selected financial institutions. The management of these loans is to facilitate strategic mergers between identified financial institutions and to preserve the strength of the acquiring institution. For loans which are secured by properties, Danaharta appoints independent professional appraisers to perform detailed valuation of individual properties. For loans which are secured by quoted shares, the fair value of the loans is determined based on the characteristics of the company whereby premiums are attached to larger stakes that offer influence or control over the company. In the case of loans secured by unquoted shares, acceptable valuation techniques are used. A uniform discount of 90% to the principal outstanding is applied in general to unsecured loans.

Danaharta's profit sharing arrangement stipulates that any excess in recovery value over and above Danaharta's acquisition cost plus direct costs will be shared between the selling financial institution and Danaharta on a 80:20 basis. However, the financial institution's share of the upside will be limited to the shortfall value plus a holding cost of 8% per annum. For larger loans where valuation is either onerous or inconclusive, a risk-sharing arrangement with the selling financial institution is done on a case-by-case basis.

As consideration for the loans acquired from financial institutions, Danaharta pays cash and/or issues zero-coupon, Government-guaranteed, tradable bonds with yields approximating those of Malaysian Government Securities with similar tenor. These bonds are issued on a monthly basis with a initial tenor of five years and a rollover option exercisable at Danaharta's discretion for up to an additional five years. For loans acquired from development finance institutions, Islamic loans and unsecured loans, cash payments are made.

The financing requirement of Danaharta is estimated to be RM15 billion. The paid-up capital of Danaharta is currently RM1.5 billion.

Danaharta's asset management approach is divided into two categories, loan management and asset management. The management approach taken by Danaharta will depend on the viability of the loans. For viable loans, Danaharta

will undertake the loan management approach whereby Danaharta will rehabilitate or restructure the loans including rescheduling the payments and debt-equity conversion. For non-viable loans, Danaharta will undertake the asset management approach whereby Danaharta will manage the borrower through the appointment of SA or manage the collateral either through the rehabilitation of the collateral or foreclosure if all other options have been exhausted.

Danaharta's estimated life span is 7-10 years. Danaharta expected to complete all its acquisition of loans by June 1999, which is 6 months ahead of the original schedule of end-1999.

D. Danamodal Nasional Berhad

Danamodal Nasional Berhad (Danamodal) was incorporated on 10 August 1998 as a wholly-owned subsidiary of Bank Negara Malaysia to undertake the recapitalization exercise of the banking institutions so as to ensure that banking institutions continue to be well-capitalized at all times.

The objectives of Danaharta are:

- Recapitalization and strengthening of the banking industry - Danamodal serves as an interim funding vehicle for banking institutions to meet their capital adequacy requirements. The capital injections are in the form of equity or hybrid instruments. Danamodal operates on market-based principles and methodologies; and
- Consolidation and rationalization of the banking system.

Danamodal also plays an important role in facilitating the restructuring of banking institutions. Danamodal operates within the existing regulatory and supervisory framework and consistent with national objectives. As a strategic shareholder in the recapitalized banking institutions, Danamodal is in a position to facilitate the consolidation and rationalization process and to act as a catalyst to guide mergers.

Danamodal operates within the following parameters:

- Operates within the existing relevant regulatory and supervisory framework.

- Minimizes the use of public funds and ensures equitable burden sharing amongst stakeholders. The first loss principle is applied in all its capital injection through the writing down of the value of investments of the existing shareholders to reflect its net tangible assets prior to any capital injection. Danamodal will only inject capital into banking institutions after these institutions have sold their NPLs to Danaharta whereby the existing shareholders would have to bear the losses from the sale.
- Operates based on commercial and market-oriented principles. Danamodal will only recapitalize viable banking institutions (based on the assessment and due diligence review conducted by reputable, international financial advisers).
- As a strategic shareholder, Danamodal exercises its rights to inject best practices, promote managerial competence, enhance risk management and operating efficiency and improve the banking institutions' profitability.
- Danamodal formulates a set of comprehensive performance targets and monitors the performance of these institutions closely.

Danamodal will rely extensively on three principal instruments, namely common shares, Irredeemable Non-Cumulative Convertible Preference Shares (INCPS) or subordinated loans. The choice or combination thereof will depend primarily on the cash flow characteristics of the instruments and the unique circumstances of the banking institutions concerned.

In cases where the capital injection is made in the form of common shares, Danamodal will protect its investment from potential downside risks through the use of a call option. In the event that losses arising from the current asset portfolio reduces the net tangible asset per share significantly, the existing shareholders will compensate Danamodal by transferring their shares to Danamodal at nominal value.

Danamodal will appoint at least two nominees to sit on the Board of Directors of the recapitalized banking institutions as Executive Director and as either Deputy Chairman or Chairman. The Board representations will commensurate with the injection of tier-1 capital by Danamodal.

Total funding requirement of Danamodal under the worst case scenario has been estimated to be RM16 billion. This amount will ensure that the risk-weighted capital ratio of all banking institutions to be at least 9%. These funds

will be raised in the form of equity, hybrid instruments, or debt in both the domestic and international markets.

Danamodal strives to maintain transparency and disclosure in management, operations and selection criteria. Danamodal also publishes its own financial statements in accordance with international accounting standards.

E. Corporate Debt Restructuring Committee

The Corporate Debt Restructuring Committee (CDRC) was set up in July 1998 to provide a platform for borrowers and creditors to amicably and collectively work out debt problems. The CDRC process helps to ensure that viable businesses continue to have access to financing.

The objectives of CDRC are as follows:

- To minimise losses to creditors, shareholders and other stakeholders through voluntary co-ordinated workouts;
- Preserve viable businesses that are affected by the current economic conditions; and
- To introduce and implement a comprehensive framework for debt restructuring.

The debt restructuring approach and framework adopted by CDRC are as follows:

- CDRC seeks to assist in the restructuring of debts of viable companies with total aggregate debts of at least RM50 million from more than one financial institution.
- The companies should not be in any insolvency administration.
- CDRC does not have any legal powers and provides a flexible and informal framework outside court proceedings.
- As all legal rights of the parties coming to CDRC are preserved, it is critical that all parties must voluntarily agree to abide by the established guidelines.

- Companies which have already sought the protection pursuant to Section 176(10) of the Companies Act, 1965 may apply on the condition that the Restraining Orders obtained against the Financial Institutions be withdrawn once the creditors agree to a standstill.
- The CDRC framework calls for the financial institutions to voluntarily give the debtors a reasonable period of time in order for consultants to determine the company's financial health and needs before further decisions are made.
- During the standstill period, the financial institutions should keep credit lines in place and not initiate insolvency procedures unless either the debtor or the creditor formally terminates the restructuring exercise.
- Consultants are appointed where necessary to review the affairs of the debtor and make the necessary recommendations to the creditors and the debtors.

A steering committee comprising representatives from Bank Negara Malaysia, the Ministry of Finance and the private sector with experience in the legal, accounting and banking fields has been set up to monitor the progress of the various debt workouts performed by the creditors' committee.

The roles and functions of the creditors' committee are as follows:

- A creditors' committee comprising representatives of creditors will be formed. The creditors' committee should be of a manageable size and represent the interests of at least 75% of the total debts of all creditors. The quorum to convene the meeting shall be 2/3 of the members.
- A lead institution and a designated individual within the lead institution, must be appointed early in the restructuring process to manage and co-ordinate the entire debt restructuring process of a particular debtor. The lead institution may seek the assistance of a consultant with the consent of the debtor and the creditors.
- Agree and assess the viability of the debtor.
- Decide on the terms for the debtor to continue to receive financial support.

- Negotiate with the debtor to arrive at some agreed options once the business is deemed viable.
- Report to the steering committee on the progress of all the debt restructuring exercises on a regular basis, including cases where the creditors' committees encounter inter-creditor or debtor-creditor disputes so that the steering committee can assist in the process.

The rights of creditors under the CDRC are:

- Creditors' existing collateral rights must continue.
- Additional or new credit extended during the restructuring process to enable the debtor to continue operations should receive priority status, subject to the consent of all participating creditors.
- Creditors retain the right to exercise independent commercial judgement and objectives but should consider the impact of any action on the other creditors and the viability of the debtor.
- Debt trading is allowed under certain conditions but the selling creditor has the professional obligation to ensure the buyer does not have a detrimental effect on the restructuring process.

The five stages in a CDRC workout process are as follows:

- Initial meetings of debtors and creditors to consider debt restructuring exercise and to obtain temporary standstill. Creditor's Committee is formed and a lead creditor is identified.
- Consultants are appointed, where necessary.
- Consultants to conduct initial review and report on findings on the viability of the business and their recommendations therein.
- If restructuring exercise proceeds, a formal standstill is to be executed amongst the creditors, and consultants are formulate strategies for restructuring.
- Implementation of strategies.

The CDRC framework is not new. It has been successfully implemented in various other countries, most notably in the United Kingdom. Although the framework gives an indicative time frame of completion for each of the stages, the time frame could be varied depending on the circumstances of the debtor, to be mutually agreed by the parties involved.

F. Progress of Restructuring Plan¹¹

i) Danaharta

Danaharta has purchased and managed NPLs amounting RM21.7 billion from the financial system, of which RM15.1 billion was from the banking system. These NPLs accounted for 20% of NPLs of the banking system as at end of December 1998. With the removal of NPLs from the banking system, the net NPL ratio of the banking system based on the 6-month classification declined from 8.1% as at end-September 1998, 7.6% as at end-December 1998.

ii) Danamodal

Danamodal has injected capital into 10 banking institutions in the form of Exchangeable Subordinated Capital Loans (ESCL) amounting to RM6.15 billion. This increased the RWCR of the banking system from 11.2% as at end-June 1998 to 11.9% as at end-January 1999, hence, increasing the capacity of banking institutions to generate new lending.

Danamodal has also signed Definitive Agreements with seven banking institutions to convert the ESCL into permanent Tier-1 and/or Tier-2 capital. To strengthen the management of these banking institutions, Danamodal has appointed Chairmen, Deputy Chairmen and Executive Directors into the respective Boards of recapitalized banking institutions. Banking institutions which received capital injection from Danamodal are RHB –Sime (RM 1.5 billion) Arab – Malaysian Bank (RM 800 million) followed by Oriental Bank (RM 700 million).

Shareholders of banking institutions which are recapitalized by Danamodal will have to pay 12 per cent interest per annum plus the principal sum that was injected to regain ownership. This is a laudable requirement as it shows that taxpayer monies are not cheap.

Danamodal has injected some RM 6.209 billion into ten banking institutions. Danamodal raised RM 11 billion (RM 3 billion through BNM 's seed capital and RM 8 billion from issue of Bonds.

iii) CDRC

CDRC has received 48 applications for debt restructuring, involving debt of RM22.7 billion. Two restructuring plans have been implemented thus far and 26 creditor committees have been formed to oversee the restructuring efforts. The progress on bank restructuring had been on track. Danaharta had acquired and managed NPLs from the banking institutions amounting to RM15.1 billion, equivalent to about 20% of total NPLs of the banking system. Including NPLs acquired from other financial institutions, the total NPLs acquired and managed amounted to RM21.7 billion. Danamodal had injected RM6.15 billion in the form of Exchange Subordinated Capital loans into ten institutions. CDRC had received 48 applications for assistance with debt restructuring. Total debt of the companies amounted to RM22.7 billion. A total of 26 creditor committees have already been formed and two debt restructuring schemes have been implemented. CDRC had also recently announced the debt restructuring proposal for one of the largest conglomerate, involving RM8.4 billion, without any need for direct Government financial assistance.

iv) Mergers

Eight finance companies have been absorbed/merged, whilst another 14 finance companies will be absorbed/merged this year. Five small finance companies have been allowed to operate on a stand-alone basis for the time being. Nevertheless, the plan to rationalize these small finance companies remains part of BNM's agenda to further strengthen the finance company industry.

The recent dramatic move to consolidate the banking sector to six anchor banks was announced by the governor of Bank Negara Malaysia on 29 July 1999. By the end of 30 September 1999 all the financial institutions has indicated that they have signed Memorandum of Understandings (MOUS). The Government has ambitiously announced that the merger agreements will be signed by early next year and the vesting of merged assets will be completed by March 2000. There has been some disquiet expressed as to the mergers being aggressively facilitated by the Bank Negara. It is certainly not a market driven initiative and criticisms has been expressed (albeit muted) especially by quarters from the non anchor banks and from the Chinese community as the merger exercise will result in the Chinese owned banks being reduced in number.

IV. Bankruptcy Proceedings

A. *Who can be made bankrupt?*

- An individual who was either personally present in Malaysia or had ordinarily resided or had a place of residence in Malaysia; or have been carrying business, either personally or through an agent, in Malaysia.
- An individual who is a member of a firm which carried on business in Malaysia at the time the act of bankruptcy was committed.
- An individual who is a member of a partnership which carried on business in Malaysia at the time the act of bankruptcy was committed.
- A foreigner can be adjudged bankrupt if he/she falls within the above parameters of an individual and is domiciled in Malaysia or has residential or business links in Malaysia.

B. *Who can file the bankruptcy petition?*

The debtor: The debtor himself can file a petition for bankruptcy and adjudge himself bankrupt. The petition filed is known as a debtor's petition.

The creditor: A creditor is any person, corporation and firm of creditors in partnership, who is in a position to issue execution on the judgement or to enforce an order, and is entitled to commence bankruptcy proceedings. The petition filed by a creditor is known as a creditors' petition.

C. *Filing of creditors' petition*

The conditions below must be satisfied before a creditor can present the petition for bankruptcy:

- the aggregate amount of debt owing to the petitioning creditor(s) amounts to 10,000 RM;

- the debt is a liquidated debt sum payable either immediately or at some certain future time;
- an act of bankruptcy had been committed by the debtor within 6 months before the presentation of the petition;
- the debtor is a person as described above in “Who can be made bankrupt?”.

The acts of bankruptcy are stipulated the Bankruptcy Act 1967 (Act 360) (the “Act”). The categories of acts of bankruptcy are:

- failure by a debtor to comply with the requirements of a bankruptcy notice served on him personally or by substituted service;
- where the debtor makes a conveyance or assignment of his property to a trustee for the benefit of his creditors;
- where the debtor makes a fraudulent conveyance or gift or transfer of his property. Fraud here refers to transactions not made in good faith or not for valuable consideration;
- where the debtor makes any conveyance or transfer of property or any part thereof, or creates any charge which would under any written law be void as constituting a fraudulent preference;
- if the debtor, with intention to defeat or delay his creditors, departs or absconds from his known place of residence or country, or absents himself or begins to keep house or closes his place of business;
- if he submits collusively or fraudulently to adverse judgement or order for payment of money;
- if a writ of seizure is levied against the debtor against a judgement for the sum of RM1,000 or more;
- if the debtor himself files in court a declaration of his inability to meet his creditors' claims;
- if the debtor gives notice of his suspension of payment of debts to any of his creditors;

- if the debtor makes to any two or more of his creditors an offer of composition with his creditors or a proposal for a scheme of arrangement of his affairs and such offer or proposal is not followed by registration under these rules within 14 days thereafter of a deed of arrangement with his creditors.

The act of bankruptcy must be committed personally and not through an agent, a representative, a manager or someone having control of the debtor's affairs.

D. Service of creditors' petition

A creditor's petition must be personally served. However, an order for substituted service may be made if the court is satisfied by affidavit or other evidence on oath that prompt personal service cannot be effected because the debtor has been avoiding service of the petition.

E. Filing of debtor's petition

To be able to file a debtor's petition, the debtor must declare that he is unable to pay his debts. The court makes a receiving order upon the presentation of the debtor's petition.

F. Place of filing of petition

If the debtor resides in peninsular Malaysia, the petition may be filed in any High Court in any part of the peninsular. If the debtor resides in Sabah or Sarawak, the petition must be filed in the High Court of Borneo.

G. Proceedings before the order of bankruptcy is made

Filing of a petition does not stay any actions against the property or person of the debtor. However, the petitioner may, after filing the petition, apply to the court for an order to stay any action, execution or other legal process against the property or person of the debtor.

After the petition for bankruptcy is filed, the petitioner may also apply to the court for an order appointing an interim receiver of the debtor's property. If the court appoints an interim receiver, the latter will manage the property of the debtor from the time of appointment until a receiving order is made. On the

other hand, if no appointment is made, the debtor remains free to deal with his property until a receiving order is made by the court.

H. Hearing

When the petition is heard, the court must be satisfied of:

1. the petitioning creditor's debt;
2. the commission of an act of bankruptcy;
3. the proof of service of petition, if the debtor does not appear;
4. the debtor's inability to pay his debts.

Generally, if the debtor adduces evidence of his ability to pay the debts in full within a reasonable time or convinces the court that the interests of the creditors have not been prejudiced, the court will consider the possibility of a stay, adjournment or dismissal of the petition.

I. Receiving and adjudication order

If the debt of the petitioning creditor, the act of bankruptcy and service of the petition is proved, the court will proceed to make a receiving order followed by the adjudication order¹². A receiving order and adjudication order may also be made simultaneously. The Official Assignee will be appointed as receiver of the debtor's estate.

i) Effect of Receiving order against an individual

- • A receiving order does not make the debtor concerned bankrupt.
- The Official Assignee becomes the receiver of the debtor's property.
- No creditor can initiate or maintain any action against the property or person of the debtor without the leave of the court and all pending actions are stayed.
- However, the order does not effect the power of any secured creditor to realize or otherwise deal with his security. However,

the secured creditor will not be entitled to any interest in respect of his debt after the making of a receiving order if he does not realize his security within six months from the date of the receiving order.

- The Official Assignee takes possession of all books of account, papers, all other property and deeds and documents relating to the property and affairs of the debtor.
- Powers of the Official Assignee are limited to those of care taking and safeguarding the debtor's property. The Official Assignee cannot sell or otherwise deal with the property.

The Official Assignee may appoint a Special Manager, if he is satisfied that the nature of the debtor's estate requires such an appointment. The Special Manager's appointment lasts until the first meeting of the all the creditors. The debtor himself may also appoint a Special Manager.

ii) Effect of Receiving order against a partnership or a firm

- A receiving order operates as if it was made against each of the persons who, at the date of the receiving order, is a partner of the firm.
- No adjudication order can be made against a firm but can only be made against an individual partner if he has been served with a writ of summons in the ordinary proceedings upon which judgment was obtained, or with the leave of the court where the process is taken against him individually.
- Bankruptcy proceedings cannot be applied to limited company or corporation which under the Companies Act 1965 is subject to winding-up orders.

iii) Rescission of receiving orders

A receiving order may be rescinded on the following grounds:

1. Where it ought not to have been made at the first instance; or

2. Where the debts are paid in full, and there is a report of the Official Assignee to the effect that there is no further debt existing; or
3. If the majority of the creditors are residing in Singapore; or outside the jurisdiction, whereby the receiving order may not have any effect on the debtor's property, and from the situation of the property and other causes, the distribution may have to be placed elsewhere and not in Malaysia; or
4. On the approval of the proposal of a composition or scheme of arrangement.

J. Proceedings consequent to receiving order

i) Statement of affairs

A statement of affairs of the debtor sets out the particulars of the debtor's assets, debts and liabilities, the names, residences and occupation of his creditors, the securities held by the respective creditors, the dates when the securities were respectively given, the causes of his insolvency, the dates when the debtor last balanced his accounts before becoming insolvent, the amount of his capital at the date of such balance, after providing for all the debtor's liabilities and making allowances for bad and doubtful debts, and such other information as the Official Assignee requires.

If the receiving order is made on the petition of the debtor, the statement of affairs must be submitted to the Official Assignee within 7 days from the date of the order. If the receiving order is made on the petition of the creditor, the statement of affairs must be submitted within 21 days from the date of the order.

If the debtor fails to file in a statement of affairs, his conduct is punishable as being in contempt of court and the court may on the application of the Official Assignee or of any creditor adjudge him bankrupt. Any false representation by the debtor will lead to a criminal charge and is an offence under the Act.

ii) Meeting of creditors

Once the statement of affairs has been received by the Official Assignee, it is the Official Assignee's duty to call a general meeting of creditors which is known as the first creditors' meeting. The purpose of this meeting is to consider whether a proposal for composition or scheme of arrangement shall be entertained, or whether it is expedient that the debtor be adjudged bankrupt, and

generally as to the mode of dealing with the debtor's property. In the case of a debtor's petition, the first creditor's meeting must be summoned for a day not later than two months after the date of the receiving order. With a creditors' petition, the meeting must be summoned for a day not later than three months after the date of the receiving order. The court may however, if it thinks it expedient or for special reasons, order it to be held at a later day. At least seven days notice of the meeting must be given to the creditors by the Official Assignee.

Every creditor, secured and unsecured, stated in the debtor's statement of affairs may attend the first auditors' meeting.

A creditor may not vote in the meeting unless, prior to the meeting, the creditor has lodged proof of his debt. The chairman of the meeting has the power to admit or reject a proof for the purpose of voting, but his decision is subject to appeal to the court. A secured creditor may vote only in respect of the balance due to him after deducting the value of his security. If a secured creditor votes in respect of his whole debt, he is deemed to have surrendered his security.

A creditor cannot vote in the meeting in respect of any unliquidated or contingent debt. A creditor in respect of any debt on or secured by a current bill of exchange or promissory note held by him cannot vote as well unless he is willing to treat the liability of the debtors of the company who were antecedent to his liability, as a security in his hands, and deduct the value thereof from his proof.

A creditor may vote either in person or by proxy.

The meeting cannot act for any purpose except the election of a chairman, the proving of debts and the adjournment of the meeting, unless there are present or represented thereat at least three creditors, or all the creditors if their number does not exceed three.

iii) Public examination of debtor

The debtor will also be subject to a public examination, under oath, as to his conduct, dealings, relationships, past and present actions, capabilities, causes of bankruptcy and also his antecedent transactions. The debtor will be examined by the court and any creditor who has tendered proof of debt. The debtor must answer all questions put to him by the court or which the court allows. When the court is satisfied that the affairs of the debtor have been sufficiently investigated, it will order that the examination be concluded.

K. *Discovery of debtor's property*

The debtor must attend the first meeting of the creditors and submit to such examination and give such information as the meeting requires. The debtor must give an inventory of his property, a list of his debtors and creditors and the details of the debts due to and from them respectively, co-operate with the Official Assignee, execute all necessary documentation, deeds and instruments and generally do all such acts and things in relation as are required by the Official Assignee of any order of the court. He must aid to the utmost of his power in the realization of his property and the distribution of the proceeds among his creditors, and shall if required by the Official Assignee to do so answer all questions and submit to such medical examination and do all such other things as are necessary for the purpose of effecting an insurance on his life.

The different mechanism in place to aid the Official Assignee in discovering the property of the debtor are:

1. a warrant issued by the court to cause the debtor to be arrested and direct that any books, papers, money and goods, in his possession be seized and kept safely as prescribed until such time as the court orders in the following circumstances:
 - (a) if there is, after a bankruptcy notice has been issued or a bankruptcy petition presented, evidence that the bankrupt absconded, is in hiding or is remaining in hiding with a view to avoid or delay proceedings in bankruptcy;
 - (b) if, after the bankruptcy petition has been presented, the debtor is about to remove his goods with a view to concealing his assets or destroying them;
 - (c) if, after service of the petition or receiving order made against him, the debtor removes his goods above the value of RM50 without the leave of the Official Assignee;
 - (d) the debtor, without any good cause, fails to attend any examination ordered by the court;
 - (e) if there is probable reason to believe that the assets are insufficient to pay a dividend of RM50 per centum or if there is probable reason to believe that the debtor has committed any offence punishable under the Bankruptcy Act 1967;
2. the court may summon, upon the application of the Official Assignee or any creditor who has proven his debt after the receiving order has been made, before it any person known or suspected to have in his possession any of the estate or effects belonging to the debtor, or deemed capable of giving information to the court in respect of the

- debtor, his dealings or property, or supposed to be indebted to the debtor; and
3. the court may make any order for the examination upon oath of any person anywhere in Malaysia.

L. Proof of debts

The creditors lodge their claims with the Official Assignee, a process which is known as proof of debt and the Official Assignee himself verifies the claims. Every creditor must prove his debt as soon as may be after the making of a receiving order. Where a creditor has lodged his claim after the date fix as the last day of lodging and his proof is rejected as a result, he may appeal to the court.

Only liquidated debts are provable in bankruptcy. Unliquidated debts are not provable except for those arising by reason of a contract, promise or breach of trust. All liquidated debts and liabilities present or future, certain or contingent¹³, to which the debtor is subject at the date of the receiving order or to which he may become subject before his discharge by reason of any obligation incurred before the date of the receiving order are deemed to be debts provable in bankruptcy.

Non-provable debts comprise the following:

- Unliquidated debts arising otherwise than by reason of a contract, promise or breach of trust.
- A person having notice of any act of bankruptcy available against the debtor cannot prove for any debt or liability contracted by the debtor subsequent to the date of him so having notice.
- Any order by the court that the value of any debt or liability is incapable of being fairly estimated, thereby not being provable.

A creditor proves his debt by delivering to the Official Assignee an affidavit, made by the creditor himself or an authorized officer of the creditor, verifying the debt.

A receiving order does not affect the power of any secured creditor to realize or deal with his security. The secured creditor has three courses of action:

1. He can realize his security; if the proceeds is not enough to satisfy his claim, he may lodge proof of debt for the balance in which event he ranks as an unsecured creditor;

2. He can surrender the security to the Official Assignee for the general benefit of the creditors and become an ordinary creditor;
3. He can refuse to realize his security, in which event, he must state in his petition or proof of debt the particulars and assessed value of the security; he is admitted as a petitioning creditor or entitled to receive a dividend only in respect of the balance due to him after deducting the assessed value.

M. Composition or Scheme of Arrangement

Instead of adjudicating the debtor bankrupt, the debtor¹⁴ or creditors may make a proposal for a composition or scheme of arrangement in satisfaction of the debts due to them under the bankruptcy proceedings. A special resolution of a majority in number, representing at least three-fourths in value of all the creditors who have proved their debt is required to entertain the suggestion of composition or scheme of arrangement. The terms and manner of payment of the composition or scheme must be settled at the first meeting or any adjournment thereof.

The composition or scheme of arrangement is only binding on all creditors if there is a special resolution of a majority in number, representing at least three-fourths in value of all the creditors who have proved their debt and the court approves the composition or scheme. In approving a composition or scheme, the court considers the report of the Official Assignee as to the terms of the composition or scheme, the conduct of the debtor, and any objections which may be made by or on behalf of any creditor.

The composition or scheme will only be approved by the court if the court:

1. is satisfied that provision is made for payment in priority to other debts, of all debts directed to be so paid in the distribution of the property of a bankrupt;
2. is given proof that the requisite majority of the creditors has been obtained;
3. on the report of the Official Assignee, that provision is made for payment of all proper costs, charges and expenses of and incidental to the proceedings and all fees and percentages payable to the Official Assignee;

4. is satisfied that the terms of the composition or scheme are reasonable and are calculated to benefit the general body of creditors.

Upon approval, the composition or scheme of arrangement must be registered. The debtor is deemed to have committed an act of bankruptcy if he fails to do so within 14 days.

Upon approval, the court will rescind the receiving order and annul the order of adjudication, if any, and the debtor or the trustee under the composition or scheme is put into possession of the debtor's property.

The composition or scheme may be annulled by the court if:

1. the composition or scheme is put forward by means of fraud;
2. the composition or scheme cannot, in consequence of legal difficulties or for a sufficient cause, proceed without injustice or undue delay to the creditors or to the debtor;
3. a default is made in payment of any installment due in pursuance of the composition or scheme.

Upon annulment of the composition or scheme, the property of the debtor vests in the Official Assignee and the court may adjudge the debtor bankrupt.

The trustee under the composition or scheme must also pay over, and account to the Official Assignee for any money or property of the debtor which have come into his hands.

As an alternative to annulling the composition or scheme based on the default in payment pursuant thereof, the court may enter final judgement against the debtor for the amount of such payment and the Official Assignee or any creditor may take proceedings under the Act on such final judgement.

N. Adjudication of Bankruptcy

When a receiving order has been made on a creditors' petition, any creditor or the Official Assignee may apply to adjudge the debtor a bankrupt. Amongst the grounds for obtaining an adjudicating order are:

1. a composition or scheme of arrangement cannot be agreed upon;

2. there had been a composition or scheme of arrangement and a default is made in the payment of any installment under the composition or scheme of arrangement;
3. a resolution to adjudge the debtor bankrupt was passed at the first meeting of the creditors;
4. debtor has in writing consented to be made bankrupt.

An adjudication order against a firm is made against the partners individually.

O. Getting possession of the property

The Official Assignee is entitled to take possession of the deeds, books, and documents of the bankrupt and all other parts of his property capable of manual delivery. Where any part of the property of the bankrupt consists of stock, shares in ships, shares or any other property transferable in the books of any company, office or person, the Official Assignee may exercise the right to transfer the property to the same extent as the bankrupt might have exercised if he had not become bankrupt. Any things in action is deemed to have been assigned to the Official Assignee. A search warrant may be granted by the court if the court is satisfied that there is reason to believe that property of the bankrupt is concealed in a house or place not belonging to him.

The powers of the Official Assignee, subject to the Act, to deal with the property include:

1. to sell all or any part of the property of the bankrupt, by public auction or private contract;
2. to give receipts for any money received by him, which receipts shall effectively discharge the person paying the money from all responsibility in respect of the application thereof;
3. to prove, rank, claim, and draw a dividend in respect of any debt due to the bankrupt;
4. to exercise any powers vested in the Official Assignee under the Act and execute any powers of attorney, deeds and other instruments for the purpose of carrying into effect the provisions of this Act.

Additionally, the Official Assignee, subject to any order of the court, may:

1. carry on the business of the bankrupt so far as is necessary for the beneficial winding up of the same;

2. bring institute or defend any action or other legal proceeding relating to the property of the bankrupt;
3. employ, with the permission in writing of the Attorney General, a solicitor to take any proceedings or do any business;
4. accept, as the consideration for the sale of any property of the bankrupt, a sum of money payable at a future time, subject to such stipulations as to security and otherwise as he thinks fit;
5. mortgage, charge or pledge any part of the property of the bankrupt for the purpose of raising money for the payment of his debts;
6. refer any dispute to arbitration, compromise all debts, claims and liabilities, whether present or future, certain or contingent, liquidated or unliquidated, subsisting or supposed to subsist, between the bankrupt and any person who may have incurred any liability to the bankrupt on the receipt of such sums payable at such times, and generally on such terms as are agreed on;
7. make such compromise or other arrangement as is thought expedient with creditors or persons claiming to be creditors in respect of any debts provable under the bankruptcy;
8. divide in its existing form, amongst the creditors according to its estimated value, any property which from its peculiar nature or other special circumstances cannot be readily or advantageously sold.

P. Avoidance and Executory Contracts

The Bankruptcy Act 1967 provides for the avoidance of certain transactions antecedent to the date of bankruptcy as against the Official Assignee. They are as follows:

1. Any voluntary settlement of property by the settler who then becomes a bankrupt within two years of the date of settlement is deemed absolutely null and void against the Official Assignee unless it falls within the exceptions¹⁵;
2. Any voluntary settlement of property by the settler who then becomes a bankrupt within five years of the date of settlement is null and void against the Official Assignee unless the parties claiming under the settlement can prove that the settler was at the time of making the settlement able to pay all his debts without the aid of the property comprised in the settlement and that the interest of the settler in such property had passed to the trustee of such settlement on the execution thereof;
3. Every conveyance, transfer, charge or payment made by the bankrupt, and every judicial proceeding taken by the insolvent and every obligation incurred, having been served with a bankruptcy petition within six months from the date of transaction, to a creditor in preference over other creditors shall be deemed fraudulent and void against the Official Assignee¹⁶;

4. Assignment¹⁷ of existing or future book debts by a bankrupt who is engaged in any trade or business, is void against the Official Assignee in respect of the book debts that had not been paid at the date of the act of bankruptcy¹⁸;
5. All transactions¹⁹ occurring 12 months prior to the act of bankruptcy may be reviewed by the court as to whether the consideration given or received by the bankrupt is of fair market value. Where the court finds that the consideration given or received by the bankrupt in the transaction was conspicuously in excess of or conspicuously lower than the fair market value of the property or services at the time of transaction, the court may give judgement in favor of the Official Assignee against the other party to the transaction or against any other person who was privy to the transaction with the bankrupt or against any other such persons. The judgement if the difference between the value of the consideration given or received by the bankrupt and the fair value of the market value of the property or services at the time of the transaction.

In addition to the aforesaid, the Official Assignee has the power to disclaim any part of the property of the debtor which consists of land of any tenure burdened with onerous covenants, of shares or stock in companies, of unprofitable contracts or of any other property that is unsaleable or not readily saleable by reason of any onerous act or to the payment of any sum of money. Any person entitled to the benefit or subject to the burden of a contract made with the bankrupt disclaimed may apply to the court for an order rescinding the contract on such terms as to payment or damages for the non-performance of the contract.

The Official Assignee may not disclaim a lease without the leave of the court except in any cases which may be prescribed or where all persons interested in the property consent to such disclaimer.

The effect of disclaimer is that it determines the rights, interests and liabilities of the property concerned, which may pertain to the Official Assignee. The rights of the bankrupt's family are also extinguished by the disclaimer, although they may have equitable interest. The Official Assignee is discharged from all personal liability in respect of the property disclaimed as from the date the property is vested in him.

The disclaimer will generally not affect a third party except as may be necessary to release the bankrupt, his property and the Official Assignee from liability. Any person injured by the disclaimer is deemed a creditor of the bankrupt to the extent of injury and may accordingly sue for damages for that injury, as a debt in bankruptcy.

R. *Distribution of Property*

After the proving of debts by the creditors, the Official Assignee is to declare and distribute dividends amongst them. Dividends are to be divided in accordance with the following rules:

- The first dividend, if any, shall be declared and distributed within 12 months after the adjudication unless the Official Assignee, for reasons to be given to creditors, decides to postpone the declaration to a later date;
- Subsequent dividends shall, in the absence of sufficient reason to the contrary, be declared and distributed at intervals of not more than 12 months;
- Before declaring a dividend, the Official Assignee shall cause notice of his intention to do so to be gazetted and shall also send reasonable notice thereof to each creditor mentioned in the bankrupt's statement who has not proved his debt;
- When the Official Assignee has declared a dividend, he shall send to each creditor who has proved his debt, a notice showing the amount of the dividend, and when and how it is payable;
- When the Official Assignee has realized all the property of the bankrupt, he shall declare a final dividend;
- Allowance may be made to the bankrupt, out of his property, for the support of the bankrupt and his family;
- The bankrupt is entitled to any surplus remaining after payment in full of his creditors.

S. *Priority of Debt*

The following debts are paid out *pari passu* first:

1. all local rates and land tax due from the bankrupt at the date of the receiving order, and having become due and payable within 12 months next before that time;

2. income tax and other assessed taxes assessed on the bankrupt up to the 31st day of December next before the date of the receiving order, and not exceeding in the whole one year's assessment;
3. wages or salary of any clerk, servant, laborer or workman not exceeding RM1000 in respect of services rendered to the bankrupt during the period of five months next before the date of the receiving order or the date of the termination of his service if the latter occurs within twelve months of and precedes the date of the receiving order;
4. all amounts due in respect of contributions payable during the 12 months before the date of the receiving order, by the bankrupt as the employer of any person under any law relating to provident funds;
5. all amounts due in respect of workmen's compensation under any law relating to workmen's compensation accrued before the date of the receiving order.

The remaining debts are paid out *pari passu*.

If there is any surplus after payment of the foregoing debts, it will be applied in payment of interest from the date of the receiving order at the rate of RM6 per centum per annum on all debts proved in the bankruptcy.

T. Discharge of Bankrupt

A bankrupt may at any time after being adjudged bankrupt apply to the court for an order of discharge. Once the court has appointed a day for the hearing of an application for discharge, a notice of the hearing will be inserted in the Gazette by the Registrar of the High Court.

On the hearing of the application for discharge, the court takes into consideration the report of the Official Assignee as to the bankrupt's conduct and affairs, including a report as to the bankrupt's conduct during the proceedings under his bankruptcy. Every creditor who has proved in bankruptcy may be heard by the court.

The granting of a discharge is entirely at the discretion of the court. The court can:

1. refuse the order; or
2. suspend the operation of the order for a specified time; or
3. suspend the operation of the order until a dividend of not less than fifth per centum has been paid to the creditors; or
4. grant an order of discharge subject to such conditions as aforesaid.

Subject to any condition imposed by the court, where a bankrupt is discharged, the discharge will release him from all his debts provable in the bankruptcy but will have no effect on the functions of the Official Assignee and the operation of the Act and will not release the bankrupt from

1. any debt due to the government of Malaysia or of any State; or
2. any debt with which the bankrupt may be chargeable at the suit of:
 - a) the Government of Malaysia or any State or any other person for any offence under any written law relating to any branch of the public revenue; or
 - b) any other public officer on a bail bond entered into for the appearance of any person prosecuted for any such offence; or
3. any provable debt which he incurred in respect of, or forbearance respect of which was secured by means of, any fraud or fraudulent breach of trust to which he was party; or
4. any liability in respect of a fine imposed for an offence.

V. Winding-Up Proceedings

A. *Applicable law*

The primary legislation governing winding-up proceedings are Part X of the Companies Act 1965 and the Companies (Winding-Up) Rules 1972, which contains the applicable court procedures for winding-up proceedings.

B. *What can be wound-up?*

Winding-up proceedings apply only to companies, whether registered or unregistered under the Companies Act, 1965. There are two types of winding-up: 1) voluntary winding-up and 2) compulsory winding up by the courts.

C. *Voluntary winding-up*

A voluntary winding-up may be a member's or creditors voluntary winding-up. Member's voluntary winding-up takes place only where the company is solvent and the creditors will be paid in full. This type of winding-up commences at the time of the passing of the resolution for voluntary winding-up.

Conditions for member's voluntary winding-up:

1. The members resolve by special resolution to wound up the company; and

2. A declaration of solvency that states that the company will be able to meet its debts within a period not exceeding 12 months after the commencement of winding-up is required.

Creditors can voluntary wind-up a company in the following circumstances:

1. When the period, if any, fixed for the duration of the company by the memorandum or articles expires, or the event, if any, occurs, on the occurrence of which the memorandum or articles provide that the company is to be dissolved, and the company in general meeting has passed a resolution requiring the company to be wound up voluntarily; or
2. If the company so resolves by special resolution.

When a company has passed a resolution for voluntary winding-up, any creditor or contributory may apply to have the company wound up by the court but the court must be satisfied that the voluntary winding-up cannot be continued with due regard to the interests of the creditors or contributories.

D. Compulsory winding-up by the court

An application can be made to the court for an order to wind-up a company. The application is done by way of a petition. Every petition for winding-up of a company by the Court must also be verified by an affidavit which is the prima facie evidence of the statements in the petition. On filing, the petition must nominate an approved liquidator²⁰ who is entitled to be appointed as liquidator if an order for the winding-up of the company is made by the Court.

E. Parties who may petition

The company: Directors of a company may petition for its winding-up without reference to the members.

Creditors: Creditors includes contingent or prospective creditor, but not creditors who rely upon a debt on which there is a substantial dispute. The court will not, however, hear a petition presented by a contingent or prospective creditor until he has given such security for costs as the court thinks reasonable, and until he has established to the court's satisfaction a prima facie case for the winding-up.

Contributory: This category includes any person who is the personal representative of a deceased contributory, or the trustee in bankruptcy, or the Official Assignee of the estate of a bankrupt contributory of the company. However, parties who fall within this category will have to satisfy certain criteria before they can rely on certain grounds of petition.

Liquidator: A liquidator appointed in a voluntary winding-up may petition for a winding-up by the court. Liquidator also includes provisional liquidator.

The Minister: The Minister may petition either pursuant to an investigation under Part IX of the Companies Act 1965 or where the number of members in the company, other than a company the whole of the issued shares in which are held by a holding company, is reduced below two.

The Central Bank: The Central Bank may petition for the winding-up of a company which is:

1. a licensed institution; or
2. a scheduled institution in respect of which a ministerial order to regulate has been made under section 24(1) of the Banking and Financial Institutions Act 1989; or
3. a non-scheduled institution in respect of which a ministerial order to investigate and control its business and affairs has been made under section 93(1) of the Banking and Financial Institution Act 1989.

The Registrar of Companies: The Registrar of Companies may petition for the winding-up of a company. However, the petition may be made on two grounds:

1. the company is being used for unlawful purposes or any purpose prejudicial to or incompatible with peace, welfare, security, public order, good order or morality in Malaysia; or
2. the company is being used for any purpose prejudicial to national security or public interest.

F. Grounds of petition

i) Registered Companies

Registered companies comprise companies incorporated under the Companies Act 1965. Some of the circumstances in which the court may order the winding up of a registered company are:

1. the company has by special resolution resolved that it be wound up by the Court;
2. the company is unable to pay its debts. A company is deemed to be unable to pay its debts where:
 - a) a creditor to whom the company is indebted in a sum exceeding RM500 then due, has served on the company a demand under his hand requiring the company to pay the sum so due, and the company has for three weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor;
 - b) execution, or other process, issued on a judgement, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part; or
 - c) it is proved to the satisfaction of the court that the company is unable to pay its debts; in determining whether a company is unable to pay its debts, the court shall take into account the contingent and prospective liabilities of the company;
3. the directors have acted in the affairs of the company in their own interests rather than in the interests of the members as a whole, or in another manner whatsoever which appears to be unfair or unjust to other members; and
4. the Court is of the opinion that it is just and equitable that the company be wound up.

Inability to pay debts

This is the common ground for the presentation of petition to the court to wind up a company. The test is that of commercial solvency, that is, the company is unable to meet its current debts as they fall due. The fact that the company can meet all its liabilities upon liquidation bears no weight if the wealth cannot be realised immediately. The debt, however, must be undisputed in that there must clearly be a debt and the amount owing is not open to argument.

ii) *Unregistered Companies*

Unregistered company includes a foreign company and any partnership association or company consisting of more than five members but does not include a company incorporated under the Companies Act 1965. No unregistered company may be wound up voluntarily. The circumstances in which an unregistered company may be wound up are as follows:

1. if it is dissolved or has ceased to have a place of business in Malaysia, or has a place of business in Malaysia only for the purpose of winding-up its affairs, or has ceased to carry on business in Malaysia;
2. if it is unable to pay its debts;
3. if the court is of the opinion that it is just and equitable that the company should be wound up.

A company incorporated outside Malaysia may be wound up as an unregistered company notwithstanding that it is being wound up, or has been dissolved, or has otherwise ceased to exist as a company under or by virtue of the laws of the place under which it was incorporated.

G. Place of filing of petition

The petition is presented at the office of the Registrar of the High Court and the latter would appoint the time and place at which the petition is to be heard. The petitioner is entitled to file the petition in any branch of the High Court of Malaya irrespective of where the company is situated.

H. Hearing

Only those with locus standi to petition may be heard. Before the hearing, those who intend to attend must serve on the petitioner notice of intention to appear. Anyone who fails to do so may not attend the hearing without special leave of the High Court concerned. Anyone who intends to oppose the petition must file an affidavit in opposition at least seven days before the date appointed for the hearing of the petition.

I. Hearing of the petition

In the preliminary, the petitioner must satisfy the court that:

1. the petition has been duly gazetted and advertised;
2. the prescribed affidavit verifying the statements therein and the affidavit of service, if any, have been duly filed;
3. the consent in writing of the approved liquidator nominated by the petitioner has been obtained and filed;
4. a sum of RM300 has been deposited to cover the fees and expenses to be incurred by the approved liquidator or the Official Receiver as the case may be.

For a petition that is based upon the company's inability to pay its debt, the court will apply the commercial insolvency test to determine the solvency of the company.

Some companies, upon or prior to the presentation of a winding-up petition, seek the protection under s 176 of the Companies Act 1965, which provides the formal mechanism to adopt a scheme of arrangement or compromise. A restraining order pursuant to s 176 may be applied for and granted by way of ex parte applications.

J. Winding-up Order

A winding-up order usually contains the following orders:

1. that the company be wound up by the court;
2. that a certain liquidator be appointed for the purpose of the said winding-up;
3. that a certain bank is the bank in which the liquidator is to open a trust account.

Where the order does not appoint a liquidator, the Official Receiver will be so appointed and thereafter acts as the provisional liquidator and continues to act as such until he or some other person is appointed liquidator, and is capable of acting as such.

The order must also contain a notice stating that it will be the duty of the person who is at that time the secretary or chief officer of the company and as such of the persons are liable to make out or concur in making out the company's statement of affairs as the liquidator may require, to attend on the liquidator forthwith on the service of the order.

Once the order is entered, the only way to stop the winding-up is by way of an application for a stay of proceedings or by an appeal against the order.

K. Effect of the Winding-up Order

Such an order operates in favor of all the creditors and contributories of the company as if made on the joint petition of a creditor and of a contributory. The appointed liquidator will take into his custody or under his control all the property and thing in action to which the company is or appears to be entitled. Upon the appointment of a liquidator, the powers of the directors of the company cease but they retain the power to have the company represented in winding up.

Every invoice, order for goods or business letter issued by or on behalf of the company or a liquidator of the company or a receiver or manager of the property of the company, being a document on or in which the name of the company appears, must have the words “in liquidation” added after the name of the company where it first appears.

All proceedings against the company are automatically stayed upon the making of the winding-up order and none shall proceed without the leave of the Court.

After the presentation of the petition for the compulsory winding up of a company by the court and before the winding up order, a provisional liquidator may be appointed by the Court. Generally, provisional liquidators are appointed to prevent directors or shareholders from dissipating assets or otherwise prejudicing the position of creditors and/or contributories pending the making of the winding up order or the decision upon an appeal against such an order.

The order appointing a provisional liquidator will state the nature and give a short description of the property of which the provisional liquidator is ordered to take possession and the duties to be performed by him. A provisional liquidator may exercise all the functions and powers of a liquidator subject to such limitations as the rules or the court may prescribe.

L. Proceedings after the Winding-up Order

i) Statement of affairs

One or more of the directors of the company and the secretary or any such person directed by the Court must complete a statement as to the affairs of the company as at the date of the winding up order showing:

1. the particulars of its assets debts and liabilities;
2. the names and addresses of its creditors;
3. the securities held by them respectively;
4. the dates when the securities were respectively given; and
5. such further information as is prescribed or as the Official Receiver or the liquidator requires.

The statement of affairs must be filed within 14 days after the date of the winding-up order. Any request for extension must be made with the Official Receiver or liquidator or the Court.

The liquidator may hold personal interviews with every such relevant person as is necessary for the purpose of investigating the company's affairs.

The liquidator must send a summary of the statement of affairs as soon as practicable to each creditor mentioned in the company's statement.

After receiving the statement of affairs, the liquidator must, as soon as practicable, submit a preliminary report to the court:

1. showing the amount of capital issued, subscribed or paid up, and the estimated amount of assets and liabilities;
2. if the company has failed, stating the causes of the failure; and
3. stating whether in his opinion further inquiry is desirable as to any matter relating to the promotion, formation or failure of the company or the conduct of its business.

ii) *Meetings*

First meeting: If a liquidator has not been appointed, the official receiver will summon separate meetings of creditors and contributories of the company for the purpose of determining whether or not an application is to be made to the court to appoint a liquidator in place of the official receiver.

Court meetings: The court may direct meetings of the creditors and contributories to be called, held and conducted in such manner as it directs for the purpose of ascertaining the wishes of the creditors and contributories as to any matters relating to the winding-up of the company.

Liquidator's meetings: The liquidator may also summon meetings of creditors or contributories by notice, for the purpose of ascertaining their wishes in matters relating to the winding-up.

Voting at the meetings: In the case of a first meeting of creditors or of an adjournment thereof, a person may not vote as a creditor unless he has duly lodged with the Official Receiver not later than the time mentioned for that purpose a proof of the debt which he claims to be due to him from the company.

In the case of a Court meeting or liquidator's meeting of creditors, a person shall not be entitled to vote as a creditor unless he has lodged with the liquidator a proof of the debt which has been admitted wholly or in part before the date of the meeting.

A creditor cannot vote in respect of any unliquidated or contingent debt, or any debt the value of which is not ascertained. A creditor in respect of any debt on or secured by a current bill of exchange or promissory note held by him cannot vote as well unless he is willing to treat the liability of the debtors of the company who were antecedent to his liability, as a security in his hands, and deduct the value thereof from his proof.

Secured creditors are only allowed to vote in respect of the balance due to him after deducting the value of his security. If a secured creditor has voted in respect of his whole debt, he will be deemed to have surrendered his security unless the Court on application is satisfied that the omission to value the security has arisen from inadvertence.

iii) Public Examination

If the liquidator has in his report stated his opinion that:

1. a fraud has been committed; or
2. some material fact has been concealed in the promotion or formation of the company or in relation to the company since its formation;
3. some officer of the company has failed to act honestly or diligently or has been guilty of any impropriety or recklessness in relation to the affairs of the company.

The court may direct that the persons or officers named in the report attend before the court and to be publicly examined as to the above issues. The person examined is examined on oath and must answer all questions put to him by the court.

Persons who may be publicly examined include those who were previously officers of the company, bankers, advocates or auditors, or persons who are known or suspected to have in their possession any property of the company or who are supposed to be indebted to the company or persons whom the Court deems capable of giving information concerning the promotion, formation, trade dealings, affairs or property of the company. The court also has the power to summon anyone connected to the company.

The liquidator and any creditor or contributory may take part in the examination, either personally or by counsel. The court may put, or allow to be put, such questions as the court thinks fit.

M. Discovery of the Company's Property

The different mechanisms in place to aid the liquidator in discovering the property of the company are:

1. the power to require any contributory, trustee, receiver, banker, agent or officer of the company to pay, deliver, convey, surrender or transfer to the liquidator or provisional liquidator forthwith or within such time as the Court directs any money, property, books and papers in his to which the company is prima facie entitled; and
2. the court may summon before it any officer of the company or person known or suspected to have in his possession any property of the company or supposed to be indebted to the company, or any person whom the Court deems capable of giving information concerning the promotion, formation, trade dealings, affairs or property of the company;

N. Proof of Debts

In respect of the winding-up of insolvent companies, subject to the priority rules provided by the Companies Act 1965 for the winding-up of companies, the following rules of bankruptcy apply:

1. rules in respect of the rights of secured and unsecured creditors;
2. rules in respect of debts provable;
3. rules in respect of the valuation of annuities and future and contingent liabilities;
4. rules in respect of the estates of bankrupt persons;
5. rules in respect of all persons who in any such case would be entitled to prove for and receive dividends out of the assets of the company and make such claims.

(See “Proof of debts” in Bankruptcy)

On the other hand, in the winding-up of solvent companies, debts payable on a contingency and all claims against the company present of future certain or contingent ascertained or sounding only in damages are admissible to proof against the company. Subject to the position of claims in tort, the general intention in the law of winding-up is to allow every conceivable kind of claim to be proved provided that the debt is legally enforceable, ie not unenforceable by virtue of some statutory or other prohibition. The following debts are not allowed to be claimed:

1. Unliquidated debts arising otherwise than by reason of a contract, promise or breach of trust; and
2. Any order by the court that the value of any debt or liability is incapable of being fairly estimated, thereby not being provable.

O. Procedure of proof of debts

A creditor proves his debts by lodging an affidavit with the liquidator verifying the debt. The liquidator will examine every proof and determine whether to admit or reject them, in whole or in part. The Court may fix a date on or before which creditors are to prove their debts or claims, after which they will be excluded from the benefit of any distribution made before those debts are proved. The liquidator may also fix a day, from time to time, on or before which the creditors of the company are to prove their debts or claims, after which they will be excluded from the benefit of any distribution by giving not less than 21 days notice. The notice is given by advertising in the Gazette and in such newspaper as the liquidator thinks appropriate.

Where a creditor has lodged his claim after the date fixed by the liquidator of the Court and the liquidator has rejected his claim, the creditor may appeal to the liquidator within seven days from the date of the notice of the decision against which the appeal is made. The liquidator may allow the appeal and make provision for the dividend upon such proof, or may dismiss the appeal. If the creditor is dissatisfied with the decision of the liquidator, he may appeal to the Court.

P. Liquidator

i) Duty

It is the duty of the liquidator after his appointment to:

1. give the official receiver such information and such access to and facilities for inspecting the books and documents of the company, and generally such aid as may be required for enabling the official receiver to perform his duties under the Companies Act 1965;
2. take into his custody, or under his control, all the property and things in action to which the company is or appears to be entitled;
3. submit a preliminary report to the court after receipt of the statement of affairs;

4. keep proper books recording minutes of proceedings at meetings and other prescribed matters;
5. settle a list of contributories unless the court dispenses with it;
6. open and pay all moneys received by him into the liquidator's general account, which is a trust account in the bank named in the winding-up order; and
7. lodge, every six months, with the registrar of companies and the official receiver an account of receipts and payments and a statement on the status of the winding-up.

ii) Powers of liquidator with authorization

The liquidator has the power, with the authority of the court or committee of inspection, to:

1. carry on the business of the company so far as is necessary for the beneficial winding-up of the company;
2. pay any class of creditors in full subject to the prescribed priority of debts;
3. make any compromise or arrangement with creditors or persons claiming to be creditors;
4. compromise any calls and liabilities to calls, debts and liabilities capable of resulting in debts and any claims present or future certain or contingent ascertained or sounding only in damages subsisting or supposed to subsist between the company and a contributory or other debtor or person apprehending liability to the company, and all questions in anyway relating to or affecting the assets or the winding up of the company, on such terms as are agreed, and take any security for the discharge of any such call, debt, liability or claim, and give a complete discharge in respect thereof; and
5. appoint advocate to assist him in his duties.

iii) Powers of liquidator without authorization

Without the need for authorization from the court or the committee of inspection, the liquidator has the power to:

1. bring or defend any action or other legal proceeding in the name and on behalf of the company;
2. compromise any debt due to the company other than calls and liabilities for calls and other than a debt where the amount claimed by the company to be due to it exceeds RM1500;
3. sell the immovable and movable property and things in action of the company by public auction, public tender or private contract with power to

transfer the whole thereof to any person or company or to sell the same in parcels;

4. do all acts and execute in the name and on behalf of the company all deeds, receipts and other documents and for that purpose use when necessary the company's seal;
5. prove rank and claim in the bankruptcy of any contributory or debtor for any balance against his estate, and receive dividends in the bankruptcy in respect of that balance as a separate debt due from the bankrupt and rateably with the other separate creditors;
6. draw, accept, make and indorse any bill of exchange or promissory note in the name and on behalf of the company with the same effect with respect to the liability of the company as if the bill or note had been drawn, accepted, made or indorsed by or on behalf of the company in the course of its business;
7. raise on the security of the assets of the company any money requisite;
8. take out letters of administration of the estate of any deceased contributory or debtor, and do any other act necessary for obtaining payment of any money due from a contributory or debtor or his estate;
9. appoint an agent to do any business which the liquidator is unable to do himself; and
10. do all such other things as are necessary for winding up the affairs of the company and distributing its assets.

The above powers of the liquidator are subject to the court's control on the application of any creditor or contributory.

Q. Making calls on contributories

After the making of a winding-up order, the liquidator, must settle a list of contributories. The court will dispense with the settlement of the list if it appears that it will not be necessary to make calls on or adjust the rights of contributories.

On a company being wound-up, every past and present member is liable to contribute to the assets of the company to an amount sufficient for the payment of its debts and liabilities and the costs, charges and expenses of the winding-up. In the case of a company limited by shares, the liability of the member is limited to the amount, if any, unpaid on his shares and, similarly, in the case of a company limited by guarantee, the liability is limited to the extent of the member's guarantee.

Before making the call, the liquidator must first obtain the approval of the committee of inspection for the proposed call²¹. If there is no such committee, the liquidator has to obtain special leave of the Court.

R. *Avoidance and Executory Contracts*

The Companies Act 1965 provides that, in the event of a winding-up by the Court, certain transactions are void as against the liquidator. For the purposes of ascertaining the effect on certain transactions, the date of the winding up is deemed to be the date of the presentation of the petition of compulsory winding up by the court.

i) Disposition of property after winding up

Any disposition of the company's property, including things in action, or any transfer of shares or alteration in the status of the members of the company made after the commencement of the winding up will, unless the court otherwise orders, be void.

ii) Avoidance under bankruptcy law

Any transfer, mortgage, delivery of goods, payment, execution or other acts relating to property made or done by or against a company which, had it been made or done by or against an individual, would in his bankruptcy under the law of bankruptcy be void or voidable, will in the even of the company being wound up, be void or voidable equally void.

Any transfer or assignment by a company of all its property to trustees for the benefit of all its creditors is void.

Under bankruptcy law, any conveyance, or transfer of or charge on property, a payment made or obligation incurred by a person who is unable to pay his debts as they become due from his own money, in favour of a creditor, having the effect of giving that creditor a preference over the other creditors is deemed fraudulent and void against the Official Assignee if the transaction occurs within three months before the presentation of the petition for bankruptcy. In order for a transaction to be an undue preference, the following tests must be satisfied:

1. There must be a "conveyance of transfer of property", " a charge on property", a "payment made" or an "obligation incurred by the company";

2. There must be a creditor/debtor relationship;
3. The transaction must have taken place within six months prior to the presentation of the petition for winding up by the court;
4. The transaction must have the effect of giving a creditor a preference, priority or advantage over other creditors. This test is objective and the intent or state of mind of the debtor is not relevant. The transaction which has the effect of giving a creditor a preference is one that gives a creditor a preference in respect of debts then due and owing over present creditors as distinct from debts falling due to other creditors in the future; and
5. At the time of the transaction, the company must be insolvent.

iii) *Fraudulent trading*

If, in the course of the winding up of a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or for any fraudulent purpose, the court may, if it thinks proper so to do, declare that any person who was knowingly a party to the carrying on of the business in that manner is to be personally responsible for all or any of the debtor's other liabilities of the company as the court may direct. The court may give such further directions as it thinks proper for the purpose of giving effect to its declaration.

iv) *Misfeasance*

Where in the course of winding up it appears that there is any person who has taken part in the formation or promotion of the company or any past or present liquidator or officer has misapplied or retained or become liable or accountable for any money or property of the company or been guilty of any misfeasance or breach of trust or duty in relation to the company, the court may on the application of the liquidator or of any creditor or contributory examine into the conduct of such person and compel him to repay or restore the money or property or any part thereof with interest at such rate as the court thinks just.

v) *Sale at undervalue or overvalue*

Any transaction involving acquisition of property, business or undertaking to the company being wound up:

- from a person who is the director of the company at the time of transaction; or

- from a company whereby at least one of its directors is also a director of the company being wound up,

which took place two years before the commencement of the winding up, for cash consideration may be reviewed by the liquidator who may recover from the person or company any amount by which the cash consideration for the acquisition exceeded the value of the property business or undertaking at the time its acquisition.

Conversely, where there is a transaction involving a sale to the company being wound up in the same situation above, the liquidator may review the transaction and recover any amount by which the value of the property, business or undertaking at the time of the sale exceeded the cash consideration.

vi) Distress and execution after winding up

After the commencement of winding up, any attachment, sequestration, distress or execution put in force against the estate or effects of a company being wound up by the court is void. Further, any creditor who has issued execution against, or attached the goods or lands of the company is not entitled to retain the benefit of the execution or attachment against the liquidator if the execution or attachment is not completed²² before the commencement of the winding up by the court. However, the court in its discretion may set aside any rights of the liquidator in favor of the creditor to such extent and subject to such terms as the court thinks fit.

vii) Charges void for want of registration

Every charge created by a company registered in Malaysia is void against the liquidator and any creditor of the company unless a statement of prescribed particulars of the charge is lodged with the registrar of companies for registration within 30 days after the date of its creation.

viii) Invalidity of floating charge

A floating charge on a company's undertaking or property created within six months of the commencement of the winding up is, unless it is proved that the company immediately after the creation of the charge was solvent, invalid except to the amount of any cash paid to the company at the time of or subsequently to the creation of and in consideration for the charge.

ix) Disclaimer of onerous property

The liquidator may disclaim any part of the property of the company which consist of:

1. any estate or interest in land which is burdened with onerous covenants;
2. shares in corporations;
3. unprofitable contracts; or
4. any other property that is unsaleable, or not readily saleable, by reason of its binding the possessor thereof to the performance of any onerous act, or to the payment of any sum of money.

However, the liquidator must obtain leave of the court or the committee of inspection before disclaiming the property.

The disclaimer operates to determine, as from the date of disclaimer, the rights, interests and liabilities of the company and the property of the company in or in respect of the property disclaimed. The disclaimer will generally not affect a third party except as may be necessary to release the company and its property from liability. Any person injured by the disclaimer is deemed a creditor of the bankrupt to the extent of injury and may accordingly sue for damages for that injury, as a debt in bankruptcy.

S. *Vesting of Property*

As soon as possible after the winding up order, the court should cause the assets of the company to be collected and applied in discharge of its liabilities. On the application of the liquidator, the court may by order direct that all or any part of the property of whatsoever description belonging to the company or held by trustees on its behalf shall vest in the liquidator and thereafter the property shall vest accordingly.

T. *Dividends*

Within three months form the date of his notice fixing the last date for creditors to prove their debts, the liquidator must send a notice of dividend to each creditor whose proof has been admitted, and pay a dividend. However, if the liquidator feels that it is necessary to postpone the declaration of notice beyond the limit of three months, he must give afresh notice fixing a new date for creditors to prove their claims.

Dividend which remain unclaimed for more than six months from the date when they became payable must be paid forthwith to the official receiver to be deposited in the company's liquidation account.

W. Priority of Debts

The following debts ("preferential debts") are paid in priority to all other unsecured debts in the order as they appear:

1. payments to third parties, of sums received by the company under a contract of insurance against liability to third parties taken out by the company;
2. costs and expenses of the winding up, including the taxed costs of a petitioner payable, the remuneration of the liquidator and the costs of any audit carried out;
3. all wages, salary (whether or not earned wholly or in part by way of commission) including any amount payable by way of allowance or reimbursement under any contract of employment or award or agreement regulating conditions of employment, of any employee not exceeding RM1500 or such other amount as may be prescribed from time to time whether for time or piecework in respect of services rendered by him to the company within a period of four months before the commencement of the winding up;
4. worker's compensation under any written law relating to worker's compensation accrued before the commencement of the winding up;
5. remuneration payable to any employee in respect of vacation leave, or in case of his death to any other person in his right, accrued in respect of any period before the commencement of the winding up;
6. all contributions payable during the twelve months next before the commencement of the winding up by the company as the employer of any person under any scheme of superannuation or retirement benefit which is an approved scheme under the federal law relating to income tax; and
7. federal tax assessed under any written law before the date of the commencement of the winding up or assessed at any time before the time fixed for the proving of debts has expired.

Whilst debts in the each class rank in the order as above, debts of the same class rank equally between themselves.

If the assets of the company are not sufficient to meet all the liabilities, the court may make an order as to the payment out of the assets of the company, the costs, charges and expenses incurred in the winding up in such order of priority as the court thinks fit. In addition, where the assets of the company are not sufficient to pay the preferential debts stated in paragraph (c), (e) and (f) above,

the said debts will have priority over the claims of the holders of debenture under any floating charge, and will be paid out of the property subject to that charge.

Where assets have been recovered under an indemnity for costs of litigation given by certain creditors, or have been protected or preserved by the payment of moneys or the giving of indemnity by creditors, where expenses in relation to which a creditor has indemnified a liquidator have been recovered the Court may make such order as it deems just with respect to the distribution of those assets and the amount of those expenses so recovered with a view to giving those creditors an advantage over others in consideration of the risk assumed by them in so doing.

If there is any surplus after all the claims against the company and all costs of liquidation have been met, the court will adjust the rights of the contributories among themselves and distribute the surplus among the persons entitled thereto.

X. *Dissolution*

After the complete winding up of the company, dissolution may take place, whereupon the company will be removed from the register of companies. The liquidator is the person who applies for a company's dissolution. However, in practice, such application is rarely made.

VI. Criminal Liability

An act of insolvency is not a criminal act. However, where any business of a company is carried on with an intent or purpose to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, every person who was knowingly a party to the carrying on the business with that intent or purpose is guilty of an offence against the Companies Act 1965. Such an offence is punishable by three years imprisonment or a fine of RM10,000.

Further, if in the course of winding up it appears that any person who has taken part in the formation or promotion of the company or any past or present liquidator or officer has:

1. misapplied or retained or become liable or accountable for any money or property of the company; or
2. been guilty of any misfeasance or breach of trust or duty in relation to the company,

the Court may on the application of the liquidator or of any creditor or contributory examine into the conduct of that person liquidator or officer and compel him to repay or restore the money or property or any part thereof with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust or duty as the court thinks just.

Prosecution

If, in the course of a winding up by the Court, it appears to the court that any past or present officer, or any member, of the company has been guilty of an offence in relation to the company for which he is criminally liable, the court may, either on the application of any person interested in the winding up or of its own motion, direct the liquidator either himself to prosecute the offender or to refer the matter to the Minister.

It is also the duty of the liquidator to report in writing to the Official Receiver if it appears to him in the course of winding up that the company being wound up will not be able to pay its unsecured creditors more than fifty sen in the ringgit. If the Minister thinks that the case is one which warrants further investigation, he will apply to the court for an order conferring on him or any person designated by him all such powers of investigating the affairs of the company. Thereafter, if the Minister considers that the case is one in which a prosecution ought to be instituted, he may institute proceedings accordingly.

NOTES

1. This section is derived from Dr. Thillainathan's paper on corporate restructuring and is being used in this report with his permission.
2. The prolonged rapid growth of the economy over long periods should have made for a higher GDP share of services but in fact it had declined from 43.9% in 1985 to 42.7% in 1995. Over the corresponding period the share of primary production in GDP had declined from 31.2% to 21.0% whereas on the other hand the share of manufacturing had increased from 19.7% to 33.1%.
3. For an alternative explanation see Raghuram et al 1998. According to Raghuram, transactions in a market-based model are based on market-generated price signals and require an infrastructure that facilitates private contracting.

East Asia was characterized by a weak contracting infrastructure and massive capital inflows in the 1990s. To protect their interest, the foreign lenders invariably made short-term loans and relied on the threat of not rolling over the loans to ensure that the borrowers serviced their loans. When the Asian crisis struck, the decision of some lenders to call back the loans or of some investors to pull out their investments made others to do the same thus causing a stampede of capital outflows. This was a rational response and not a panic. Given the poor laws and weak enforcement, it did not make sense for the lenders or investors to take their time in going to the courts to enforce their rights.

4. The initial situation of over full employment and opportunities for repatriating guest workers made the problem of unemployment less acute.
5. Although the government deficit was still small, its expected contingent liabilities were escalating on account of its implicit guarantee of bank deposits and infrastructure projects as well as the explicit guarantee of the principal (and of a minimal return) to investors/contributors of the large unit trusts and provided funds.

In respect of those infrastructure projects for which the government had guaranteed traffic volumes, this had ceased to be a problem. But in respect of others, it had step-in rights if the concessionaires ran into financial difficulties. But these were not obligations. As the government was not prepared to let the projects be auctioned off to the highest bidders, these step-in-rights became de facto obligations.

6. In the first half of 1998, 782 winding-up petitions were filed under the Companies Act – nearly equal to the number of cases filed during all of 1997 – and courts issued 248 winding-up orders.
7. Stock market capitalization as a percentage of GDP are as follows for the various periods: 1975-79 – 45.2%, 1980-84 – 89.5%, 1985-89 – 101.1% and 1990-94 – 198.8%.
8. This section is derived variously from analyst reports and the Bank Negara 1998 Annual Report.
9. This section is derived from the Bank Negara 1998 Annual Report.
10. This section is derived from Bank Negara sources.
11. This section is derived from financial media and official sources.
12. An adjudication order vests all the property of the bankrupt on the Official Assignee. Certain property of the bankrupt will not pass to the Official Assignee, such as property held by the bankrupt on trust and the income of the bankrupt for subsistence.
13. The Official Assignee makes an estimate of the value of any debt, or liability, which by reason of its being subject to any contingency or contingencies, or for any other reason, does not bear a certain value.
14. Including any of its members (ordinary or preferred shareholders).
15. The exceptions are:
 - (i) if the settlement is made before and in consideration of marriage;
 - (ii) where settlements are made in favorite of a purchaser or incumbrancer in good faith and for valuable consideration;
 - (iii) where the settlements are made in consideration of marriage or for the future settlement on or for the wife or children whose right accrued after marriage.

The definition of settlement includes any conveyance, or transfer of property, bill, bond, note, security for money or covenant for the payment of money and any gift of money.

16. This provision does not affect the rights of any person making title in good faith and for valuable consideration through or under a creditor of the bankrupt.
17. Assignment includes assignment by way of security or other charge on book debts.
18. This does not apply to an assignment of book debts registered pursuant to any written law if the assignment is valid under that law.
19. The prescribed transactions are those where the bankrupt has sold, purchased, leased, hired, supplied or received property or services.
20. Only approved company auditors may apply to be an approved liquidator.
21. A committee of inspection is usually appointed when there is a large number of creditors and contributories to help the liquidator to call meetings to ascertain their wishes. The committee will consist of creditors and contributories of the company and persons granted general powers of attorney or are specially authorized by the creditors or contributories in such proportions as meetings of creditors and contributories have agreed or, if there is a difference, as determined by the court.
22. It is provided under the Companies Act 1965 that, for the purposes of this power of avoidance,

an execution against goods is completed by seizure and sale;

an attachment of a debt is completed by receipt of the debt; and

an execution against land is completed by sale or, in the case of an equitable interest, by the appointment of a receiver.

COUNTRY REPORT FOR THE PHILIPPINES

by
Daniel J. Fitzpatrick*

I. Introduction

This report provides the economic and legal background on the Philippine approach to corporate insolvency as part of the conference on Insolvency Systems in Asia held in Sydney, Australia on November 29 and 30, 1999. Where possible, it adheres to the general guidelines for country reports provided by the organizers of the conference.

The Philippines escaped the worst ravages of the Asian crisis primarily because its larger corporations and banks generally had more manageable levels of exposure to foreign debt at the outset of the crisis. Nevertheless, several high profile corporate failures and the resulting rescue attempts have illustrated the need for insolvency law reform in the Philippines. Existing insolvency legislation, which consists of a colonial era law and a Marcos era decree, is outmoded and lacking in detail.

In response to the crisis and its impact on company insolvency, the Philippine Securities and Exchange Commission (SEC), which has quasi-judicial jurisdiction over debt relief petitions, has begun efforts to develop more detailed rules on these matters. This is considered to be a stop gap measure until the

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passage of new legislation on insolvency, which might be submitted to the legislature next year.

Part II of this report will provide brief background information regarding the economic conditions in the Philippines and the impact of the Asian crisis on Philippine lenders and debtors. Part III will focus on debtor-creditor relationships in the Philippines. Part IV will discuss formal insolvency mechanisms that are in general use. Part V will provide a brief outline on how the Philippines treats insolvent banks, and Part VI will offer some views on the likely direction of Philippine insolvency practice in the coming years.

II. A Summary of Overall Economic Conditions and the Extent of the Debt Crisis

A. *The Asian Crisis and the Philippines*

Observers generally agree that the Philippines suffered less from the Asian crisis than many of its neighbors. The Philippine peso experienced only a relatively mild devaluation during the first six months of the crisis. In fact, while other countries' economies contracted severely in 1998, the Philippines was able to escape a recession, with GDP actually growing, albeit only marginally so, during that year. During the first half of 1999, led by a rebound in exports and agriculture, the Philippines appeared to have turned the corner in terms of economic growth. During the first two quarters of 1999, the economy chalked up significant gains in gross domestic product from the previous year.¹

The impact of this milder version of the Asian flu was painful though not catastrophic for borrowers and lenders. While the two hundred largest firms experienced significant increases in their debt equity ratios (approximately 24 percent from 1996 to 1997), the debt equity ratios of smaller firms grew at a significantly less dramatic rate.²

In terms of corporate insolvency, while the number seeking formal rescue proceedings increased significantly, the numbers did not approach those seen in Thailand or Indonesia. Since 1997, only 67 companies have sought protection from creditors by filing petitions for suspension of payments.

Likewise, lenders fared relatively well. Although the non-performing loans of banks did increase, only a few of the larger commercial banks have closed their doors because of the crisis.

Theories abound as to why the Philippines came through the crisis relatively unscathed. Reasons include the fact that the government was in a reasonably strong fiscal position and that Philippine companies been far less leveraged than companies in other Asian countries when the crisis hit.³

Nevertheless, the crisis revealed vulnerabilities in the Philippine economic regulatory system, particularly concerning debtor-creditor relations, which this report discusses in more detail below.

B. The Impact of the Crisis on Corporate Debtors

The industries suffering the most from the Asian crisis were the manufacturing and real estate sectors. In manufacturing, rising production costs and poor sales growth led to a 92 percent decrease in profits in 1997. As of the second quarter of 1999, manufacturing was lagging other sectors in emerging from the crisis.⁴ The real estate sector continued to suffer from high interest rates and falling demand.

Although agriculture suffered a pronounced downturn during the crisis, bad weather more than falling currency was the primary cause. With more favorable weather conditions in 1999, this sector has bounced back sharply.

Not surprisingly, the crisis did affect the number of companies seeking relief through formal insolvency proceedings. In 1997, 19 companies petitioned the SEC for debt relief. In 1998, 36 companies did so. The numbers have dropped off significantly in 1999, however, with only 12 companies filing with the SEC as of the end of October. By far the largest and most notorious of these filings over the past several years was that of Philippine Airlines in June 1998.

In general, the categories of companies seeking relief reflect the areas of the economy that have suffered significant stress during the crisis. The majority of companies that have sought debt relief from the SEC have been either real estate developers or manufacturers.

C. The Impact of the Crisis on Lenders

Having entered the Asian crisis in a position of relative strength, the banking sector helped to buttress the Philippine economy during the Asian crisis. Extremely high capital adequacy ratios (over 16 percent before the crisis) helped allay depositor's fears and minimized incentives of foreign investors to withdraw funds.⁵

Nevertheless, the crisis has taken its toll, the effects of which are becoming more and more apparent as the non-performing loans (NPL's) of commercial banks have continued to creep upwards into the mid-teens. Further troubling is the increase in bank assets characterized as "real and other properties owned and acquired". These numbers have increased substantially in 1999 from the previous year, as banks have foreclosed on properties securing loans or otherwise settled problem loans by taking mortgaged or other property as payment in kind.⁶ Long established redemption rights for borrowers, as well as a still depressed real estate market, have prevented banks from selling all but the most attractive properties.

In 1998 the Bangko Sentral Pilipinas (the Republic's central bank) closed 22 banks.⁷ Critics have noted that the government could have acted far more swiftly in many of these closings.⁸ Instead, the government has been pushing consolidation and greater competition from foreign banking institutions. Increasingly higher capital requirements should reduce the current fifty banks to approximately a dozen in a few years. Banking reform legislation in Congress, expected to pass this year, will allow foreign banks to acquire 100 percent of distressed banks where local capital is unavailable.⁹

D. The Effectiveness of Insolvency Mechanisms During the Economic Crisis

As will be described more fully below, the suspension of payments proceedings under the Philippine Securities and Exchange Commission (SEC) serve as the primary method of formally resolving corporate insolvency. These proceedings are as insufficient for at least two reasons. First, they allow for only a debtor-initiated insolvency proceeding. Unlike in jurisdictions such as Hong Kong, creditors in the Philippines lack a means of initiating or driving a formal proceeding for appointing a receiver to run the debtor on their behalf. Second, the SEC's proceedings have lacked a set of clear rules and have reflected, in general, a pro-debtor bias.

Because of the perceived shortcomings of the SEC's procedures, debtors and creditors usually resort instead to informal workouts. In this context, anecdotal evidence suggests that debtors sometimes threaten to initiate SEC proceedings as a means of negotiating more favorable restructuring agreements with their creditors.

III. Debtor-Creditor Relationships

Before the onset of the Asian crisis, the primary sources of direct lending capital in the Philippines were the non-bank financial institutions (NBFIs) that would purchase commercial paper directly from issuers and, more importantly, banks, which also purchased commercial paper and offered loans, either alone or as part of lending syndicates.

Few, if any, corporations are currently issuing commercial paper. Nevertheless, various banks and NBFIs remain as creditors via commercial paper with longer maturities.

The greatest consumers of this capital are the larger corporations and the corporate groups to which they belong.

Brief profiles of these creditors and debtors and their interaction appear below.

A. Banks

1. Configuration of the Banking Sector

Banks in the Philippines are categorized as expanded commercial banks, commercial banks, savings and mortgage banks, private development banks, stock savings and loan associations, or rural banks. Fifty-three commercial banks operate in the Philippines. This grouping can be broken down as follows:

- thirty-three private domestic banks
- four locally incorporated subsidiaries of foreign banks
- thirteen foreign commercial banks
- three government controlled banks

Twenty of these banks are “expanded”, i.e. universal banks, with the right, in addition to normal commercial bank activities, to act as investment houses, to take equity positions in non-allied companies, and to own up to one hundred percent of a financial intermediary.

2. *Corporate Governance of Banks and State Involvement Therein*

Like the corporate sector in general, Philippine banking is characterized by ownership concentrated among a handful of shareholders.¹⁰ Such ownership often serves to place a bank within a larger corporate group, the members of which are frequently the bank's customers. One survey of corporate governance in the Philippines has observed that approximately half of the commercial banks in the country are associated with corporate groups.¹¹

Such relationships erode a bank's objectivity in lending to its customers. While banks are subject to limits on lending to single borrowers, they sometimes skirt this restriction by lending to various companies within a corporate group.¹²

With regard to state ownership of banks, as noted above only three banks remain under state control. These banks focus at least a portion of their activities on particular sectors under served by commercial banks.

Perhaps the greatest impact of the state-owned banks on the Philippine insolvency system is their special status in relation to insolvency proceedings. According to their charters, which are approved by the Philippine legislature and have the status of law, these banks appear to have the right, unlike other banks, to unilaterally enforce their rights against assets securing their loans despite the initiation of formal insolvency proceedings. The disruptive effect such rights have on collective insolvency proceedings is obvious. Recent actions by a state-owned bank to exercise these rights in a formal insolvency proceeding have proven quite disruptive and may result in the Philippine Supreme Court taking up this issue in the near future.¹³

B. *Non-Bank Financial Institutions (NBFIs)*

1. *Configuration of the NBFIs Sector*

The non-bank financial sector in the Philippines includes:

1. Pre-need plan companies.
2. Universal bank-related securities brokers/dealers, finance companies, and investment bank houses.
3. Mutual funds, i.e. investment companies.
4. Common trust funds.

5. Insurance companies.
6. Pawn shops.
7. State-run pension funds.

The largest among the private NBFIs are the pre-need companies, the insurance companies, and common trust funds. Pre-need companies offer investors a “guaranteed”, fixed-sum future payment in order to meet a particular need. The most popular plans provide for funeral and burial expenses, educational expenses, or pensions.¹⁴ As of 1997, 88 pre-need plan companies were managing assets worth approximately two billion US dollars.¹⁵ They are regulated by the SEC.

As of the end of 1996, 134 private insurance and reinsurance companies were operating in the Philippines. Life insurance companies controlled the equivalent of 3.2 billion US dollars. Non-life insurance companies controlled the equivalent of 1.3 billion US dollars. Growth in the insurance sector was strong prior to the crisis.¹⁶ The industry is regulated by the Philippine Insurance Commission.

Common trust funds are pooled investments managed by trust departments of commercial banks. Although essentially mutual funds, they are regulated by the central bank of the Philippines. Their popularity stems primarily from the banks marketing them as a deposit substitute enjoying favorable tax treatment.¹⁷ There are approximately sixty common trust funds operating in the Philippines. They have the equivalent of two billion US dollars under management.¹⁸

After pre-need plan companies, common trust funds, and insurance companies, the remaining sub-sectors are relatively small. As of the end of 1998, 17 mutual funds were operating in the Philippines, managing the equivalent of 86 million US dollars.¹⁹ They are regulated by the SEC.

While there are numerous pawnshops (over 6,000 operate in the Philippines), their asset base is quite small, amounting to less than one half of one percent of the assets of NBFIs. Their share of funds will likely shrink further as the rest of the sector becomes more efficient.

The state run pension funds are extremely large, representing trillions of pesos in assets. They perform very little direct lending to corporations however. Instead, their corporate investments are limited to commercial paper and equities.

2. *The Role of NBFIs as Creditors in Insolvency Proceedings*

As holders of commercial paper, the NBFIs would stand as unsecured creditors in insolvency proceedings. Their roles to date in insolvency proceedings have been minor. This is due partly to the fact that few issuers of commercial paper have entered formal insolvency proceedings.

C. *Firms*

1. *Corporate Governance*

Despite an active stock market, an American-derived corporations law, and a market regulator (the SEC) operating for more than 60 years, there remains a general dissatisfaction with corporate governance in the Philippines, particularly as it serves to protect minority shareholders. The reasons for this appear to be a combination of highly concentrated ownership structures (leaving minority shareholders with little opportunity for influence), reliance by corporations on affiliated banks for financing (weakening external checks on mismanagement and possibly biasing risk assessment), and interlocking directorates (creating opportunities for self dealing transactions).

Several studies of the Philippines securities market discuss the limits that such obstacles pose to establishing a regime that provides sufficient protection to minority shareholders.²⁰ Another perspective is that the family-owned and dominated corporate structure is not necessarily a cause of inadequate corporate governance in the Philippines, but rather a response to a legal system where rights are not vindicated in a reasonably predictable manner. Operating in an environment where corporate governance principles are not consistently enforced, domestic investors in the Philippines require large majorities (and the resulting protections they afford in control rights, etc.) in order to make and maintain investments in large business undertakings.²¹

2. *Financial Structure and Modes of Financing*

As noted above, the ownership of Philippine corporations has remained rather concentrated. Large publicly held companies remain the exception rather than the rule. Of the one thousand largest corporations in the Philippines, approximately ten percent are publicly traded.²²

Concentrations of ownership are seen with a majority of publicly held companies as well. One study of ownership concentrations reveals that

companies have significant concentrations of ownership among the top five shareholders.²³ Further, relatively small portions of the shares of public listed companies are actively traded. The Philippine Stock Exchange requires that its listed companies make available only 10 to 20 percent of their shares for trading. With the exception of a few companies, public trading for companies is limited to about these levels.

Many Philippine companies are associated with larger corporate groups. A recent study identified 39 corporate groups in the Philippines. The companies within these groups make up 31 percent of the total sales of the largest thousand companies. This figure becomes even more dramatic after factoring out the multinationals and their sales: the 39 corporate groups generated 46 percent of the sales of the 754 largest domestic corporations.

Public offerings are not the favored form of financing. Instead there is a tendency, especially with companies falling within the corporate groups, to rely on affiliated banks and guarantees from affiliated corporations.

3. *Recent Economic Performance*

Although the Philippines lagged behind other Asian economies in growth during the 1980's, economic activity picked up considerably beginning in 1992. From 1992 to 1997, annual GDP growth averaged 4.5 percent per year, peaking at 5.9 percent in 1996. The services sector led this expansion, averaging 5.3 percent for this period. The industrial and agricultural sectors grew at rates of 4.7 percent and 2.6 percent respectively.

Although the Asian crisis significantly affected the Philippines, its effects were far less damaging than those suffered by neighboring countries. Levels of foreign investment, the value of the peso, and trade surpluses dropped precipitously, but the Philippines was able to avoid a recession. Recent economic statistics indicate a return to growth in 1999.

D. *Relationships Between Creditors and Debtors*

1. *Credit Risk Analysis and Debtor Monitoring*

In the Philippines, banks and other financial institutions regularly perform thorough risk analysis and generally charge interest rates that correspond to the perceived credit risk of the borrower.²⁴ Commercial paper issuers must first obtain a credit rating.²⁵ The recent economic crisis has made banks and other

creditors even more hesitant with credit. Nevertheless, it has been observed that domestic banks in the Philippines tend to be less strict about issuing loans than their foreign-owned counterparts. According to one commentator, domestic banks sometimes “lend on the basis of the name or the relationship with the borrower.”²⁶

Loan applicants who fail to meet the basic loan requirements normally are denied loans. However, numerous exceptions to this rule have arisen recently. Orient Bank, closed in late 1998, provides one example of excessive loans to insiders and other related persons.

2. *Called Loans—the Usual Response*

Debtors in such cases usually attempt to work out a rescheduling of debts. The creditor’s response normally depends on whether its claims are secured. Because judicial action to collect on unsecured debt is considered slow and unpredictable, unsecured creditors are usually more amenable to attempting an informal workout. Secured creditors are much more willing to pursue foreclosure.²⁷

Anecdotal evidence also indicates that debtors with trouble keeping their loans current have used the threat of filing a petition for suspension of payments with the SEC as a means of coercing an agreement from creditors. Given the pro-debtor bias observed recently at the SEC, this threat appears to have at least some effect on the negotiating process.

3. *Financial Information Required from Debtors*

See Section III.D.1 of this report.

4. *Loan Security*

Philippine law allows creditors to secure their loans through real estate mortgages, chattel mortgages, pledges, and guarantees. Banks and financial institutions usually employ various combinations of these methods.

Trade creditors use such methods less often. Although suppliers in a liquidation theoretically have security interest in property sold to their customers that remains unpaid for, this right is rarely enforced.²⁸

Other creditors have used leases or trust receipts as a means of securing repayment. In each instance, title remains with the supplier. This could prove helpful, as it may allow the creditor to recover his property regardless of whether the debtor initiates formal insolvency proceedings. Further, the failure of the debtor to comply with the trust agreement could possibly subject him to criminal liability.

Finally, there is the practice of using post-dated checks to secure loans. As a part of a loan arrangement, the debtor writes out bank checks for each payment. If the debtor fails to keep his account sufficient to cover these checks as they are presented, he is subject to criminal prosecution.

E. Marketability of Assets Sold in Distress Sales

The marketability of assets sold under distress depends on the strength of the second-hand market and any legislative or regulatory provisions, which discourage such sales.

The general demand for prior owned assets has increased in line with the Philippines' recovery from the Asian crisis. Nevertheless, several legislative/regulatory provisions continue to add uncertainty or costs to such transactions. Two important ones are:

- The right of the debtor to redeem the property up to a year after the sale by paying the obligation due. This provision often times results in banks bidding their exposure to purchase the property, then holding it for at least one year until the redemption right expires.
- The absence of a unified collateral registry. This reduces a buyer's certainty that movable property is being sold free and clear of liens.

IV. Formal Insolvency Mechanisms

A. Overview

1. Types of Insolvency Mechanism and Applicable Laws

Formal insolvency procedures in the Philippines are established and defined by the Insolvency Law (enacted in 1909) and Presidential Decree No. 902-A (amended in 1981). The Insolvency Law established procedures for (1) a

temporary suspension of payments, (2) voluntary liquidation, (3) involuntary liquidation, and (4) composition. PD 902-A transferred jurisdiction over petitions for suspension of payments by corporations to the Securities and Exchange Commission (SEC). It also introduced the concept of corporate rehabilitation and vested the SEC with the power to oversee such efforts.

The SEC currently does not have binding regulations for suspension of payments cases. Instead, procedures are governed by past precedents and a brief set of internal guidelines circulated in October 1997.

Thus, as it has evolved in practice, the following insolvency mechanisms are currently available:

1. Voluntary proceedings under the SEC for simple suspension of payments when the debtor has assets sufficient to cover all of its liabilities.
2. Voluntary proceedings under the SEC for suspension of payments coupled with a prayer for appointment of a rehabilitation receiver or management committee when the debtor lacks sufficient assets to cover its liabilities.
3. Voluntary proceedings for liquidation under court supervision under the Insolvency Law.
4. Involuntary insolvency under court supervision and the Insolvency Law.
5. Composition, by which a debtor may avoid insolvency by reaching an agreement with his creditors at the early stages of a liquidation.

By far the most resorted to procedure is the suspension of payments proceeding under the SEC.

2. *The Implementation Structure and the Capacity to Handle Bankruptcy Cases,*

Two venues in the Philippines exist for resolving the insolvency of corporate debtors: the regular courts and the SEC. When the Insolvency Law was enacted in the early 1900, the venue was the trial courts. It remained that way until 1981, when then President Marcos issued Presidential Decree 1758, which amended Presidential Decree 902. The amendments expanded the exclusive, quasi-judicial jurisdiction of the SEC to include petitions for suspension of payments submitted by corporations. PD 902-A also vested in the SEC the right to continue jurisdiction over the liquidation of a company if it determined that the rehabilitation of the company was not feasible.

Thus, there exist two different venues in which formal insolvency cases involving corporations may be initiated, depending on the particular matter:

- SEC: petitions for suspension of payments (usually coupled with a prayer for appointment of a rehabilitation receiver).
- Trial Courts: petitions for voluntary insolvency proceedings and involuntary insolvency proceedings.

These are discussed in more detail below.

B. Key Aspects for Insolvency Proceedings under the SEC

Although the Insolvency Law contains a detailed description of a set of procedures for handling suspension of payments cases, the SEC has not followed them. Instead, the SEC follows its own set of policy pronouncements. The October 1997 SEC guidelines for suspension of payments set forth a skeletal description of the procedures on how these cases should be handled. The guidelines and general precedents establish the following framework:

1. A debtor files a petition with attachments containing relevant financial information. In its petition the debtor should indicate whether or not it is solvent.
2. The SEC appoints a three person hearing panel, one of whom is an SEC Commissioner.
3. In cases of petitions for simple suspension of payments, the hearing panel issues a provisional suspension of payments order for thirty days.
4. In cases of petitions for simple suspension of payments coupled with a prayer for appointment of a rehabilitation receiver (where the debtor is insolvent), the hearing panel appoints an interim receiver and issues a provisional suspension of payments order for thirty days.
5. In each case, creditors are required to comment on the petition within twenty days of filing.
6. The hearing panel either dismisses the petition or grants the petition for suspension of payments (appointing a permanent rehabilitation receiver when warranted). A debt moratorium should normally not last longer than six months (though this period may be extended if approved by the SEC).

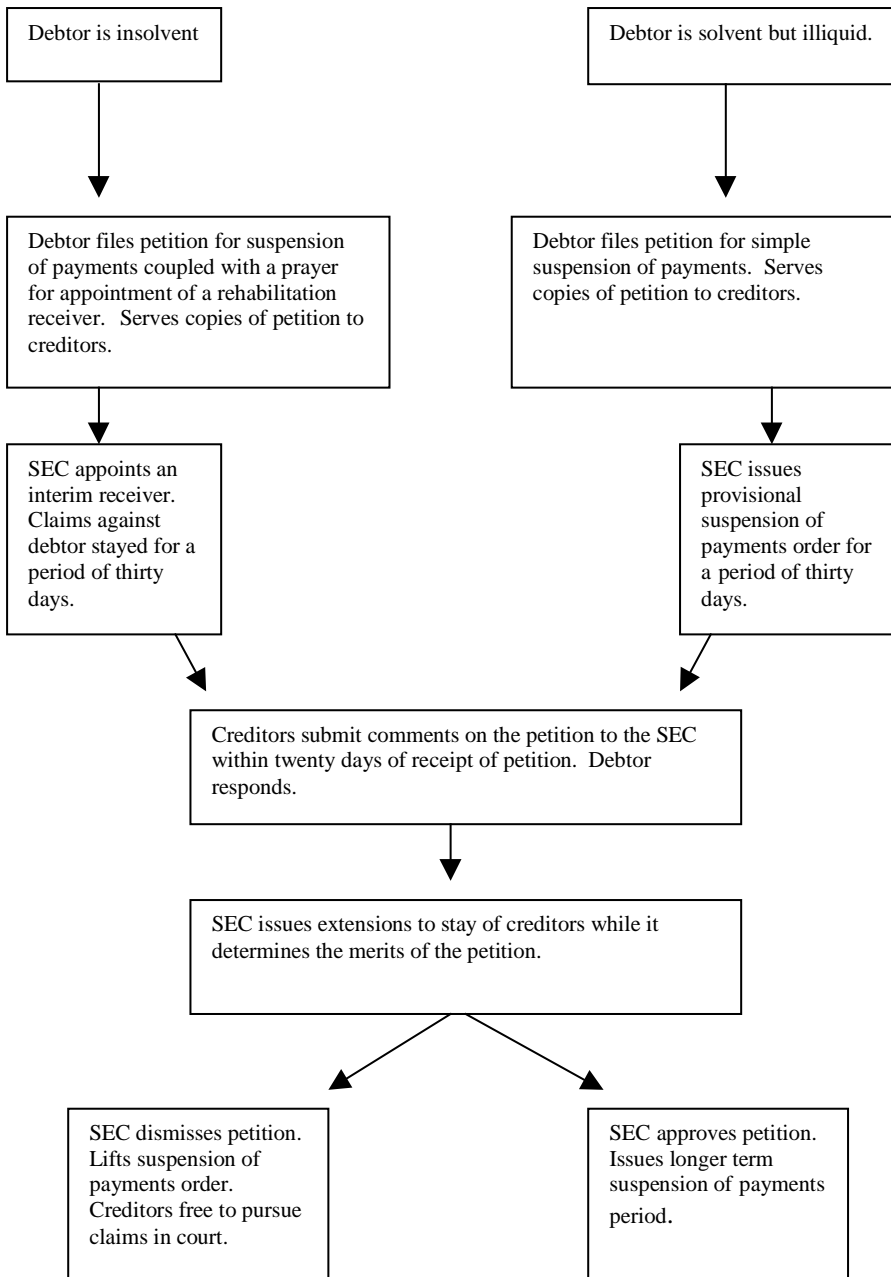
7. If the SEC determines during the proceedings that a more intrusive external management scheme is needed (for instance if evidence of abuse by current management arises), it may appoint a management committee.

Please note that SEC oversight over these cases varies widely, making a summary of practice and procedures to be a general one at best. See below for a diagrammatic representation of these procedures.

With such minimal written standards, case law has played a relatively important role. For instance, a set of cases in the mid-1990's established that the claims of secured creditors are stayed when the SEC appoints a rehabilitation receiver. This was a crucial policy development. Prior to these rulings, secured creditors were free to act unilaterally to enforce their security in these proceedings under the Insolvency Law. This line of cases also boosted the SEC's arguments that the provisions of the Insolvency Law did not apply with respect to suspension of payments cases before the SEC.

Recent studies of insolvency systems in the Philippines have characterized the SEC's procedures as being debtor-friendly and overly litigious. From an efficiency perspective, a debtor-friendly insolvency proceeding distorts pre-existing contractual arrangements and encourages forum shopping.

The overly litigious nature of SEC proceedings has efficiency costs as well. A perusal of any of the pleadings on file at the SEC would reveal that the attorneys argue more over the law than the ultimate merits of the case. Factual disputes, when they do arise, tend to focus on whether the debtor is solvent or not. In the meantime, while the parties litigate this threshold issue, the debtor's value as a going concern depreciates rapidly.



A final point worth mentioning is the absence of any mechanism in SEC proceedings for reducing creditors' claims without their individual consent. The end result is often times the maintenance of an SEC suspension of payments order *ad infinitum* or until the creditors voluntarily agree to a haircut.

Statistics on Suspension of Payments Cases before the SEC

Total Number of Suspension of Payments (i.e. Reorganization) Cases Filed in the Past Five Years and Their Disposition

Year	Number Filed	Number of these Cases that have been Dismissed or otherwise Denied	Number of these Cases where the Petition has been Voluntarily Withdrawn	Number of these Cases in which a Repayment or Rehabilitation Plan has been Approved	Number of these Cases in which a Repayment or Rehabilitation Plan has not yet been Approved
1995	10	5	2	1	2
1996	9	3	1	1	4
1997	19	12	3	1	3
1998	36	11	5	4	16
1999	12	4	0	0	8
Total	86	35 (40.7%)	11 (13.2%)	7 (8.1%)	33 (38.3%)

Number of Days until Voluntary Withdrawal, Dismissal of Case, or Approval of Plan

Resolution	Number of Cases with Sufficient Data Available	Average Number of Days to Resolution	Median Age (Days) at Which Cases are Resolved
Case Dismissed or Denied	33	419	258
Petition Voluntarily Withdrawn	10	181	97
Repayment or Rehabilitation Plan Approved	7	517	418

As of November 1999, the average age of the thirty cases still unresolved exceeded 580 days. The average age of the twenty cases filed before 1999 and remaining unresolved exceeded 700 days as of November 1999.

The relatively high number of cases where the petition was withdrawn or dismissed comports with the general perception that some debtors file suspension of payments cases as a means of leveraging a settlement with creditors. It further provides some evidence that while the SEC can dispose of blatantly insufficient petitions within a reasonable time period, it has greater trouble resolving cases where the documentation is more voluminous, the issues more complex, and the parties more vocal and contentious.

Effect of Insolvency Proceedings on the Efficiency and Welfare of Creditors and Debtors: Response to Specific Criteria

Issue	Response
Criteria for a reorganization decision and its effect on the economic value of the firm.	<p>The SEC has not published any specific criteria for a reorganization decision. Nevertheless, these proceedings have been characterized as geared toward protecting the debtor. Further, the SEC does not require any formal vote by the creditors as a prerequisite to a reorganization decision.</p> <p>Without clear and enforced deadlines, proceedings often times drag out for several years or more during which time the value of the firm in the proceedings drops markedly.</p>
Process of drawing up reorganization plans and its effect on the relative bargaining position of stakeholder.	<p>The debtor and the interim rehabilitation receiver draw up a plan.</p> <p>This, along with the reluctance of the SEC to dismiss cases and order a liquidation, adds to the bargaining position of shareholders, owners, and management <i>vis a vis</i> the creditors.</p>

Issue	Response
<p>Corporate governance of the firm during insolvency proceedings and while the firm is in a reorganization process.</p>	<p>When a management committee is appointed, these individuals have usually asserted control over the debtor. Receivers at times assert control and at others are designated as monitors.</p> <p>The lack of clear rules in this area often times have led to disputes between the receiver/management committee and the debtor's management.</p> <p>Further, the lack of a trained cadre of insolvency professionals diminishes the likelihood of effective management during the reorganization process.</p>
<p>Quantum or other rules for the adoption of a plan.</p>	<p>No creditor vote is required.</p>
<p>Cram down</p>	<p>In the sense that the SEC has the right to approve plans despite creditor objections, cram down procedures do exist.</p>
<p>Division of economic values by various stakeholder, particularly among shareholders and creditors.</p>	<p>Often times, plans contemplate the impairment of creditors' claims while allowing shareholders to maintain their equity in the company. This approach could be characterized as violating the principle that creditors be paid before shareholders.</p> <p>Further, the absence of "adequate protection" provisions and the right to vote on a plan apart from secured creditors significantly erodes the bargaining power and hence security of secured creditors.</p>
<p>Any special or favorable treatment of a particular stakeholder such as employees.</p>	<p>None stated, though the desire to avoid liquidation and break-up of the company could be seen as favorable to employees.</p>
<p>Duration of time for the proceedings and their effect on the economic value of the firm as well as welfare of various stakeholder; and statutory limitations on the duration of time for proceedings and their practical effects.</p>	<p>Proceedings can go on for several years or more. The SEC has not established any formal deadlines for terminating this process.</p> <p>Many companies that came under suspension of payments proceedings are no longer operating.</p>

Issue	Response
Course of actions that follow non-adoption of a plan or termination of the proceedings, and their impact on the firm's operation and value as well as on the payoffs to various stakeholder.	The usual course of action is to dismiss the petition, thereby allowing creditors to act unilaterally to enforce their claims. Recently, in one case, the SEC ordered the debtor's liquidation.
Availability and convenience of the sale of assets, operations, or the firm itself to a third party during insolvency proceedings.	This is theoretically available. Such sales, however, are somewhat hampered by the lack of clear legal basis for the SEC actions during these proceedings.
Impact of the start of insolvency proceedings on the behavior of the firm, its creditors, trading partners, and on the value of the firm.	The usual tendency is to struggle for advantage by filing motions at the SEC.
Respective incentives of managers, shareholders, creditors, employees, and the government in facing the insolvency proceedings, including the incentives of some stakeholders to play protracted waiting games or wars of attrition.	Anecdotal evidence indicates that owners use the protracted proceedings to force creditors into a voluntary settlement.
Industrial policy and other policy concerns of the government facing insolvent firms, the likelihood and the mode of the government's intervention in insolvency proceedings.	<p>The best example of government policy impinging on the SEC proceedings is the case of Philippine Airlines. Though not intervening directly, the Government of the Philippines made it clear that it favored a result that kept the airline intact and flying.</p> <p>On the other hand, government-owned financial institutions have sought to foreclose on debtors that are under suspension of payments proceedings, arguing that their charters, which have the force of law, exempt them from any stays issued by the SEC.</p>

C. Key Aspects for Insolvency Proceedings under the Trial Courts

Although the trial courts of the Philippines remain an avenue for both voluntary and involuntary insolvency proceedings, few if any entities have used this route in recent years. Nevertheless, they are reviewed briefly here.

1. Voluntary Proceedings for Liquidation under the Insolvency Law

Initiation of Proceedings

A corporation may initiate voluntary liquidation proceedings by filing a petition in court.²⁹ Apparently, only the corporation may initiate such proceedings; shareholders have no authority to do so.

The requirements for initiating the proceedings are not particularly taxing. The corporation need only plead that (1) its debt exceeds one thousand pesos, (2) its inability to pay all its debts in full, (3) its willingness to surrender all its property not exempt from execution for the benefit of its creditors.³⁰ As part of its petition, the corporate debtor must include detailed information regarding its assets and liabilities.³¹

Penalties for Delays in Filing

Philippine law has not established any penalties for failure by management to file a petition for involuntary proceedings once a company has become insolvent.

Automatic Stay

With voluntary liquidation proceedings in the Philippines, the stay is not automatic. The law requires the court to issue an order declaring the debtor insolvent. Upon issuance of the order, “all civil proceedings pending against the said insolvent shall be stayed.”³² The law does not appear to allow secured creditors to act unilaterally despite the stay, as is the case with suspension of payments provisions under the Insolvency Law.

Management of the Debtor during Liquidation

The property of the insolvent is initially managed by the sheriff of the municipality in which the debtor is located. The sheriff manages the property until the creditors elect an Assignee.³³

The Insolvency Law requires that the court set a meeting date between two and eight weeks after issuance of the order for purposes of having the creditors elect an Assignee. Notice of the date and time of the meeting is provided by mail and by publication in a newspaper of general circulation.

At the meeting, creditors vote by number and by size of claim. However, secured creditors are allowed to vote for an Assignee only to the extent that they concede that their claims are unsecured.³⁴

In order to be elected, an Assignee needs the support of one half the creditors holding one half the amount owed by the debtor.³⁵ If the creditors fail to elect an Assignee, the court may appoint one.³⁶ Upon the Assignee's appointment, the court is required to convey all the debtor's property to the Assignee.³⁷

Avoidance Powers

Under the Insolvency Law, the Assignee has the sole power to bring an action to set aside a fraudulent transfer.³⁸ The law defines transfers quite broadly. It subjects to scrutiny any transactions made 30 days before filing of the insolvency petition. Transactions specifically mentioned by the law include:

- sales made outside the ordinary course of business.
- seizures made by virtue of a confession of judgment by the debtor.
- sales not supported by adequate consideration.³⁹

At least one commentator has observed that these actions are seldom enforced in the Philippines.⁴⁰

Liability of Managers and Shareholders

Although not specifically mentioned, the Insolvency Law does allow for the possibility of the Assignee to seek restitution against managers of the debtor. The Assignee may bring a claim against anyone who "having notice of the commencement of the proceedings in insolvency, or having reason to believe that insolvency proceedings are about to be commenced, embezzles or disposes of any money, goods, chattels, or effects of the insolvent." The law calls for double damages against such persons.⁴¹

The Insolvency Law also provides for criminal penalties. The primary focus here is on activities that compromise the integrity of the proceedings, such as secreting or transferring assets after insolvency proceedings have begun, or destroying records. Penalties range from three months to five years imprisonment.⁴²

Sale and other Disposition of Assets

The Assignee's duties and powers include selling the assets that have been transferred to him from the debtor.⁴³ The Assignee may sell encumbered property either free and clear (after payment of the claims secured by the property) or subject to existing liens.⁴⁴ Receivables of the debtor may be sold as well, if they cannot be collected without unreasonable delay or expense.⁴⁵

In general, sales of property should be by public auction. The court, however, upon motion, may allow a private sale if it determines that it is in the best interest of the debtor's estate.⁴⁶

Treatment of Claims

The Insolvency Law does not establish a specific deadline by which creditors submit their claims. However, if a creditor wishes to vote for the Assignee, he must submit his claim to the clerk of the court at least two days before the election.⁴⁷ Any interested party may object to any claim of a creditor, so long as he does so at least one day before the election. The court then makes a summary decision to determine whether the challenged creditor has the right to vote.⁴⁸

A late filing creditor may maintain his right to payment so long as sufficient funds remain and that the delay did not result from the creditor's neglect.⁴⁹

The law mandates that disputes over claims prior to the election of an Assignee be settled summarily. But the law requires a full trial to resolve whether a creditor with a disputed claim deserves a liquidation dividend.⁵⁰

Priority of Claims

The Philippine Civil Code establishes the priority of creditors of an insolvent debtor. Article 2241 recognizes numerous types of liens on personal property, including tax liens, mortgages, claims for misappropriation of the property, claims for the purchase price for the property, hotelkeepers liens, claims for transportation, salvage and repair of the property, and crop liens. Article 2242 recognizes various types of liens on real property, including tax liens, mortgages, mechanics liens, and judgment liens.

Proceeds from the sale of property securing claims go to the lienholders of the particular property. Proceeds remaining after these payments go to the unsecured creditors. When the sales proceeds of a particular property are

insufficient to satisfy all the secured claims thereagainst, the Assignee must pay any taxes assessed on the property. The other lien holders share the remaining proceeds *pro rata*.⁵¹

Article 2244 of the Civil Code prioritizes the claims of unsecured creditors, ranking them as follows: claims that would not normally apply to corporations (such as funeral expenses) are not included.

1. Unpaid wages for services rendered to the insolvent by employees, laborers, or household helpers for one year preceding the commencement of the insolvency proceedings (but see Labor Code provisions, below).
2. Compensation due the laborers or their dependents under laws providing for indemnity for damages in cases of labor accident, or illness resulting from the nature of the employment.
3. Fines and civil indemnification arising from a criminal offense.
4. Legal expenses and expenses incurred in the administration of the debtor's estate for the common interest of the creditors, when properly authorized and approved by the court.⁵²
5. Taxes and assessments due the national government, other than those assessed on a particular property.
6. Taxes and assessments due any province, other than those assessed on particular property.
7. Taxes and assessments due any city or municipality, other than those assessed on particular property.
8. Damages for death or personal injuries caused by a quasi-delict (i.e., an unintentional tort claim).
9. Gifts due to public and private institutions or charities.
10. Credits that, without special privilege, appear in (a) a public instrument or (b) in a final judgment, if they have been the subject of litigation.⁵³

Unsecured claims falling outside one of the above classes do not enjoy a preference.⁵⁴ They receive payment *pro rata* from remaining proceeds without reference to date of claim.⁵⁵ Shareholders are then entitled to payment according to the Corporation Code if any proceeds remain.

Finally, it is worth mentioning that Article 110 of the Labor Code seems to contradict the above order of payment:

In the event of bankruptcy or liquidation of an employer's business, his workers shall enjoy first preference as regards wages due them for services rendered during the period prior to

the bankruptcy or liquidation, any provision of law to the contrary notwithstanding. Unpaid wages shall be paid in full before other creditors may establish any claim to a share in the assets of the employer.

A series of Supreme Court decisions, however, clearly indicate that this provision establishes a preference only *vis-à-vis* other unsecured creditors.⁵⁶ The provision does appear, however, to eviscerate the Civil Code's one year limit on back wages as a preferred claim.

Dissolution of the Corporate Debtor

The Insolvency Law fails to give any guidance on the legal fate of a corporation after its property has been sold and its claims have been paid off to the extent possible. Indeed, the Insolvency Law states that a corporate debtor, unlike an individual, does not have the right to a discharge of its debts.⁵⁷

Although the Corporation Code contains provisions whereby a corporation may be formally dissolved, it fails to contemplate such a dissolution within the context of a proceeding under the Insolvency Law.

2. *Involuntary Liquidation under the Insolvency Law*

Proceedings for involuntary liquidation are very similar to those for voluntary liquidation. The primary difference involves the basis for initiating the proceedings. This section will thus focus on this aspect alone.

Initiation of Proceedings

Involuntary proceedings are initiated by a petition of three or more creditors who are residents of the Philippines.⁵⁸ The creditors must file the petition in the court where the debtor is located and must allege an aggregated indebtedness of at least one thousand pesos. A creditor that has obtained a claim by assignment within thirty days of a filing is not entitled to initiate a case.

The petition must allege at least one act of insolvency, a list of which is set forth in the Insolvency Law. The ones applicable to corporations (as opposed to individuals) appear below:

- Concealing or removing its property to avoid attachment or seizure.

- Allowing its property to remain under attachment or legal process for three days for purposes of hindering, delaying, or defrauding creditors.
- Willfully allowing, or offering to allow, a judgment in favor of any creditor for purposes of hindering or delaying or defrauding any other creditor.
- Allowing property to come under attachment or legal process for purposes of hindering or delaying or defrauding creditors.
- Transferring property with the intent of defrauding creditors.
- Transferring property in contemplation of insolvency.
- Defaulting on payments on current obligations for more than thirty days.
- Failing to pay moneys held in a fiduciary capacity within thirty days of demand.
- Failing to have property subject to execution sufficient to satisfy a judgment.

The creditors must also post a bond, the amounts to be set by the court, to compensate the debtor if the petition is dismissed.

Initial Court Action

Upon receipt of a petition, the court must issue an order to the debtor to show cause as to why he should not be adjudged insolvent. The order should set a time and place for a hearing on this issue. Further, if necessary, the order may also enjoin the debtor from paying any debts or transferring property.⁵⁹

After issuance of the order, the proceedings begin to resemble those in typical civil procedure. The debtor is served a summons and may attack the petition on grounds of law or fact. Factual disputes are to be identified and resolved through trial. If the court dismisses the petition, petitioning creditors may be found liable for the costs incurred by the debtor.⁶⁰

If the debtor defaults or fails to prove his solvency, liquidation proceedings begin, in a manner nearly identical to those for voluntary insolvency proceedings.

3. *Composition in the Context of an Insolvency Proceeding*

The Insolvency Law allows a debtor to attempt to arrange a composition with his creditors after he has filed an inventory of his property and the list of his creditors. No application for confirmation of a composition may be filed unless it has the support, in writing, of a majority of the creditors whose claims have been allowed.⁶¹

After a hearing on the matter, the court is required to confirm the composition if it is satisfied that (1) it is in the best interest of the creditors, and (2) its offer and acceptance are in good faith.⁶²

The Insolvency Law, however, fails to state whether the confirmation of a composition has the effect of binding non-participating creditors. Although the Supreme Court does not appear to have ruled directly on this point, at least one case indicates that such compositions have no such binding affect.⁶³

4. *Statistics and Anecdotal Evidence*

Definitive statistics on the number of proceedings under the Insolvency Law nationwide are difficult to obtain. A survey of several regional trial courts in the Manila metropolitan region (among the busiest dockets for corporate cases in the country) reveals the following.

Regional Trial Court	Period Covered	Number of Cases Filed	Average Number of Cases Filed Per 12 Month Period
Makati	January 1998 to October 1999	3	1.6
Pasig	January 1994 to October 1999	9	1.5
Manila	January 1996 to October 1999	5	1.3
Pasay	January 1998 to October 1999	4	2.2

Review of the pleadings from some of these cases, and discussions with court officials reflect a mixed record in terms of actual practice. For example, the sheriffs taking possession of the property after a declaration of insolvency are not bonded. This has lead some creditors to voice concerns about the property's safekeeping. In another example, a court-appointed Assignee had yet to post a

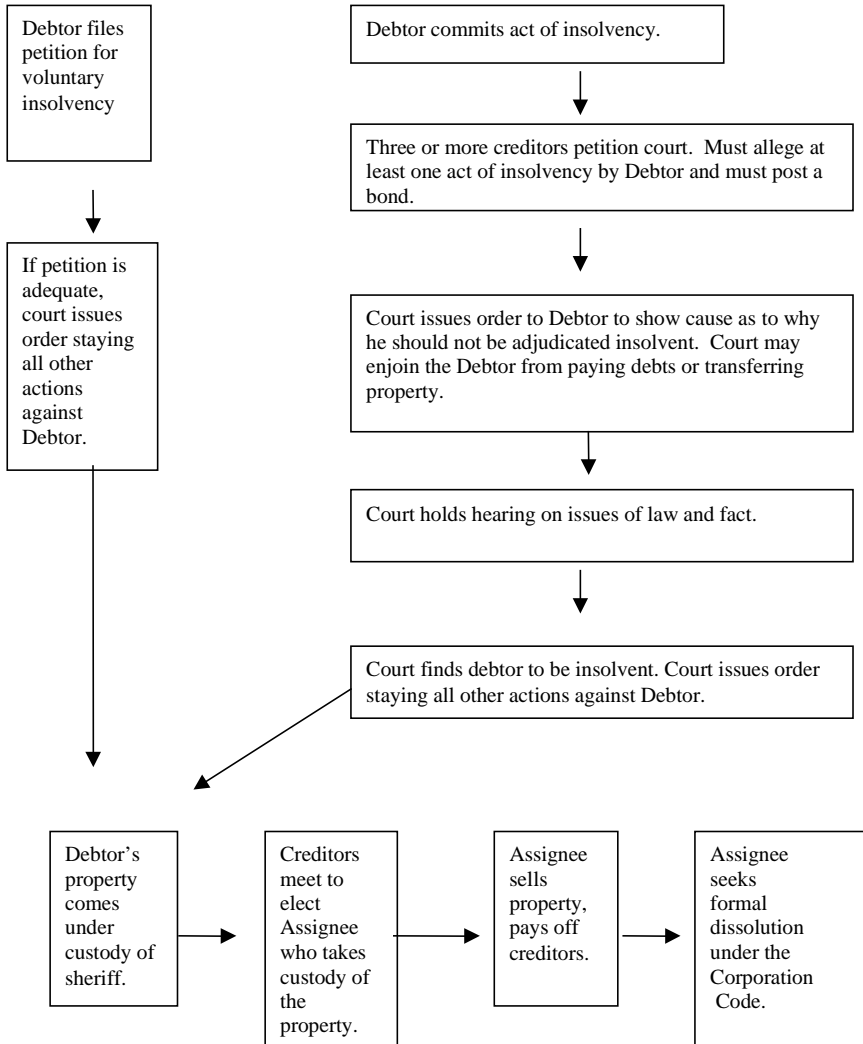
bond and take possession of the property despite being appointed more than a year earlier.

Effect of Insolvency Proceedings on the Efficiency and Welfare of Creditors and Debtors: Response to Specific Criteria

Issue	Response
Criteria for a reorganization decision and its effect on the economic value of the firm.	Not applicable.
f drawing up reorganization plans and its effect on the relative bargaining position of stakeholder.	Not applicable.
Corporate governance of the firm during insolvency proceedings and while the firm is in a reorganization process.	Not applicable.
Quantum or other rules for the adoption of a plan.	The primary means by which the creditors are involved in plan formulation is through their initial involvement in electing the Assignee. If the creditor is secured, he does not have the opportunity to vote.
Cram down.	Not applicable.
Division of economic values by various stakeholder, particularly among shareholders and creditors.	Insolvency proceedings clearly favor creditors as they are paid before shareholders. They also favor secured creditors because their liens either are paid from proceeds of the sale or follow the property to the new purchaser. However, the Civil Code rule requiring senior and junior lien holders to share pro rata is very problematic.
Any special or favorable treatment of a particular stakeholder such as employees.	Employees are paid first among the unsecured creditors for all back wages.
Duration of time for the proceedings and their effect on the economic value of the firm as well as welfare of various stakeholder; and statutory limitations on the duration of time for proceedings and their practical effects.	There does not seem to be many statutory obstacles to a quick resolution of these proceedings. In practice, however, such proceedings could take a significant amount of time.

Issue	Response
Course of actions that follow non-adoption of a plan or termination of the proceedings, and their impact on the firm's operation and value as well as on the payoffs to various stakeholder.	Not applicable.
Availability and convenience of the sale of assets, operations, or the firm itself to a third party during insolvency proceedings.	This is available.
Impact of the start of insolvency proceedings on the behavior of the firm, its creditors, trading partners, and on the value of the firm.	There appears to be some dispute as to whether the debtor's operations need to be shut down during the insolvency process.
Respective incentives of managers and shareholders, various creditors, employees, and the government in facing the insolvency proceedings, including the incentives of some stakeholder to play protracted waiting games or wars of attrition.	One of the major drawbacks to the Insolvency Law is the lack of incentives for individuals to use it. Often times, nearly all the debtor's property has been pledged. Because unsecured creditors are likely to receive very little in such cases, they have little incentive to initiate a proceeding.
Industrial policy and other policy concerns of the government facing insolvent firms, the likelihood and the mode of the government's intervention in insolvency proceedings.	There exists an assumption among policy makers and judges that liquidation means the loss of jobs and rehabilitation means the saving of them. This is not necessarily true and should be reconsidered.

5. *Diagram of Proceedings before the Regional Trial Courts*



V. Markets for Ailing Firms and Their Assets

A. *Markets for the Assets of Financially-Troubled Firms*

In general, see Section III.E of this report. Other than the Philippine Deposit Insurance Corporation (which acts as the receiver / liquidator of closed banks), there is no government agency or state-owned enterprise specializing in acquiring and selling the assets of bankrupt or otherwise financially troubled firms.

B. *Markets for the Assets and Shares of Firms During Insolvency Proceedings or Reorganization*

The markets for real estate assets of such firms are well developed. Likewise, the market for shares would likely be reasonably well developed if the company is publicly traded.

VI. Informal Insolvency Proceedings

A. *Workouts*

Partly due to the perceived shortcomings of the formal insolvency procedures at the SEC, and the difficulty of acting unilaterally to collect debt by means of the courts, banks and other creditors have actively undertaken workouts as a means of resolving problem loans. This practice is discussed below.

1. *Legal Basis*

The Philippines has no specialized legislation for initiating and finalizing workout negotiations. The basis for a workout is a contract between the debtor and its creditors. Usually the creditors will negotiate a group agreement with the debtor with a set of unified obligations. This then replaces the individual loan agreements by means of a novation.

These agreements usually modify the loan arrangements concerning payment schedules, the capitalization of overdue interest, and the rate of interest going forward. Very often, these obligations are secured by pledges of the debtor's property (which is a significant benefit for creditors who had previously been unsecured).

2. *Key Players*

The key players in a workout are primarily the banks and the debtor itself. The government usually does not involve itself directly. Debtors, however, sometimes petition the government for favorable regulatory treatment in order to improve future performance so as to facilitate a loan restructuring and avoid a bankruptcy.

3. *Relationship Between Workouts and Formal Insolvency Proceedings*

Creditors have traditionally preferred workouts to suspension of payments proceedings at the SEC. As described above, the SEC has been criticized for its lengthy proceedings and its pro-debtor bias. This perception may change, however, with the passage of the new Rules of Procedure on Corporate Recovery.

Anecdotal evidence suggests that debtors use the threat of filing a suspension of payments petition to obtain concessions from creditors during workout negotiations.

B. *Composition Agreements*

As noted above, a new agreement between the debtor and its creditors is the usual result of a successful debt restructuring effort. This agreement could contemplate a debt rescheduling, the offer to secure unsecured loans, the surrender of property securing a loan followed by its lease back to the debtor, a debt-equity swap, or the commitment of a debtor to sell non-core assets to raise cash for debt servicing. They are not binding on parties who refuse to join the agreement.

For a description of three workouts and their results, see Appendix 1.

VII. General Information on Bank Insolvency Regimes

A. *General Description*

The task of responding to bank insolvency rests with both the BSP (i.e., the Central Bank) and the Philippine Deposit Insurance Corporation (PDIC).

The Central Bank Act contemplates the appointment of a conservator or the appointment of a receiver depending on the financial circumstances at the bank in question. The body within the BSP that makes these decisions is the Monetary Board, which is headed by the Governor of the BSP.

Conservatorship

If it comes to attention of the Monetary Board that a bank is unable or unwilling to “to maintain a condition of liquidity deemed adequate to protect the monetary interests of the depositors and creditors” the Board may appoint a conservator to take over the bank’s operations. The conservator serves until the Board determines that the bank can operate on its own or until the Board determines that the bank’s continuance in business would result in losses to its depositors or creditors. In any case, the term of the conservatorship should not exceed one year.⁶⁴

The conservator should be skilled in bank management. He or she may be connected with the BSP, but cannot be paid by the BSP during that period. The conservator’s salary is set at 2/3 of that of the president of the bank in question and is paid out of the bank’s funds.

Proceedings in Receivership or Liquidation

The Monetary Board may order a bank shut down and appoint the Philippine Deposit Insurance Corporation as a receiver under the following circumstances:

- The bank is illiquid (provided that the illiquidity is not caused by a financial crisis in the banking community).
- The bank is insolvent.
- The bank cannot continue in business without involving probable losses to its depositors or creditors.
- The bank has willfully violated a cease and desist order.⁶⁵

The PDIC-receiver supplants the management of the bank, taking charge of its assets and liabilities and representing it personally for the benefit of the bank’s creditors. The appointment of the receiver renders exempt all property of the bank from garnishment, attachment, or other collection proceedings.⁶⁶

Within ninety days of the receiver's appointment, the Monetary Board determines whether the bank can be rehabilitated or whether it needs to be liquidated. Liquidation entails the appointment of a liquidator, the approval of a liquidation plan, and the filing of a formal liquidation proceeding at the regional trial court. The priority claims in such liquidations is determined by the Civil Code's general rules on preference and concurrence of creditors (see Section IV.C.1 of this report).

B. Resolution of Bank Insolvency in Practice

Observers have described the process of closing and liquidating banks to be somewhat slow but sufficient. More problematic is the actual decision to initiate the process. For reason of legal repercussion and systemic risk, bank regulators have been reluctant to act as forcibly and as quickly as some critics would want.⁶⁷

Bank Closures and Liquidation 1993-1997

	1993	1994	1995	1996	1997
Initiation of Receivership (bank closure)	4	16	9	6	14
Initiation of Liquidation	12	0	11	0	25

Source: Philippine Deposit Insurance Corporation, 1997 Annual Report

In 1998, 22 banks were closed by the BSP.⁶⁸

VIII. Problems, Future Tasks, and Trends

A. The Problems

There is an almost universal consensus that the current Philippine framework for resolving corporate insolvency is lacking. The problems came to fore in connection with the financial troubles of Philippine Airlines (PAL), which filed a petition at the SEC in 1998 for suspension of payments and the appointment of a rehabilitation receiver.

Thereafter PAL sought protection from the unilateral actions of American creditors in United States bankruptcy court on grounds that the Philippine insolvency proceedings were underway. This led to a series of pleadings and hearings where various creditors contested the motion of PAL on grounds that the proceedings in the Philippines provided inadequate protections to creditors.

These disputes, which, in effect, put the Philippines insolvency system on trial, appear to have been settled (most of the motions in US courts have been withdrawn). Nevertheless, they raised significant concerns about the state of the Philippine framework for insolvency and whether it was adequate in a rapidly globalizing economy.

While the problems in any legal system are the results of a complex combination of factors, it is safe to identify three areas where reform is needed. In the immediate term, the SEC needs to improve its own procedures for resolving suspension of payments cases under P.D. 902-A. On a longer-term basis, the Philippines needs to address the legislation underlying its insolvency efforts. To this end, several members of the Philippine Congress have called for new insolvency legislation. Finally, the Philippines needs to determine whether the SEC should remain the forum for resolving corporate insolvency or whether this task should be transferred to a specialized court or returned to the regional trial courts.

These issues are discussed below.

B. Reform of the SEC Regulations for Handling Suspension of Payments Cases

The SEC has begun the effort to improve its internal regulations regarding corporate insolvency. In August 1999, after several months of drafting and deliberation, the SEC circulated its Rules of Procedure for Corporate Recovery (“Rules”) to the public for review and comment. This circulation, as well as two public hearings on the Rules, generated a significant amount of input on how the Rules could be modified. As of the time of the completion of this report, the SEC was still considering various amendments and options regarding the Rules.

The Rules provide detailed regulations on two avenues of debt relief that had developed under the SEC. Rule III of the Rules governs petitions for suspension of payments and rescheduling of debts. Rule IV governs petitions for corporate rehabilitation. The Rules also establish the means by which a company would be liquidated were the effort to reschedule debts or rehabilitate the debtor fail.

Because the Rules were still undergoing review and revision, a detailed review of their provisions would be premature. Instead, on the next several pages is an outline of the key provisions in Rule III (Suspension of Payments) and Rule IV (Rehabilitation).

Outline of Suspension of Payments and Rehabilitation Procedures in the Proposed Rules on Corporate Recovery

(References are to the particular Rule and Section respectively)

Action Issue	Suspension of Payments	Rehabilitation
Filing Requirements	<p>Debtor is illiquid but solvent (III-1)</p> <p>Debtor must provide financial information as well as a proposed repayment schedule (III-2). Failure to file documents does not preclude issuance of an order staying the actions of creditors.</p>	<p>Debtor is insolvent (IV-1).</p> <p>Similar to suspension of payments, but a rehabilitation plan replaces the repayment schedule (IV-2).</p> <p>Rehabilitation plan may be submitted within 60 days after the filing (IV-14).</p> <p>Evidence of fraud known by debtor precludes filing (IV-3).</p>
Who may file?	Only Debtor.	Debtor, shareholders or creditors (IV-1).
Effect of Filing	<p>SEC issues order suspending all actions and any disposal of property without SEC approval for 30 days (III-4).</p> <p>Extensions allowed up to six months (III-4) from the time of filing.</p>	<p>SEC issues order suspending all actions and any disposal of property without SEC approval for 60 days (IV-4).</p> <p>Extensions allowed every 30 days upon SEC approval (IV-9). Extensions beyond 180 days allowed with creditor approval or SEC override (IV-9).</p>
Receiver, Committee or Other Trustee to Represent Creditors	<p>Oversight Committee consisting of three individuals, one representing secured creditors, one representing unsecured creditors and one representing the SEC.</p> <p>A Management Committee may be appointed when there is evidence of abuse by current management (III-17). The Management</p>	<p>Interim Rehabilitation Receiver (IV-4). Method of compensation is same as that of Management Committee member (IV-12).</p> <p>Interim Rehabilitation Receiver recommends when Debtor may dispose of assets.</p> <p>Management Committee is allowed when there is evidence of abuse by current management (IV-23).</p>

Action Issue	Suspension of Payments	Rehabilitation
	Committee has greater control of the debtor (III-17).	
Schedule for Determination of Fate of Company	Initial hearing within 20 days of date of filing (but delay likely if there are problems with service on all creditors or if creditors object to petition) (III-5). Automatic dismissal after eight months if SEC does not issue order (III-8).	Initial hearing within 20 days of date of filing (but delay likely if there are problems with service on all creditors or if creditors object to petition) (IV-5). Last possible date for hearing not stated.
Input of Creditors	May file oppositions or comments to the petition (III-6). No voting allowed.	SEC may not approve plan if majority of unsecured creditors and secured creditors (counted separately) oppose it. But approval allowed if the opposition is manifestly unreasonable (IV-16).
Affect of Order	Debt moratorium for up to two years on all debts. No debt reductions apparently allowed. Order includes lessors as well. (III-8). After the debt moratorium expires, repayments resume according to an SEC approved payment schedule (which may take several years to fulfill).	Not stated.
Conversion of Case to Other Action?	SEC may convert case to rehabilitation up through the end of the two-year moratorium (III-12, III-13).	To liquidation upon failure to submit plan or if plan fails to meet goals (IV-21).

From an efficiency perspective, one of the more controversial questions regarding the Rules is the need for two separate routes for corporate reorganization. Prior case law and the underlying legislation may explain much of this. However, to the extent possible, it would be optimal if the Rules were to minimize the possibility of a debtor first seeking suspension of payments and thereafter switching to rehabilitation as a stalling tactic.

Another controversial area is the right of the creditors *vis a vis* the SEC to decide whether a debt moratorium or rehabilitation plan is justified. The proposed Rules allow no creditor vote in connection with approval of a suspension of payments order. With regard to rehabilitation, the proposed Rules allow the SEC to override the creditors' objections if it determines that they are manifestly unreasonable.

A creditor-driven determination on company reorganization is more likely to arrive at a commercially correct solution. However, the introduction of creditor voting adds to procedural complexity and increases the likelihood of dispute and litigation. A regulator-driven determination, by contrast, avoids procedural complexity but is less likely to arrive at a conclusion in line with the primary stakeholders, i.e., the creditors. As currently formulated, the proposed Rules lean toward a regulator-driven determination.

C. Legislative Reform

The legislation that shapes the insolvency process in the Philippines includes the Insolvency Law, P.D. 902-A, the Civil Code, and to a certain extent, the Corporation Code. This patchwork of legislation is contradictory in places and is lacking in coverage in others. Indications are that efforts to draft legislation that would address these concerns will begin soon. However, such legislation is not expected to become law for several years. Reform at the SEC thus becomes crucial as an interim measure.

D. Choice of Forum

It has been said that the Philippines is unique in having an administrative agency adjudicate corporate reorganizations. While the SEC has been viewed as a superior forum to the regional trial courts for these types of cases, observers both from inside and outside the SEC recognize that this arrangement is far from perfect. One suggestion raised has been the creation of commercial court, which would handle insolvency cases, among other commercially complex disputes. But, as with legislative reform, this solution is likely several years away.

Appendix 1

Brief Descriptions of Three Workout Efforts in the Philippines⁶⁹

CASE A: A corporation and its wholly-owned subsidiary (the “Companies”) accumulated debts to twenty four different creditor banks in the amount of roughly Two Billion Six Hundred Million Philippine Pesos (PHP2,600,000.00). The assets of the Companies however amounted to over Three Billion Philippine Pesos (PHP3,000,000,000.00) although a majority of the assets were in the form of raw undeveloped land, some of which were subject to a joint venture agreement with two other developers. Out of the twenty-four creditor banks, only three were fully secured. The rest of the creditor banks were either unsecured or only partially secured (the “Unsecured Banks”). The Companies, hoping to reduce their level of debts which will allow them to continue their operations and at the same time service their loans, made the following proposal to their creditor banks: the Companies would enter into *dacion en pago*⁷⁰ arrangements over their unencumbered real estate properties with their creditor banks and restructure the remaining debts with the Unsecured Banks. At a creditors’ meeting called by the Companies, they offered to enter into a collateral trust agreement in which the Companies would create a first mortgage over their unencumbered real estate properties and chattels and a second mortgage over its previously encumbered real estate properties and chattels. The principal stockholders of the corporation were also to execute a joint and several suretyship in favor of the Unsecured Banks. While the terms of the agreement between the Companies and the Unsecured Banks were to be negotiated, the Unsecured Banks were not to bring any suit against the Companies for defaulting on their loans. A Memorandum of Agreement to refrain from filing suit was distributed to the Unsecured Creditors.

Only eight banks from the Unsecured Banks (the “Consortium”) signaled their intention to restructure the Companies’ debts in exchange for security on their unsecured or undersecured loans. Protracted negotiations ensued between the Companies and the Consortium to come up with a mutually acceptable Term Sheet. Some of the terms agreed upon by the parties were that the restructured loans were to have a term of seven years with a two-year grace period on the principal repayment. There will also be a two-year grace period on the interest.

The Consortium engaged the services of external counsel to draft an omnibus agreement that would contain the restructuring of the loans, the collateral trust agreement, and the joint and several suretyship agreement, among others, and which was to be subsequently reviewed by the legal counsel of the Companies.

A significant feature of the omnibus agreement is that it allowed any of the other Unsecured banks who were not members of the Consortium to adhere to the terms of the agreement within a certain period of time from the signing of the omnibus agreement.

The Companies and the Consortium eventually signed the omnibus agreement. However, to date, the Consortium has not been able to annotate the mortgage created in the appropriate Register of Deeds because the parties cannot agree on the valuation to be used for the properties which will secure the obligation of the Companies.

CASE B. A publicly-held corporation accumulated debts, in the form of short term loans, of roughly Three Billion Pesos (PHP3,000,000,000.00) with around twelve (12) creditor banks, all of which were unsecured. The company experienced some liquidity problems and was thus unable to pay the loans as they became due. The company and the creditor banks executed a Memorandum of Agreement wherein they agreed that the company was to execute a mortgage trust indenture in favor of the creditor banks and that for a period of one year, the creditor banks would not bring suit against the company for collection of its loans.

During the one year period, the company presented a rehabilitation plan to the said creditor banks. The company and the creditor banks agreed on the terms of the rehabilitation plan and eventually executed an omnibus agreement. Some of the features of the omnibus agreement are that some of the short term loans of the company were converted into long term loans while others were made into convertible loans with a ten-year maturity. Interest on these convertible loans would also be paid only upon maturity. For the long-term loans there was a moratorium of interest for the first two years. Further, a grace period of principal of three (3) years was agreed upon by the parties.

The whole process took over a year and a half to complete. However, two of the creditor banks who had signed the memorandum of agreement refused to sign the omnibus agreement and have threatened to file a collection suit against the company. The total exposure of these two creditor banks amounts to about two percent of the total loans of the company.

CASE C: In an informal work-out involving one of the Philippines' biggest mining companies, a business plan was worked out by the debtor with its

creditors composed of loan and foreign banks. During the work-out the creditors were advised of certain weaknesses in their security and were thus given additional security by the debtor. In this work-out, the local banks appear to be more receptive than the foreign banks to the work-out which was believed to have been brought about by the inadequate loan-loss provisioning of these local banks.

Addendum:

THE RULES OF PROCEDURE ON CORPORATE RECOVERY

A. Introduction

On 21 December 1999, the SEC approved the Rules of Procedure on Corporate Recovery (“Rules”). They formally went into effect on 15 January 2000. The Rules purport to carry out the objectives of PD 902-A and “to assist the parties in obtaining a just, expeditious and inexpensive settlement of cases.”⁷¹

The Rules establish two avenues for formal reorganization proceedings: Suspension of Payments (Rule III) and Rehabilitation (Rule IV). The Rules also establish procedures for appointing a Management Committee (Rule V) and for Liquidation (Rule VI).

This addendum will provide a general overview of each of these procedures under the new Rules.

B. Suspension of Payments: A Temporary Respite for Distressed Companies

Under Rule III of the Rules, a company may petition the SEC to be declared “in the state of suspension of payments.” The procedures are relatively simple. The goal is to give solvent but temporarily illiquid companies a short break from creditors in order to reestablish their financial health.

A company may initiate suspension of payments proceedings by filing a petition at the SEC. The petition must allege the company's solvency (i.e., that its assets exceed its liabilities) and "the existence and nature of the temporary cause of its inability to meet its obligations." The petition must be accompanied by specific documents enumerated in the Rules.⁷²

After the petition is filed, the Rules require the SEC to issue an order suspending all court actions against the petitioner for thirty days. The order must prohibit the debtor from transferring or encumbering property without SEC approval.⁷³

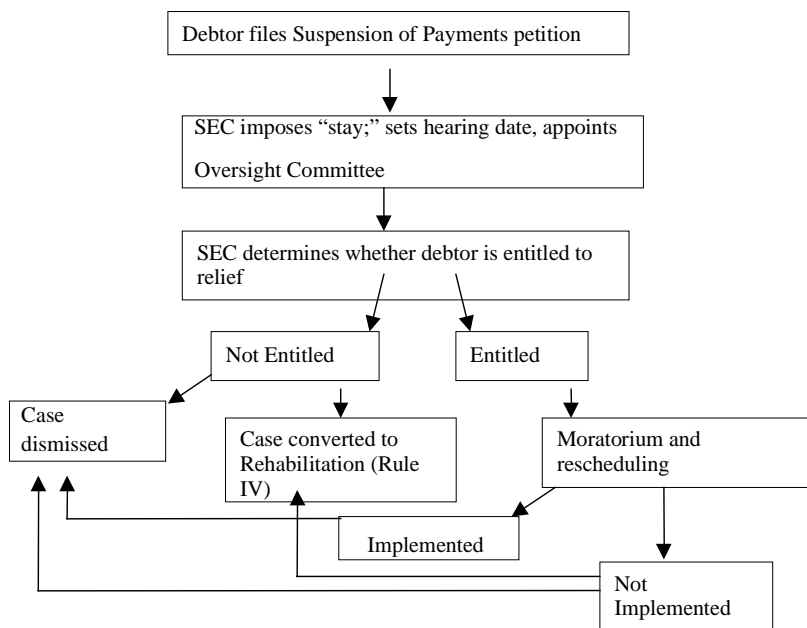
Within twenty days of the petitioner's filing, the SEC is required to hold a hearing on whether the debtor is entitled to relief. The relief contemplated by the Rules is a debt moratorium (for up to as long as a year) followed by a repayment schedule approved by the SEC. Before the hearing, creditors have the opportunity to submit comments on the debtor's petition.

The Rules are not completely explicit as to the criteria for determining whether the debtor is entitled to relief. The Rules suggest that the debtor needs to show that its assets exceed its liabilities, but that it cannot meet its current obligations as they come due.⁷⁴ The debtor, however, must show that this inability will last less than a year, i.e., that within this period it will be able to resume payments on all its obligations. Otherwise, the debtor will be considered technically insolvent and the case will be dismissed or converted to rehabilitation.⁷⁵

During the time the debtor is under Suspension of Payments proceedings, the Rules contemplate that an "Oversight Committee" will monitor the debtor. The Committee ensures "that the assets and business of the debtor are conserved while a suspension order is in effect."⁷⁶ The members of the Oversight Committee, consisting of a representative of the secured creditors, the unsecured creditors, and a representative of the debtor, are entitled to attend meetings of shareholders and the board of directors. They are allowed access to financial information of the debtor, particularly information on the debtor's transactions.⁷⁷

The Rules provide for termination of the proceedings when the debtor has paid back its obligations according to the repayment schedule approved by the SEC.⁷⁸

A diagram of Suspension of Payments proceedings under the Rules is set forth below.



C. Rehabilitation: Longer Term Restructuring with Creditor Input

Under Rule IV of the Rules, a debtor whose liabilities exceed its assets or who is considered “technically insolvent” (unable to meet obligations in full during the coming year) may petition the SEC to be placed under rehabilitation.⁷⁹ The procedures somewhat resemble those for Suspension of Payments, modified to allow for creditor input into the process and to allow the possibility of petitions for adequate protection by secured creditors.

A debtor may initiate proceedings by filing a petition with the SEC. While it is contemplated that most petitions will be filed by debtors, the Rules allow creditors or shareholders to file a petition on the debtor’s behalf.⁸⁰

The petition should set forth the causes of the debtor’s insolvency and methods by which the debtor will regain financial stability.⁸¹ The documents that must accompany the petition are the same as those required under Suspension of

Payments proceedings, except that the debtor must attach a rehabilitation plan to his petition rather than a repayment schedule.

Upon receipt of a petition, the SEC is required to issue an order appointing an Interim Receiver, suspending court actions against the debtor, and prohibiting the debtor from transferring or encumbering any of its assets outside those normally treated in the ordinary course of business. The debtor is required to serve the petition and the order on all creditors along with notification that additional documents (for instance, the rehabilitation plan) may be obtained from the Interim Receiver.

Within forty-five days of the issuance of the order, the SEC must hold an initial hearing on the petition where the SEC will consider any motions to have the petition dismissed outright. Grounds for dismissal include, among others, the insufficiency of the petition in form or substance, willful misrepresentation of facts, and non-feasibility of the debtor's rehabilitation.⁸² Given the difficulty in proving such grounds, however, it is unlikely that the SEC will dismiss any but the most inadequate petitions at this point in the proceedings. Rather, the time of reckoning for the debtor comes when it attempts to gain support from the creditors in approving the plan.

Creditor support for the plan becomes crucial under the Rules. The Rules prohibit the SEC from approving a plan if either the secured creditors or unsecured creditors, counted by size of claim, oppose the plan.⁸³

If a creditor class opposes the plan, however, the SEC, on motion, may approve the plan, provided that it finds that the objections of the opposing class or classes are "manifestly unreasonable". The plan shall be deemed ipso facto disapproved if the SEC fails to override the creditors within thirty days from the time the plan is submitted for approval.⁸⁴

If opposition to a plan is not overridden, the case is converted to Liquidation proceedings under Rule VI. Further, a case will be converted to Liquidation proceedings if no plan has been approved within 180 days from the issuance of the suspension order, and the creditors refuse to allow an extension beyond this time period.⁸⁵

If the SEC approves a plan, it must issue an order imposing "such terms, conditions or restrictions as the effective implementation and monitoring thereof shall reasonably require".⁸⁶ Further, the SEC is required to appoint a Rehabilitation Receiver (unless the plan calls for a different arrangement).

One of the most important aspects of approval of the rehabilitation plan is the binding effect it has on creditors. An approved plan suspends creditors' claims

against the debtor, allowing payments only according to the plan. While contracts of the debtor with its creditors remain in effect, they “shall be interpreted . . . insofar as they are not in conflict with the provisions of the plan.”⁸⁷ The Rules, in essence, establish that the rehabilitation plan acts as a partial novation of the debtors’ contractual obligations with its creditors. Debts that arise after approval of the plan are not subject to the SEC’s suspension order.

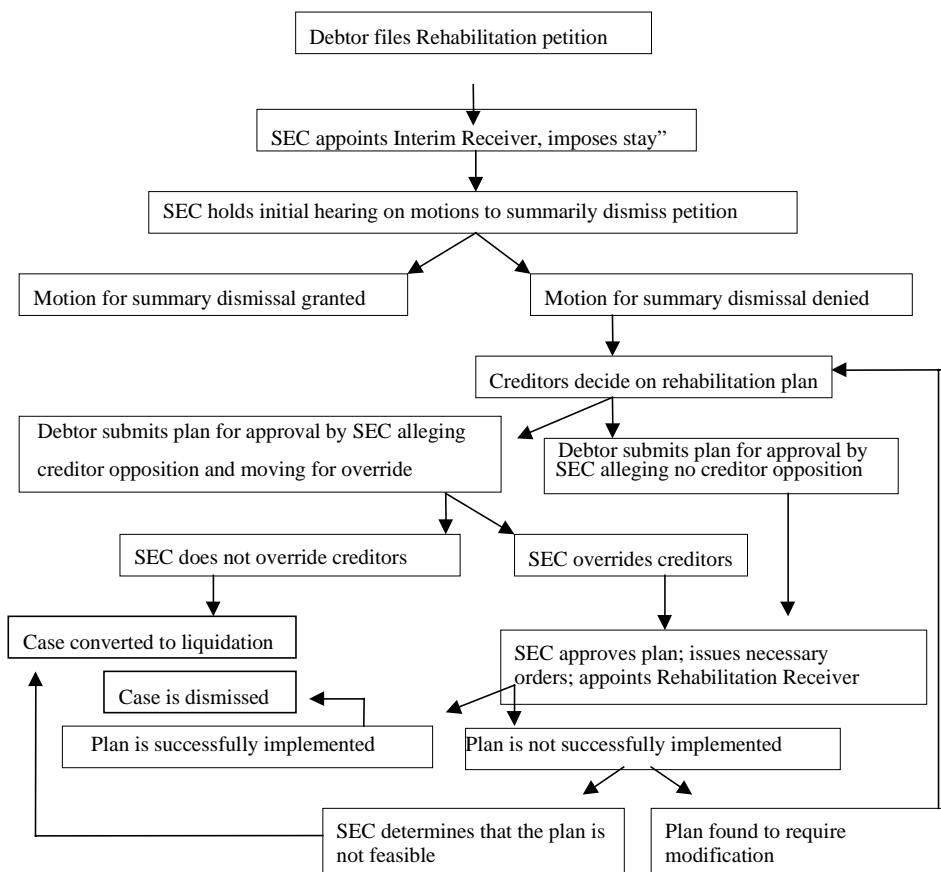
If the plan is implemented fully, the SEC must dismiss the case. If the debtor fails to meet the obligations under the plan, the SEC may consider modifications thereto. Such modification, however, must not be opposed by the creditors.⁸⁸

Throughout the Rehabilitation proceedings, a receiver acts as “an officer” of the SEC, assisting in moving the proceedings forward. Before approval of the rehabilitation plan, the Interim Receiver plays this role. The Rules set forth a detailed list of the powers and functions of the Interim Receiver.⁸⁹ They can be collapsed, however, into three basic functions: (1) monitoring the debtor’s management, (2) assisting in the preparation of a rehabilitation plan, and (3) facilitating creditor participation in the rehabilitation proceedings.

After approval of the plan, the SEC appoints a Rehabilitation Receiver, whose primary task is to monitor the plan’s implementation. He serves until the plan is deemed fully implemented.

An additional safeguard in this process is the concept of adequate protection. The Rules allow a secured creditor to petition the SEC for relief where the debtor is failing to take commercially reasonable steps to protect the property securing the creditor’s claim or where depreciation is increasing the extent that the debtor is under secured. In the former case, the SEC may order the debtor to take steps necessary to protect the property, such as providing adequate insurance or maintenance. In the cases where depreciation is the problem, the SEC may allow offsetting payments or the pledging of additional collateral. The SEC, however, may deny such a request if it determines that such remedies would “prevent the continuation of the debtor as a going concern or otherwise prevent the approval and implementation of a Rehabilitation Plan.”⁹⁰

A diagram of Rehabilitation proceedings under the Rules is provided below.



D. Establishment of a Management Committee: When Current Management Needs to Be Displaced

Under normal circumstances, the Rules contemplate an Oversight Committee (in Suspension of Payments) or a receiver (in Rehabilitation) to act in a monitoring capacity, with the debtor’s management remaining in control. The Rules, however, provide for a more intrusive administration of the debtor when circumstances indicate that such is necessary to protect the interests of the creditors and the investing public.

Upon agreement of the parties or upon showing of the danger of loss or destruction of assets or paralysis of the debtor's business operations, the SEC may order the creation of a Management Committee. The SEC appoints a representative of the secured creditors (nominated by the seven creditors holding the largest claims in that category), a representative of the unsecured creditors (nominated by the seven creditors holding the largest claims in that category) and a representative of the debtor (nominated by the board of directors).⁹¹

The Management Committee may take custody and control over the assets owned or possessed by the debtor. Further, the Committee is required to displace the management and board of directors of the debtor and "assume their rights and responsibilities to the extent necessary to operate the business of the debtor and preserve its assets and those in its possession."⁹² Within a period of thirty days from appointment, the Committee must recommend whether the proceedings should be continued, terminated or converted to alternative proceedings under the Rules (for instance, from Rehabilitation to Liquidation).

E. Liquidation: Selling Off the Debtor's Assets if a Rehabilitation Fails

Where a rehabilitation effort fails to either be approved or implemented successfully, the Rules contemplate the debtor's liquidation under the auspices of the SEC. This process is rather straightforward, contemplating, under normal circumstances, the closure of the debtor's operations,⁹³ the appointment of a liquidator,⁹⁴ the collection and sale of the debtor's assets according to an SEC-approved liquidation plan,⁹⁵ and the repayment of creditors under the priorities established in the Civil Code.⁹⁶

Perhaps the most novel provision regarding liquidation under the Rules involves a means around the traditional liquidation method of shutting down the company and selling the assets piecemeal. The Rules specifically allow for the transfer of "all or some of the property of the debtor into a newly-created, wholly-owned subsidiary of the debtor, for purposes of continuing the operations of the enterprise or part of it, and selling the shares of the subsidiary in order to pay off the creditors of the debtor . . ."⁹⁷ Such a liquidation technique may encourage the sale of enterprises as going concerns and encourage exchanges of creditors' claims for the shares of the debt-free subsidiary.

F. Initial Conclusions on the Rules

Legal reformers and the banking community in the Philippines had hopes that the Rules of Procedure on Corporate Recovery would bring some predictability to a process that had been characterized as “having no substantive or procedural rules to safeguard the interests of creditors.”⁹⁸ To a significant extent, these hopes have been fulfilled. The Rules provide a much-needed framework for processing and resolving insolvency cases.

Nonetheless, the SEC compromised on creditor rights in several specific areas, most notably regarding adequate protection and “cram down,” two areas where the policies of protecting creditor rights and encouraging reorganizations come into profound conflict. Although the Rules establish standards for determining a secured creditor’s entitlement to adequate protection, the SEC reserves the right to deny such protection even when deserving when granting such would “prevent the continuation of the debtor as a going concern or otherwise prevent the approval and implementation of a Rehabilitation Plan.” Likewise, while the Rules allow a class of creditors to veto the approval of a rehabilitation plan, SEC reserves the right to override such veto (i.e., to cram down the creditors) if it determines that the creditors’ objections were “manifestly unreasonable.”

Some may argue that these exceptions essentially eviscerate the key creditor protections in the Rules. And clearly this danger exists. Nonetheless, by creating a legal framework for making such decisions, the Rules at least force the SEC to bring these controversial decisions into public light. Better this than a series of iron clad rules that, in the end, are silently ignored.

Thus, having taken a significant step in establishing a legal framework where none before existed, the SEC deserves both time and room: to see if its hearing officers can apply the Rules in moving cases forward and to determine whether it can muster the political will to make appropriate choices in balancing debtor and creditor rights.

NOTES

1. Economy Grows Faster than Expected, Targets in IMF Plan Reviewed, *Business World*, August 30, 1999.
2. *Business World* Top 1000 Corporations in the Philippines 12 (1998).
3. Fitch IBCA, *International Public Finance: Republic of the Philippines 1* (July 1999)
4. Economy Grows Faster than Expected, *supra* note 2.
5. Fitch, *supra* note 4, at 11.
6. N. Reyes, Recovery by Digging a Hole, *Business World*, November 10, 1999, at 28.
7. Trouble in Paradise, Story of Three Bleeding Banks, *Philippine Daily Inquirer*, August 16, 1999, at D2.
8. *Id.*
9. Fitch, *supra* note 4, at 12.
10. Of 18 publicly listed banks with ownership data available, the largest five shareholders controlled 59.2 percent of the bank on average. C. Soldana, *Philippine Corporate Governance Environment and Policy and their Impact on Corporate Governance and Finance* 34 (submitted in connection with the OECD Conference on Corporate Governance in Asia, March 1999).
11. *Id.* at 18
12. BSP to Modify Borrowers' Limit, *Philippine Daily Inquirer*, October 8, 1999, at B1.
13. Landbank Sets Uniwide Case to High Court, *Business World*, September 16, 1999.
14. AGILE, *Strengthening Philippine Mutual Funds and Improving the Public's Perception of Them* 53 (July 1999)

15. Id.
16. Between 1992 and 1996 assets of life insurance and non-life insurance companies grew by 120 and 86 percent respectively. At the time of writing the author had not found information regarding the effects of the crisis on the industry
17. AGILE, *supra* note 15, at 56.
18. Id. at 17.
19. Id.
20. E.g., Soldana, *supra* note 11. AGILE, *Corporate Governance in the Philippines: An Assessment of Needed Reform Efforts* (Draft, November 15, 1999).
21. E-mail message from Charles Woodruff (November 16, 1999) (commenting on draft version of this report).
22. Soldana, *supra* note 11, at 8.
23. Id. at 11-12.
24. T. Regala, *Report on the Philippines 7* (submitted in connection with the Asian Development Bank Symposium on Insolvency Law Reforms, January 1999).
25. Id.
26. Id. at 10.
27. Id. at 11.
28. C. Lim and C. Woodruff, *Managing Corporate Distress in the Philippines: Some Policy Recommendations 18* (IMF Working Paper, September 1998). It is rarely enforced because liquidations occur rather infrequently.
29. Insolvency Law § 14.
30. Id.
31. Id. §§ 15, 16.
32. Id. § 18.
33. Id. § 78.
34. Id. § 29.
35. Id. § 30.

36. Id. § 31.
37. Id. § 32.
38. Insolvency Law § 36, par. 8. Board of Liquidators vs. Exequiel Floro, et al., G.R. No. L-15155 (December 29, 1960) (noting that the Assignee alone is empowered to bring such actions).
39. Insolvency Law § 70.
40. Regala, supra note 25, at 58.
41. Insolvency Law § 37.
42. Insolvency Law § 71.
43. Id. § 36, par. 4.
44. Id. § 36, par. 5.
45. Id. § 41.
46. Id. § 36, par. 4; § 39.
47. Id. § 29.
48. Id.
49. Id. § 45.
50. See id. § 62.
51. Civil Code, arts. 2246-50.
52. Note that this payment ranking appears to conflict with language in Section 42 of the Insolvency Law, which provides for the payment of Assignees: “Assignees shall be allowed all necessary expenses in the care, management, and settlement of the estate, and shall be entitled to charge and receive for their services commissions upon all sums of money coming into their hands and accounted for by them . . .”
53. The credits within this category are sub-ranked by the priority of the dates of the instruments and of the judgments, respectively. Civil Code, art. 2245
54. Civil Code, art. 2244.
55. Id. art. 2251
56. E.g., Development Bank of the Philippines v. NLRC, G.R. 97175 (May 18, 1993).

57. Insolvency Law § 52.
58. Companies that are doing business in the Philippines fall within the category. Regala, supra note 25, at 69 (citing State Investment House v. Citibank).
59. Id. § 21.
60. Id. § 23.
61. Id. § 63.
62. The Insolvency Law also requires that the insolvent not be guilty of any acts that would bar it from discharge under the law. Id. However, because discharge is not available to corporate debtors, it is likely that this provision would not apply.
63. McMicking v. Padern, Moreno, Jiminez & Co., et al., G.R. No. 10193 (Oct. 12, 1917) (ruling on the merits of a claim of a non-participating creditor vis a vis creditors with claims that arose subsequent to the composition).
64. New Central Bank Act § 29.
65. New Central Bank Act § 29.
66. Id.
67. Trouble in Paradise, supra note 7, at D2.
68. Id.
69. The descriptions are excerpted from T. Regala Follow On Report on the Philippines 27-29 (submitted in connection with the Asian Development Bank Symposium on Insolvency Law Reforms, October 1999).
70. Dation in payment, whereby property is alienated to the creditor in satisfaction of a debt in money, is recognized as a mode of payment in Philippine law. See Article 1245, Civil Code of the Philippines.
71. Rules, § 1-2.
72. Id. § 3-2
73. Id. § 3-4.
74. Id. § 3-1.
75. Id. § 3-12.
76. Id. § 3-9.

77. Id. § 3-11.
78. Id. § 3-14.
79. Id. § 4-1.
80. Id.
81. Id. § 4-2.
82. Id. § 4-6.
83. Id. § 4-20. The Rules recognize only two classes of creditors: secured and unsecured. Id. § 2-10. Decisions are calculated by size of claim only. Id. § 2-8.
84. Id. § 4-20.
85. Id. § 4-9.
86. Id. § 4-21.
87. Id. § 4-21.
88. Id. § 4-23.
89. Id. § 4-12.
90. Id. § 4-10.
91. Id. § 5-2.
92. Id. § 5-3.
93. Id. § 6-2.
94. Id. Sections. 6-3, 6-4.
95. Id. Sections 6-6 - 6-8.
96. Id. § 6-6. See Section IV.C.1 *supra*, for a discussion of the priorities under the Philippine Civil Code.
97. Id. § 6-10.
98. US Export-Import Bank and First Securities Bank's Motion to Lift Injunction in *In re Philippine Airlines*, at 8 (Bankr. N.D. Cal. June 16, 1999).

COUNTRY REPORT FOR SINGAPORE

Insolvency Service Singapore

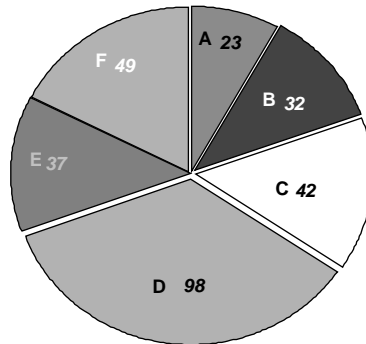
I. An Overall Economic Conditions and the Extent of the Debt Crisis

In the 1998/1999 Annual Report of the Monetary Authority of Singapore (MAS), the Chairman of MAS stated that “the Singapore economy experienced the full brunt of the regional economic crisis in 1998. Real GDP grew by just 1.5% compared with 8.0% in 1997. The slowdown was across the board. Although the worst of the crisis seems to have passed, and the region is beginning to stabilise, major uncertainties remain. These include the sustainability of a strong US economy, Japan’s economic prospects, the situation in Indonesia and progress in implementing structural reforms in the crisis economies.” To counter the economic slowdown:

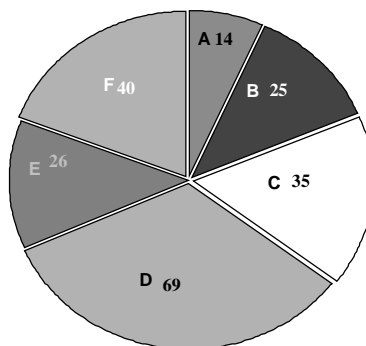
- (a) MAS eased its monetary policy stance;
- (b) MAS ensured the soundness of the banking system by maintaining high standards of prudential supervision;
- (c) the Government strengthened cost competitiveness and fostered economic recovery;
- (d) the Government is also building up key capabilities to develop Singapore into a world class financial centre. The strategy is:
 - (i) to promote a vibrant asset management industry;
 - (ii) to develop deep and broad capital markets in debt, equity, and derivatives; and
 - (iii) to build a strong and competitive banking industry.
- The extent of bad debts and their impact on debtor firms, creditors and the government.

- number and size of firms that fell into financial difficulty, the size of their bad debts, causes of the financial difficulty, and impact of financial difficulty on their performance in relevant markets.

Between January and September 1999, 281 companies were wound up. The majority of the debtor companies had paid up capital between S\$100,001* to S\$500,000. See Chart below:



Compared to the same period in 1998, the total number of companies wound up was 209. Again, the majority of the companies had paid up capital of S\$100,001 to S\$500,000. See chart below:



Key for both Charts above

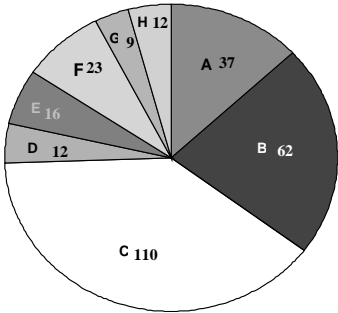
- A = S\$0 to S\$2
- B = S\$3 to S\$50,000
- C = S\$50,001 to S\$100,000
- D = S\$100,001 to S\$500,000

- E = S\$500,001 to S\$1,000,000
- F = Above S\$1,000,000

* All figures are Singapore dollars

Types of companies that faced financial difficulty is shown below:

Company Liquidation Cases by Industry
(Includes Private Liquidators) (January – September 1999)



A	=	Manufacturing	37 Cases
B	=	Construction	62 Cases
C	=	Commerce	110 Cases
D	=	Transportation/Storage & Warehousing and Communication	12 Cases
E	=	Financial Institutions/Insurance Services/Real Estates	16 Cases
F	=	Business Services	23 Cases
G	=	Community/Social/Personal Services	9 Cases
H	=	Others	12 Cases
<hr/>			
TOTAL			281 Cases

The size of the debt owed by companies from January 1999 to 30 September 1999, based on the Proofs of Debt lodged by creditors, amounted to S\$388,060,511.73 owed to 2,343 creditors. The size of the debt based on the proof of debts lodged in 1998 amounted to S\$337,325,226.08 owed to 2,974 creditors.

- number and size of banks and NBFIs that fell into financial difficulty, and size of their bad debts and capital shortage

Nil

- The impact of the economic crisis on debt problems

The assets recovery process of companies that went into liquidation and individuals adjudicated bankrupts was enhanced by Official Assignee/Official Receiver and greater emphasis placed on

it. The assets recovery process was used to reduce the impact of financial loss on creditors. In corporate insolvency, for the whole of 1998, S\$19,417,440.69 was paid out to 2,587 creditors of the wound-up companies. Up to September 1999, S\$1,840,932.11 was paid to 344 creditors. In individual bankruptcies for the whole of 1998, as a result of realisation of bankrupts' assets, S\$31,171,690.48 was paid to 6,266 creditors. Up to September 1999 in individual bankruptcies S\$29.4 million was paid to 5,203 creditors. Some of these creditors were financial institutions eg banks and credit card companies. [See below for the amount of dividends paid in corporate insolvencies and individual bankruptcy cases.] Huge amount of dividends were paid during the economic crisis in 1997 and 1998.

Individual Bankruptcy Dividends Paid To Creditors

Year	Dividend paid million S\$	No. of creditors
1991	5.3	762
1992	3.8	587
1993	7.5	908
1994	22.0	1,185
1995	21.5	4,175
1996	23.7	3,656
1997	30.7	4,944
1998	31.2	6,266
Up to 30/9/1999	29.4	5,203

Company Liquidation Dividends Paid To Creditors

Year	Dividend paid million S\$	No. of creditors
1997	5.8	570
1998	19.4	2,587
Up to 30/9/1999	1.8	344

- The degree of effectiveness of insolvency mechanisms on the economic crisis

Prior to 1995, the Official Assignee commenced the process of reviewing the Bankruptcy law. In 1995, the Singapore Parliament

passed the new Bankruptcy Act. The new Bankruptcy Act was a major piece of law reform. It repealed the old Bankruptcy Act of 1888 which had remained substantially unamended for nearly 107 years. The new Bankruptcy Act followed an exhaustive review of bankruptcy law and practice in Singapore and in a number of other countries including the United Kingdom, Australia, Canada. Under the new law the archaic concept of act of bankruptcy was replaced by the simple ground of the debtor being unable to pay his debts. A debtor is now presumed to be unable to pay his debts if he fails to comply with or set aside the Statutory Demand within 21 days of service; execution issued against the debtor in respect of a judgment debt is returned wholly or partly unsatisfied or the debtor absconds or remains outside Singapore with the intention of defeating or delaying the recovery of debts by his creditors. To encourage entrepreneurship, especially in cases whereby bankruptcy has arisen from misfortune rather than malpractice, the new law provides a scheme for discharging bankrupts at the discretion of the Official Assignee. In our view this regime for discharge was adopted because automatic discharge in our view offered little or no incentive for bankrupts to make efforts to pay their debts since they knew that their debts would be written off after a fixed period of time and this would have the overall effect of discouraging the fulfilment of financial obligations by debtors. In addition, the Official Assignee's powers to supervise individual bankrupts was enhanced: this new provision benefits creditors as administrative efficiency and asset realization are enhanced by reducing the likelihood of concealment by a bankrupt of his assets. The review of the bankruptcy law was timely because when the economic crisis started, the insolvency mechanisms in place brought about by the new Bankruptcy Act were well poised to deal with the economic crisis and instil confidence in the creditors and debtors alike as to the efficiency of the insolvency laws in dealing with the crisis.

II. A Summary of the Characteristics of Debtor-Creditor Relationships

II-1 Banks

- Banking industry configuration

At end 1998, there were 145 commercial banks in Singapore, including nine local ones. Admission criteria for new banks continued to be based on reputation, financial soundness, asset

size, extent of international operations and potential contribution to Singapore as a financial centre.

- Characteristics of banks in terms of corporate governance and their relationship with the government/Historical performance records/State of prudential regulation

Banks in Singapore are licensed under the Banking Act and administered by the Monetary Authority of Singapore (MAS). The MAS is the central bank of Singapore. It formulates and executes Singapore's monetary and exchange rate policies and acts as banker and financial agent to the Government. As supervisor and regulator of Singapore's financial services sector, MAS oversees the banking, securities, futures and insurance industries. MAS runs a website and the information provided in the website is very comprehensive. Please see <http://www.mas.gov.sg>.

II-2 *NBFIs*

- Corporate governance and size/Historical performance records/State of prudential regulation

Please see comments in relation to banks above.

II-3 *Firms*

- Corporate governance

All local companies are registered under and regulated by the Companies Act (Cap 20) while partnerships/sole proprietorships are registered under and regulated by the Business Registration Act (Cap 32). The regulatory authority for companies and partnership/sole proprietorship is the Registrar of Companies and Businesses, a department under the Ministry of Finance. The Registry of Businesses regulates sole proprietorships and partnerships while companies are regulated by the Registry of Companies. In addition, the Stock Exchange of Singapore also regulates those companies which are listed on the Stock Exchange of Singapore. The shares of such companies are traded publicly. The Security Industry Council regulates takeovers and mergers. The disclosure requirements are an important feature of the legislations. The degree of disclosure required of a private limited company and a public company varies. In brief, a private limited company's obligations to disclose are limited to the filing of annual

reports, changes in directorships, obligations to hold annual general meetings and lodge annual returns etc. A public company's obligations to disclose are much more onerous. Over and above the prescribed matters which must be complied with, the public company must also comply with other laws including SES Corporate Disclosure Policy relating to disclosures. In addition to ensuring good corporate governance, under Part IX of the Companies Act, the Minister of Finance may by order initiate investigations into a company or foreign company where

(i) it is desirable that the affairs of the company should be investigated for the protection of the public, shareholders or creditors;

(ii) it is in the public interest that allegations of fraud, misfeasance or other misconduct by persons who are or have been concerned with the formation or management of the company should be investigated;

(iii) for any other reason it is in the public interest that the affairs of the company should be investigated;

(iv) in the case of a foreign company, that the appropriate authority of another country has requested the investigation. Example – the Barings' case.

The Minister must appoint inspectors to investigate. Such inspectors have wide powers of investigations and seizure of company's books records etc. An example is the case of Barings.

Good corporate governance is also ensured by other enforcement agencies such as the Commercial Affairs Department which undertakes prosecution of offences under the commercial law for, e.g., Companies Act etc. The Commercial Affairs Department was established to combat complex commercial cases. In addition, investigations for breaches of commercial law and cases involving commercial fraud are also investigated by the Police and prosecuted by the Public Prosecutor. Recently the Attorney-General's Chambers have also set up a unit called the Financial and Securities Directorate to handle the prosecution of all serious financial offences.

– Financial structure and modes of financing

The financial structure and modes of financing vary according to the corporate structure. Main financing may be from bank loans from or loans from other financial organisations. The loans may be secured or unsecured. Financing may also be from personal or family savings.

Generally, medium-sized enterprises may, besides loans from financial institutions, also use a mix of shareholders' funds and retained earnings for their financing needs. For larger enterprises, the modes of financing may consist of equity financing, bonds, syndicated loans, inter group loan and other collateral based financing. A larger enterprise may also convert itself into a public company. This will allow it to raise capital by IPOs (initial public offer of its shares) and be listed on the Stock Exchange so that its shares can be publicly traded. Documentary acknowledgement of indebtedness issued by corporate lenders in Singapore could be any of the following types:

- (1) promissory notes
- (2) bearer notes
- (3) guaranteed notes
- (4) floating rate notes (FRNs)
- (5) debentures
- (6) bonds
- (7) certificates of deposit (CDs)

II-4 Relationships Between Creditors and Debtors

- How active and effective are creditors in assessing risks and monitoring the performance of debtor firms

Institutional creditors, such as banks and finance companies are best placed to assess risks and monitor the performance of debtor firms. Most banks have dedicated risk analysis and assessment teams working closely with their consumer and corporate finance teams in reviewing the credit status and risk of existing and potential debtors. Factors normally relied upon are the financial standing and reputation of the debtor, its credit history, assets and liabilities, quality of its management, corporate disclosure policy and its past and existing corporate association with other debtors or creditors. Most banks would require debtor firms with certain levels of exposure to submit periodic credit status reports on their cash flow and leverage positions. Needless to say, debtor firms in default would be immediately placed on a credit watch list and subjected to closer monitoring and reporting requirements. For serious cases, banks and other NBFIs have recourse, inter alia, to the appointment of a receiver and manager, judicial management or, as a last resort, winding up the company.

- What is the normal course of action when a creditor finds the risks of a debtor to be excessive?

A creditor with leverage over a debtor firm will require the firm to reduce its debt exposure either by disposing of any collateral pledged with the creditor or by scaling down activities which generate such exposures. It could also require the debtor to pledge further collateral or provide additional guarantees if the risks cannot be reduced in the short term. The creditor may also resort to appointing a receiver and manager, judicial manager or enter into a scheme of arrangement or compromise with the creditor.

- What is the usual response of a debtor firm to the demands of creditors to call back loans or the threat of applying for bankruptcy?

The usual response is to request more time so that the debtor firm can trade out of its difficulties or that economic conditions may improve to its benefit. Debtors can also request loans to be re-scheduled or offer to pledge further collateral or guarantees acceptable to the creditor.

- Standards for financial information supplied respectively by debtor firms and creditors, and rigor of enforcement of the standards.

Institutional creditors require extensive information on the debtors' financial history and performance. This is backed by periodic updates which are required in the event of any significant change in their financial position. Creditworthiness of the corporation rather than its capacity to provide collateral is important. In Singapore, corporate creditworthiness is weighted against the consideration of the corporation's assets, capital, management and strategy. Additionally the interaction between practices of financial institutions, corporations and investors in the market place are continually monitored by the Monetary Authority of Singapore (MAS), the Stock Exchange of Singapore (SES), professional bodies like the Association of Banks and to a limited extent by the interest shown by international rating agencies. It would therefore be imprudent to ignore or underrate market forces when examining the standards of financial information to be supplied. Market dynamism is the catalyst responsible for the standard for financial information supplied and the rigor of their enforcement.

- Composition of Debts

Creditors may agree to voluntary arrangements for the settlement of debts through a private scheme of arrangement or through a formal scheme requiring the approval of the High Court. These mechanisms are dealt with in detail in Part III.

II-5 *Regimes for Property Right Protection*

- Rule of law for the distribution of wealth among debtors and diverse creditors in individual bankruptcy cases and liquidation cases.

The rule of law applicable in all cases of bankruptcy or liquidation is the principle of *pari passu* distribution, a Latin phrase which means equally without preference. This is not an absolute principle, however, as it applies only in the case of ordinary unsecured creditors. The principle is subject to statutory modification, giving preference to certain classes of preferential creditors and holders of fixed and floating charges. The position of secured creditors holding mortgages over properties is also not affected although they are subject to certain rules requiring disclosure of their securities.

- In the case of firms not being liquidated, the rule of law or principles behind the law as to the preservation or maximization of economic value and distribution of wealth among stakeholder (e.g. classification and priority among creditors, absolute priority rule)

Not Applicable

- Room for value-destroying waiting games by debtors and creditors respectively and the rationale for such room

Waiting games are usually not in the mutual interests of both debtors and creditors as debtors who delay informing creditors of their financial problems will usually not be treated favourably by creditors while creditors who delay assisting debtors with their debt management plans will also put their interests at risk. Partners should always endeavour to resolve debt problems expeditiously to ensure a “win-win” situation.

III. Formal Insolvency Mechanisms

III-1 Overview

- Types of insolvency mechanisms, applicable laws, presiding authority, experts frequently employed in bankruptcy proceedings and their roles in each mechanism (eg debt collection enforcement, reorganization, composition, liquidation, others)

For companies, there are four types of insolvency mechanisms under the Companies Act. They are:

(i) Scheme of Arrangement

Scheme of arrangement is governed by section 210 of the Companies Act. Under the Companies Act, a scheme of arrangement may be proposed between a company and its creditors or any class of them or between the company and its members or any class of them. The definition of arrangement is wide and includes a reorganisation of the share capital of a company by the consolidation of shares of different classes or by the division of shares into shares of different classes or by both these methods. For the scheme to be binding a majority in number representing three-fourths in value of the creditors or class of creditors or members or class of members present and voting must agree to the arrangement and it shall be binding upon approval by the Court on all the creditors or class of creditors or on the members or class of members and on the company. In a scheme of arrangement, no administrative organ needs to be involved in the implementation and management of a scheme of arrangement. It can and is often done by the company itself with its specialist advisors. However, in some cases, usually on the creditors' insistence, a scheme may provide for an independent scheme administrator to be appointed. The powers and duties of the scheme administrator is determined by the scheme document itself.

(ii) Receivership

The appointment of a receiver or a receiver and manager out of court under the provision of a debenture is regulated by Part VIII of the Companies Act. A debenture document securing a loan will contractually entitle the lender to appoint a receiver when the stated events of default arise. The appointment of a receiver arises from private agreement between the debtor and the creditor and it is for the sole benefit of the secured creditor. The function of the receiver is to realise the secured creditor's security, not rehabilitation of the company. The primary duty of the receiver is

to the debenture holder and not to the company. Appointment of a receiver and manager paralyses the powers of the company to deal with its property. The effect of a receivership upon the powers of the board of directors depends on the scope of the receivership. If a receiver is appointed to take control over a small portion of a company's assets, theoretically there is nothing to stop the company carrying on with its business using other assets. The powers of the company and the directors to deal with the assets in receivership are of course suspended; but this does not affect their powers to deal with assets outside the scope of the receivership. However, more commonly a receivership places such substantial assets in the hands of the receiver that the company must cease business. In such a case the directors will be effectively functus officio. The following are disqualified for appointment as receiver of the property of a company:

- (a) a corporation;
- (b) an undischarged bankrupt;
- (c) a mortgagee of any property of the company, an auditor of the company or a director, secretary or employee of the company or of any corporation which is a mortgagee of the property of the company; and
- (d) any person who is neither an approved liquidator nor the Official Receiver.

(iii) Liquidation

Liquidation of a company is regulated by Part X of the Companies Act. The only administrative organs or entities involved in the implementation and management of a liquidation is the liquidator himself and the Official Receiver. The Official Receiver's office is a government department which becomes by operation of law the liquidator of any company in respect of which a private liquidator is not appointed. Private liquidators are officers of the court and are subject to the supervision of the Committee of Inspection if one is appointed, the High Court and the Official Receiver. A liquidator must be an "approved liquidator". Approved liquidator means an approved company auditor who has been approved by the Minister under section 9 of the Companies Act as a liquidator and whose approval has not been revoked.

(iv) Judicial Management

This is regulated by Part VIIIA of the Companies Act and a Judicial Manager is appointed by the Court under this Part. The court may make a judicial management order in relation to the company only if it is satisfied that the company is or will be unable

to pay its debts and the court considers that the making of the order would be likely to achieve one or more of the following purposes:

- (a) the survival of the company or the whole or part of its undertaking as a going concern;
- (b) a more advantageous realisation of the company's assets would be effected than on a winding-up.

A petition for judicial management may be presented by the company, or its directors, pursuant to a resolution of its members or the board of directors or a creditor or creditors or all or any other parties together or separately. The petitioner must nominate a person who is an approved company auditor, who is not the auditor of the company, to act as a judicial manager. The court may reject the nomination.

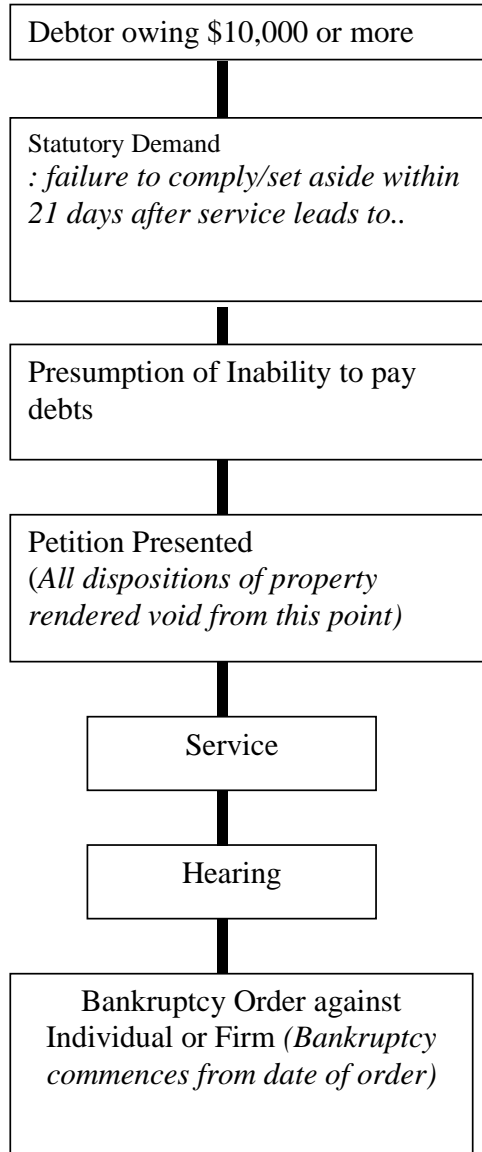
- A summary description of the implementation structure and capacity to handle bankruptcy cases, including a summary description of the court system, number of judges overseeing bankruptcy cases, their workload, infrastructure of professionals such as administrators, etc.

Bankruptcy and Company Liquidation jurisdictions are vested in the High Court of Singapore. There is no special bankruptcy court. The judicial and court systems are very effective and efficient in handling insolvency proceedings. Once a bankruptcy order is made by the High Court against an individual, or a company is wound up by the High Court, the subsequent administration of the bankrupt individual's affairs is vested in the Official Assignee and the liquidation of the company vested in the Official Receiver (unless a private liquidator is appointed). The Singapore office of the Insolvency Services comprises the Official Assignee and Official Receiver. The Official Assignee and Official Receiver is assisted by his deputy and assistants in the administration and management of the cases. The office is well established to handle bankruptcy and company insolvency cases. Despite the increase in the number of cases (both individual and company) during the recent economic crisis it was not necessary to increase the manpower of the office. The effective work systems in place enabled the effective administration of cases. The Singapore Insolvency Office is ISO 9002 certified. It is the only Insolvency Office in the world to have this certification.

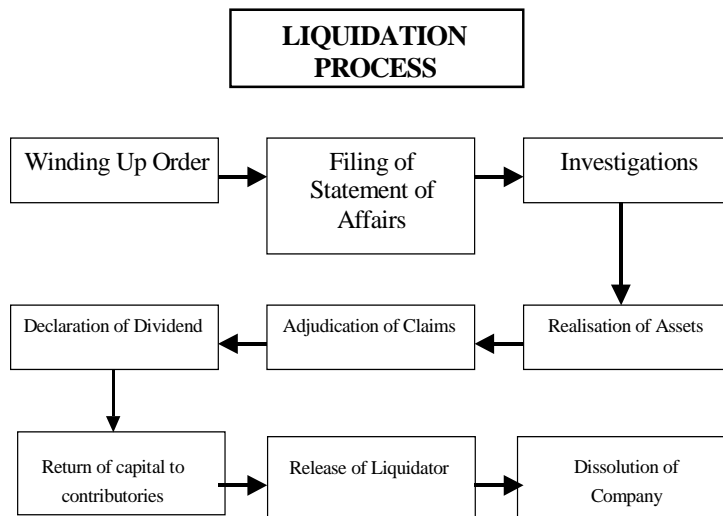
III-2 *Flow chart and key aspects for each of the proceedings*

A *Flowcharts and Description of Key Steps*

a) Flow chart for Bankruptcy Procedures under the Bankruptcy Act:



b) Flowchart for Company Wound-Up Procedures under the Companies Act:



B Comparison and Transferability Between Proceedings

Not Applicable

III-3 Proceedings under the Insolvency Laws

A Opening Procedure

1. Filing of a petition

- Criteria of insolvency (e.g. balance sheet test/liquidity test/others)

For individual insolvency proceedings, the basis for petition is a liquidated sum due and payable of not less than S\$10,000 which the debtor is unable to pay. If a statutory demand for the amount is served on the debtor in the prescribed manner and 21 days have elapsed without the debt being paid or set aside by the debtor, the debtor is presumed to be unable to pay the debts. Other grounds for proceeding would be where an execution is issued against the debtor which remains unsatisfied or the debtor has absconded from Singapore with the intention of avoiding payment of the debt. The basic test adopted is a liquidity test i.e. whether the debtor is able to meet his payments when they are due and payable.

For insolvency of companies, the usual criteria adopted is whether the debtor company is able to meet its payment obligations when they fall due. Under the Companies Act, the debtor inter alia can be wound up if it is unable to pay its debts. A debtor company must be served a letter demanding payment. The debt must not be less than S\$10,000. If the debt remains unpaid after three weeks, the creditor may present a petition to wind up the company. A company is deemed to be unable to pay its debts if it fails to meet the demand to pay within 21 days. Under the Companies Act, a company is deemed to be unable to pay its debts if:

(a) a creditor by assignment or otherwise to whom the company is indebted of a sum exceeding \$10,000 then due has served on the company by leaving at the registered office a demand under his hand or under the hand of his agent thereunto lawfully authorised requiring the company to pay the sum so due, and the company has for 3 weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor;

(b) execution or other process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part; or

(c) it is proved to the satisfaction of the court that the company is unable to pay its debts; and in determining whether a company is unable to pay its debts the court shall take into account the contingent and prospective liabilities of the company.

- Who can file the proceedings? (e.g. debtor/creditor/shareholder/others)

Under the Bankruptcy Act, any creditor can petition for the bankruptcy of the individual debtor or the latter may also self petition for its bankruptcy.

Under the Companies Act, a winding up proceedings can be filed by the company, any creditor, a contributory, the liquidator, a judicial manager, and the Minister on special grounds in the public interest.

- What kind of penalties do the laws have for filing delays?

For company winding up proceedings, once a petition is filed, a hearing date is fixed by the court and the petitioner is expected to

take all steps under the Companies (Winding Up) Rules to file the prescribed documents prior to the date of the hearing. In the event the petitioner fails to do so, on the day of hearing the winding up petition, the High Court may dismiss the petition with or without costs or adjourn the hearing conditionally or unconditionally or make any interim or other order that it thinks fit.

In a bankruptcy petition, if a creditor having served the statutory demand on a debtor delays the presentation of the petition for more than 4 months, the creditor will not be allowed to present the petition. The creditor will have to restart the procedure again. Also, if the petitioning creditor fails to attend High Court on the hearing date of the petition or fails to prosecute the petition diligently, the petition may be dismissed and no subsequent petition against the same debtor shall be presented by the same creditor in respect of the same debt without leave of the High Court.

2) Automatic Stay

- Does filing have the legal effect of banning any payment or collection of debt? If not, can any provisional measures be allowed?

Under the Bankruptcy Act, the court may at any time after the presentation of the petition stay any action, execution or other legal process against the debtor and the property of the debtor.

In the case of companies:

(i) Judicial Management

Under the Companies Act during the period beginning with the presentation of a petition for a judicial management order and ending with the making of such an order or the dismissal of the petition –

- (a) no steps can be taken to enforce any charge on or security over the company's property or to repossess any goods in the company's possession under any hire-purchase agreement, chattels leasing agreement or retention of title agreement, except with the leave of the court and subject to such terms as the court may impose; and

(b) no other proceedings and no execution or other legal process shall be commenced or continued and no distress may be levied against the company or its property except with the leave of the court and subject to such terms as the court may impose.

(ii) Winding Up

Any time after the presentation of a winding up petition and before a winding up order is made, the company or any creditor or contributory may apply to the High Court to stay or restrain further proceedings in the action and the court may stay or restrain the proceedings on such terms as it thinks fit. Where a provisional liquidator has been appointed, no action or proceedings shall be proceeded with or commenced against the company except by leave of the court and in accordance with such terms as the court may impose.

(iii) Scheme of Arrangement

There is no automatic stay. Under the Companies Act, the High Court may on the application by the company or any member or creditor of the company restrain further proceedings in any action against the company. The court may make the order on such terms the court imposes.

3) Order of Opening

- Is the order of opening needed for the procedure?

Generally, the person who presents the petition or makes the application will commence the procedure in court. In bankruptcy proceedings against an individual, the Petitioning Creditor will start the procedure. After hearing the Petitioning Creditor and debtor in a bankruptcy petition, the High Court may either make the bankruptcy order or stay or dismiss the petition on such terms and conditions it may think just.

In company liquidation, on the date of the hearing of the winding up petition, the Petitioning Creditor introduces to the court all supporting and dissenting creditors who had given notice of their appearance and intention to either support or oppose the petition. A nil list is also required to be filed if no supporting or dissenting creditors are present. A director, or any officer of the debtor

company duly authorised, can appear on behalf of the debtor company or the company may be represented by solicitors. If the debtor company opposes the winding up petition, it has the right to address the Court.

- Requirements of order of opening (e.g. consent of creditors/viability of the firm/public interests/economic considerations/consent of employee/others)

Not Applicable.

- When is the estate created and with what claims?

In an individual bankruptcy proceeding, the bankruptcy commences from the date when the bankruptcy order is made and continues until the discharge of the bankrupt. The property of the bankrupt vests in the Official Assignee on the making of the bankruptcy order.

No estate is created in a company winding up. On the winding up order being made, the appointed liquidator will realise the assets of the company and pay dividends to the creditors according to their claims (Proof of Debt) filed with the Official Receiver.

- Who manages the firm (e.g. court-appointed trustee / incumbent managers / creditors / others)
 - a. from the filing through the order of opening

Winding Up

The court may appoint the Official Receiver or an approved liquidator provisionally at any time after the presentation of a winding up petition and before the making of a winding up order. The provisional liquidator's primary duty is to preserve the status quo pending the court's final determination whether or not the company should be wound up. Usually the provisional liquidator does not have the power to sell and distribute the company's assets. The appointment of the provisional liquidator has the effect of displacing the directors although the directors may retain residual powers to oppose the winding up petition. The provisional liquidator may request the appointment of a special manager to assist in running the business of the company. The provisional liquidator's power to

carry on business is for the purpose of maintaining the company's assets with a view to facilitating the eventual beneficial winding up of the company. It does not extend to entering into contracts for the resuscitation of the company's business or to make profits.

Receivership

Generally the debenture under which the receiver is appointed will provide for the displacement of the powers of management vested in the directors of the company. Also see paragraph III-I above.

Scheme of Arrangement

A scheme of arrangement does not in itself affect the powers of management. However if creditors insist an independent scheme administrator may be appointed and the powers and duties of the scheme administrator is to be agreed upon by the company and its creditors. It is also possible for a special consultant to be appointed to oversee the affairs of the company. This is also to be decided by the company and creditors. Also see paragraph III-I above.

Judicial Management

Under section 227G(2) of the Companies Act, the Judicial Manager on his appointment shall exercise all the powers and duties of the directors. The Judicial Manager can do all things as may be necessary for the management of the affairs, business and property of the company. Please also see paragraph III-I above.

- b) from the order of opening to the approval of the reorganization plan

Winding Up

See above (a). A provisional liquidator's appointment comes to an end when a winding up order is made and a liquidator appointed. The powers of the directors come to an end with the appointment of a liquidator. Thereafter the directors have no powers to conduct proceedings on behalf of the company. The liquidator's job is to wind up the company's business, realise

the assets, pay off the creditors and return whatever is left over to the members.

Judicial Management

See above (a).

Receivership

See above (a).

Scheme of Arrangement

See above (a).

c) from the beginning of the plan's execution

As stated above in paragraph (a).

B Deliberation Procedure

1) Claims

- With whom do creditors lodge their claims? (e.g. debtors/trustees/court/others)

In individual bankruptcy, the creditors lodge their claims with the Official Assignee or with the trustee of the bankrupt's estate if a trustee is appointed. No person can be appointed a trustee in bankruptcy unless he is registered as a public accountant, an advocate and solicitor, or such person prescribed by the Minister and has no criminal conviction for fraud or dishonesty. Consent of the trustee is required before he can be appointed.

In a company liquidation, creditors would lodge their claims with the Official Receiver or the appointed Private Liquidator. Similarly, in a judicial management or receivership, the claims are lodged with the judicial manager or receiver.

- Who verifies lodged claims? (e.g. debtor/court/creditors' meeting/others)

Verification of the claims is done by the Official Assignee with the assistance of the Bankrupt and creditor in individual insolvency claims.

In a corporate insolvency, the claims are verified by the Official Receiver or the Private Liquidator or the judicial manager or receiver.

- Are late lodgings allowed? If so, how long and at what disadvantages?

In individual bankruptcy proceedings, the Official Assignee will serve notice of his intention to declare a dividend on all creditors who are mentioned in the statement of affairs for them to lodge their proof of debt not later than 14 days from the date of the notice, failing which they will be excluded from participation in the dividend. Notice will also be published in the local newspaper giving creditors 14 days from date of publication to lodge their proof of debt, failing which they will be excluded. Any creditor who fails to do so may lodge an appeal within 7 days of the Official Assignee's rejection. If no appeal has been commenced within the prescribed time, the Official Assignee or the trustee shall exclude the proof which has been rejected from participation in the dividend. The above position is similar in companies that have been wound up.

- Non-allowable claims in insolvency proceedings?

Individual Bankruptcy

(a) Demands in the nature of unliquidated damages arising otherwise than by reason of a contract, promise or breach of trust are not provable in bankruptcy.

(b) Any person having notice of the presentation of a bankruptcy petition cannot prove under the bankruptcy order made thereon for any debt or liability contracted by the bankrupt subsequent to the date of his so having notice.

(c) Debts contracted on or after the date of the bankruptcy order.

(d) Fraudulent or false debts.

(e) If in the opinion of the court the value of the debt or liability is incapable of being fairly estimated, the court may make an order to that effect, and thereupon the debt or liability shall, for the purposes of this Act, be deemed to be a debt not provable in bankruptcy.

Winding Up

The above rules applicable in bankruptcy also apply in cases of companies wound up.

- Priority of claims (e.g. secured/non-secured, suppliers/money lenders/shareholders, large/small, tax and government charges, labor compensation, administrative claims, claims incurred after the opening, preferred/subordinated)

In the companies winding up situation, once the secured creditors have been paid out of the assets that comprise their securities, the remainder of the assets (if any) will be distributed among the other creditors in the order of priority set out below:

- (a) Costs and Expenses of the Winding Up incurred by the Official Receiver including the costs of the petitioner and the remuneration of the liquidator;
- (b) Wages and salary. Only a sum equivalent to 5 months salary or \$7,500 whichever is less counts as preferred. Any excess over this will be treated as an ordinary unsecured debt;
- (c) Amount due to employee as retrenchment benefit or ex-gratia payment (subject to monetary limit as stated in (b) above);
- (d) Compensation under the Workmen's Compensation Act;
- (e) Contributions to provident funds;
- (f) Remuneration in respect of vacation leave;
- (g) Taxes including goods and services tax.

The priority of claims above is the same in an individual bankruptcy.

2) Avoidance, Executory Contracts

- Who has avoidance powers? (e.g. not allowed/creditors/trustee/court/others)

The High Court has avoidance powers on the application of the Official Assignee or the trustee in individual bankruptcy and in case of a company that has been wound up, the application may be

made by the Official Receiver or the liquidator of the wound-up company.

– Payments avoidable

(a) Transactions at an undervalue

Under section 98 of the Bankruptcy Act an individual bankrupt enters into a transaction with a person at an undervalue if (within a period of 5 years before the presentation of the bankruptcy petition) –

(a) he makes a gift to that person or he otherwise enters into a transaction with that person on terms that provide for him to receive no consideration;

(b) he enters into a transaction with that person in consideration of marriage; or

(c) he enters into a transaction with that person for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth of the consideration provided by the individual.

(b) Unfair preferences

An individual gives an unfair preference to a person if:

(a) that person is one of the individual's creditors or a surety or guarantor for any of his debts or other liabilities; and

(b) the individual does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the individual's bankruptcy, will be better than the position he would have been in if that they had not been done.

There are two time norms –

(a) 2 years before the presentation of the bankruptcy petition in the case of unfair preference given to associate of the bankrupt;

(b) 6 months in other cases.

(c) Extortionate credit transactions

A transaction will presume to be extortionate if having regard to the risk accepted by the person providing the credit:

(a) The terms of it are or were such as to require grossly exorbitant payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of the creditor; or

(b) The transaction must be entered into within 3 years before the commencement of the bankruptcy. It is harsh and unconscionable or substantially unfair.

(d) Avoidance of general assignment of book debts. General assignment of book debts prior to the presentation of the bankruptcy petition and not registered under the bills of Sale Act.

(e) Where a company has gone into liquidation within 6 months of the creation of a floating charge, that charge is void except to cover the amount of cash advanced to the company at the time of creation or subsequently, together with interest at 5% per annum. Under section 330 of the Companies Act, floating charge on the undertaking or property of the company created within 6 months of the commencement of the winding up shall, unless it is proved that the company immediately after the creation of the charge was solvent, be involved except to the amount of any cash paid to the company at the time of, or subsequently to, the creation of, and in consideration for, the charge together with interest on that amount at the rate of 5% per annum. This rule does not apply to a company which was solvent at the time of creating the charge.

(f) Liquidator's right to recover in respect of certain sales to or by company. Under section 331 of the Companies Act:

(a) Where any property, business or undertaking has been acquired by a company for a cash consideration within a period of two years before the commencement of the winding up of the company –

(i) from a person who was at the time of the acquisition a director of the company; or

(ii) from a company of which, at the time of the acquisition, a person was a director who was also a director of the first-mentioned company

the liquidator may recover from the person or company from which the property, business or undertaking was acquired, any amount by which the cash consideration for the acquisition exceeded the value of the property, business or undertaking at the time of its acquisition.

(b) Where any property, business or undertaking has been sold by a company for a cash consideration within a period of two years before the commencement of the winding up of the company –

(i) to a person who was at the time of the sale a director of the company; or

(ii) to a company of which at the time of the sale a person was a director who was also a director of the company first-mentioned,

the liquidator may recover from the person or company to which the property, business or undertaking was sold, any amount by which the value of the property, business or undertaking at the time of the sale exceeded the cash consideration.

(c) The value of the property, business or undertaking includes the value of any goodwill or profits which might have been made from the business or undertaking or similar considerations. “Cash consideration” means consideration for such acquisition or sale payable otherwise than by the issue of shares in the company.

3) On Managers (debtors)

– Is the act of insolvency itself a criminal act? If so, what are the penalties?

If a person, within 12 months before the presentation of a bankruptcy petition against him, incurs any debt without any reasonable ground of expectation of being able to pay it or having been engaged in carrying on any trade or business, he continues to trade or carry on business by incurring any debt provable in

bankruptcy within 12 months before the date of the presentation of the bankruptcy petition against him, he being insolvent on the date of incurring the debt and without any reasonable ground of expectation of being able to pay it, he shall be guilty of an offence. If convicted the punishment is a fine not exceeding \$10,000 or imprisonment for a term not exceeding three years, or both.

- Does the law stipulate a criminal investigation of chief managers including directors for their illegal activities related to the insolvency? If so, are debtors usually accused by public prosecutors?

Yes. Any illegal activity by directors will be investigated by the Police or the Commercial Affairs Department, and the offender prosecuted by the Attorney-General as Public Prosecutor.

- Are there any legal grounds for the debtors to sue chief managers for the damages caused by the insolvency on the basis of tort law? If so, how often are those legal actions taken?

A director who has breached his duties of skill, care or diligence may be sued for damages. The information regarding how often legal action is taken is not available.

- Is the liability of business entities extended to shareholders or directors personally? If so, to what extent?

The liabilities of a company are separate from those of shareholders and directors. Even if one person effectively runs the company and contracts the debts, the company is responsible in law. Therefore, one of the advantages therefore of incorporation is limited liability. In the case of a company limited by guarantee, a member is liable to contribute to the company's assets on winding up only to the amount that he agreed to guarantee. In the case of a company limited by shares, the members are called upon to contribute capital once, when shares are issued to them. A holder of fully paid shares cannot be called upon to contribute more. Even if the company is unlimited the creditors of the company do not have a direct cause of action against the members. It is also clear that directors and officers of the company are not responsible for its debts.

However in certain situations a court will ignore the separate legal personality of a company and look to the members or the

controllers of the company. This may be done to make the members or the controllers, i.e. directors, responsible for the debts of the company. Courts may ignore the separate legal personality of a company in the following situations:

(a) If a debt is contracted on behalf of a company, and at the time that debt was contracted the officer responsible had no reasonable or probable expectation that the company would be able to pay the debt. Under section 339(3) of the Companies Act the officer of the company may be convicted of an offence, and if convicted, the court may, on the application of the liquidator or any creditor or contributory of the company, declare that officer to be personally responsible for the payment of the whole or any part of the debt.

(b) The court may declare any person who was knowingly a party to the carrying on of the company's business to defraud creditors or for fraudulent purposes to be personally liable for the debts of the company. The position in (a) ie section 339(3) applies here.

(c) No dividends may be paid to shareholders of a company unless there are profits available. If a director or manager of a company willfully pays or permits the payment of a dividend when there are no available profits, he is liable to the creditors of the company for the amount of debts due to them. Section 403 of the Companies Act provides for this.

(d) Section 144(2) of the Companies Act provides that if an officer of a company or any person on its behalf –

(a) uses or authorises the use of any seal purporting to be a seal of the company whereon its name does not so appear;

(b) issues or authorises the issue of any business letter, statement of account, invoice or official notice or publication of the company wherein its name is not so mentioned; or

(c) signs, issues or authorises to be signed or issued on behalf of the company any bill of exchange, promissory note, cheque or other negotiable instrument or any indorsement, order, receipt or letter of credit wherein its name is not so mentioned.

that officer is guilty of an offence and where he has signed, issued or authorised to be signed or issued on behalf of the company any bill of exchange, promissory note or other negotiable instrument or

any endorsement thereon or order wherein that name is not so mentioned, the officer shall also be liable to the holder of the instrument or order for the amount due unless it is paid by the company.

(e) If at any time the number of members of a company (other than a company the whole of the issued shares of which are held by a holding company) is reduced below two and it carries on business for more than 6 months while the number is so reduced, a person who is a member of the company during the time that it so carries on business after those 6 months and is cognizant of the fact that it is carrying on business with fewer than two members shall be liable for the payment of all the debts of the company contracted during the time that it so carries on business after those 6 months and may be sued therefore.

(f) Under the Income Tax Act (Cap 134) the Comptroller of Income Tax may disregard certain transactions which in his opinion are fictitious.

4) Disclosure Procedure

– How does information flow between

(a) debtor-creditor:

Information flow would be governed by the contractual and commercial relationship between the parties. Whether the flow of information is high or low would to a great extent depend on the size of the debtor and the lender's exposure to it. A lender to a small enterprise or with small exposure is likely to make its own inquiries of the management and to assess the credit risk. Where the enterprise is large or the lenders' exposure is high, they are likely to require the company to appoint an accountant as a Special Consultant or Special Accountant to oversee the management of the company and to report to the lender on the prospects of the company trading out of its difficulties with or without debt restructuring. Creditors who are not financial institutions usually do not have enough bargaining power to compel the debtor to submit to investigation.

(b) trustee-creditor:

Information flow would be good if the trustee is bound under the terms of the trust deed to provide the prescribed standard of disclosure or face possible termination of his appointment.

(c) court-creditor:

In an individual insolvency, any creditor who has tendered a proof may apply to court for the examination of the bankrupt's affairs, dealings and property. The court may also require any third party to be summoned to provide information on the bankrupt's affairs.

In a corporate insolvency, the creditor may apply to the court for inspection of the company's books and also to summon persons connected with the company for examination.

(d) debtor-court:

The bankrupt or the officers of the insolvent company can be examined by the court on the application of the Official Assignee, the Official Receiver or any of their creditors.

(e) trustee-court:

The trustee is bound to report to the court if the terms of his appointment pursuant to the trust deed requires it or if the approval of his appointment by the court provides for disclosure.

- How useful is the information? Is it reliable? Is it provided in a timely manner?

Whether the information is useful or provided in a timely manner is primarily dictated by the nature and extent of the relationship between debtors and creditors and the level of exposure. Generally, institutional lenders would adopt a structured and professional approach towards the treatment of their debtors, notably the larger ones. This is understandable, as default on such debts would have a major impact on their financial performance. Under sub-para (c) and (d) above, the parties are duty bound to provide the information to the court. Such information is very useful in the subsequent realisation of assets belonging to the bankrupt or wound up company.

C *Reorganization/Composition Plan*

1. Preparation of the Plan

- Who can draw up the plan? (e.g. debtor/creditor/court/trustee/others)

(a) Individual Insolvency

For an individual insolvency, the Official Assignee prepares the composition plan or scheme of arrangement.

(b) Judicial Management

In Judicial Management, the judicial manager develops the “plan” or a statement of his proposals for the achievement of the purposes for which the judicial management order was made i.e. to rehabilitate the company.

(c) Scheme of Arrangement

The scheme is generally drawn up by the company in consultation with the creditors and members. However, the scheme will not bind the company and its members and creditors until the court approves it.

- Who initiates negotiations in preparing the plan? (e.g. debtor/creditor/court/trustee/others)

Usually the company in a scheme of arrangement would give notice of its intention to prepare the scheme and would consult its creditors (for example, the banks) for their views. In judicial management, the judicial manager prepares the plan. In an individual insolvency, the bankrupt would inform the Official Assignee of his intention to make a composition offer or a scheme of arrangement.

2. Contents of the Plan

- What kinds of methods are usually used for the plan (e.g. changes of debts/debt-equity swaps/sales of equities/others)

The methods used for the plan depend largely on whether the debts are secured or unsecured. For secured debts, the plan may involve the provision of additional security, the enforcement of the securities or the exchange of the security for other securities or an injection of an equity stake in the company or the assignment of other securities to the lenders.

For unsecured debts, lenders may have to accept a rescheduling of the debts or the conversion of the debts into equity or an exchange with other debts in discharge of the existing debts. In all cases, the directors of the company or their related companies may have to provide additional third party guarantees in support of the continued provision of financing by the banks and other lenders.

– How to classify creditors and stakeholders

(a) secured/unsecured creditors:

Secured creditors over the same security rank differently in priority according to the terms of the security arrangements and the chronological sequence in which the securities were granted.

Unsecured creditors can be further classified into preferential unsecured creditors to whom payment is granted priority over those of the ordinary unsecured creditors. Certain preferential debts are also granted priority in payment over the rights of debenture holders of any property subject to a floating charge under section 226 of the Companies Act. Where a receiver is appointed on behalf of the debenture holder or possession is taken of property subject to a floating charge, certain preferred creditors are entitled to be paid in priority to the holder of the floating charge. Employees' claims of wages, retrenchment benefits, vacation leave, provident fund payments are to be paid out of the assets covered by the floating charge if there are insufficient assets to pay them otherwise. Finally, amongst the ordinary unsecured creditors, there can be the practice of "debt subordination" which is a contractual arrangement between unsecured lenders where there are layers of "senior" and "junior" debt which has the effect of postponing repayment of "junior" debt until payment has been made of the "senior" debt.

(b) large claims/small claims creditors:

Large claims creditors are usually the institutions comprising the banks and other financial institutions. Small claims creditors are normally the trading firms and individual creditors. Their respective rights would depend on whether they are secured or unsecured creditors.

(c) bond holders:

Bond holders' rights are determined by the terms of the debenture bond issued to them which may have the option of providing for conversion of the bond into equity in lieu of repayment of the interest. Bond holders are entitled to be paid interest ahead of the shareholders and may have recourse to securities provided for in the bond document in the event of default by the issuer company.

(d) preferred/normal shareholders;

Preferred shareholders are entitled to be paid any dividends declared by the company before the normal shareholders.

(e) suppliers/money lenders:

Suppliers and moneylenders are normally unsecured creditors with little or no security for enforcement of their claims.

(f) employees

Employees' wages, retrenchment benefits, vacation leave, provident fund payments are entitled to preferential payment ahead of other unsecured creditors in the event dividends are declared by the Official Receiver or the liquidator.

(g) others

No comments.

– What is the priority between creditors and stakeholders?

(a) in the normal judicial enforcement process:

In the normal judicial enforcement process, stakeholders i.e. shareholders or members do not have priority over creditors.

(b) in the plan:

Nil

– Is inflation reflected in the plan?

Nil

3. Confirmation of the Plan

– Quantum for consent by creditors and stakeholders

(a) creditors:

In judicial management, the statement of proposals (plan) may be approved by the majority of the creditors in number and value. In a bankruptcy, a three-quarters majority in value of the creditors consenting have to approve the plan. In a scheme of arrangement, if a majority in number representing three-fourths in value of the creditors or class of creditors or members or class of members present agree to any scheme of arrangement it shall, if approved by the court, be binding on all the creditors, or class of creditor or on the members or class of members as the case may be.

(b) shareholders:

Where a compromise or arrangement is proposed under section 210 of the Companies Act between a company and its creditors or members or any class of them, the court may order meetings of the creditors or of the members to be summoned. At the meeting convened upon the order of court, the approval of the members and creditors to the scheme of arrangement must be obtained. A majority in numbers representing three-fourths in value of the members or creditors is required to approve the scheme.

(c) others:

Nil

- Other requirements for the approval of the plan by the court (e.g. consent of employee/public interests/others)

No other requirements for approval by the court. However, in a bankruptcy or corporate scheme of arrangement, any creditor who opposes the proposal is at liberty to lodge notice of his objection with the court which has the final discretion of whether to approve the plan.

- Can the court deny the consented plan? In which cases?

In a scheme of arrangement – the scheme will not bind the company and its members and creditors unless the court approves it. The court must ensure that the statutory procedure has been complied with and that the resolutions are passed by the requisite majority in value and in number and the court must ensure that the scheme is fair and reasonable. The court may also consider whether the members and creditors have been provided with sufficient information in order for them to make an informal decision. If the court is not satisfied regarding the genuineness of the resolutions it may decline the scheme. The court may not approve the scheme if it is oppressive to some members or creditors or in disregard of their interests. In judicial management at the meeting, the plan may be approved by the majority of creditors in number and value. The requirement for majority in number and value is conjunctive. If the creditors decline to approve the plan, the court may order that the judicial management order be discharged. However the court has wide powers to adjourn the creditors' meeting and make such interim orders as it thinks just.

- Can the court approve a plan that has not received consent (cram down)? In which cases?

The Court cannot approve a plan which has not received the consent of the creditors (as described above).

- Are these criteria taken into consideration in the confirmation process?
 - a) absolute priority rule:
No
 - b) best interest test:
Yes

- c) feasibility test:
Yes through the best interest rule.
- d) economic test:
Yes.

D Post-confirmation Procedures

1. Management

- Who manages the firm under the plan? (e.g. former managers/person recommended by the creditor/person recommended by the court)

In a judicial management the board of director becomes *functus officio*. It is not suggested that the directors actually vacate office. It may not be necessary for them to do so. But the directors' functions and powers are transferred to the judicial manager. The director's power to manage the company is at an end until the judicial management order is discharged. It is not necessary for a judicial manager to manage the company personally. He may appoint persons to run the company. As the corporate entity is still in existence and the business still running the appointment of judicial manager is unlikely to have the effect of discharging the employees, unlike where a receiver and manager or a liquidator is appointed by the court. Also, although not stated, presumably any rights that members have under the memorandum and articles to interfere with the management of the company would be suspended. So they cannot interfere with the judicial managers' management of the company.

- What kinds of incentives are provided to managers? (e.g. stock option/bonus/others)

Incentives to managers may take numerous forms and may be based on the contractual relationship between the company and the manager. Generally, managers who are at a certain level of seniority are provided with incentives like stock options, performance bonuses, etc.

- How are managers who execute the plan controlled? (e.g. terms/salary/dismissal/others)

In a judicial management, the judicial manager must manage the company in accordance with the “plan” which has been approved by the majority of creditors in number and value. The creditors may appoint a Committee to supervise the judicial manager. The Committee cannot interfere with the management of the company but may require the judicial manager to furnish it with such information as it may reasonably require. In the discharge of his functions, the judicial manager must ensure that members and creditors are treated fairly. A member of the company who feels that the affairs of the company have been conducted in a manner which is unfairly prejudicial to the members generally or to some part of them may petition for relief under the Companies Act. This also applies to a unhappy creditor who feels that the creditors, or some portion of them, are being unfairly prejudiced. The court has wide powers to make such orders as it thinks fit to give relief. This includes discharging the judicial manager by reason of the judicial manager acting in a manner unfairly prejudicial to the creditors or members.

2) Monitoring the Firm

– Monitoring mechanism by creditors

(a) reporting/suggestion mechanism:

In a judicial management, creditors will monitor the firm by forming a Committee of Creditors. The committee may require the judicial manager to attend and furnish the committee information as it may reasonably require. The judicial manager may revise his plans (maybe as a result of suggestion by the committee) from time to time but the revision must be approved at a creditors’ meeting.

(b) filing for the cancellation of the proceeding:

Under section 227A of the Companies Act where a company or creditor or creditors of the company consider that –

(a) the company is or will be unable to pay its debts; and

(b) there is a reasonable probability of rehabilitating the company or of preserving all or part of its business as a

going concern or that otherwise the interests of creditors would be better served then by resorting to a winding up , the court, on application, may order that the company be placed under judicial management of a judicial manager. A judicial management order unless it is discharged shall remain in force for 180 days unless extended by the court. A judicial management order may also be discharged if the creditors decline to approve the judicial manager’s “plan” or if the purposes of the judicial management order cannot be achieved. A judicial manager automatically vacates office if he ceases to be an approved company auditor.

(c) others

No comments.

– Average time between the process

(a) from the filing to provisional measures:

About 2 to 3 weeks

(b) from the filing to the order of opening:

(i) Bankruptcy Petition – 6 weeks from date of filing

(ii) Companies Winding Up Petition – 4 weeks from date of filing

(c) from the order of opening to the confirmation of the plan:

Within 60 days of his appointment, the judicial manager must come up with the plan

(d) from the confirmation of the plan to the closing of the proceedings

Nil

IV Effect of Insolvency Proceedings on the Efficiency and Welfare of Creditors and Debtors

- Criteria for a reorganization decision and its effect on the economic value of the firm

Part VIIIA of the Companies Act provides for the appointment of a Judicial Manager in order to enable a company to have breathing space to effect a rescue. During this period the company has a respite from the pressure of its liabilities. This moratorium period is to be used to draw up a reorganisation plan to save the company without the necessity of a liquidation. Basically the idea is to rehabilitate and nurse a company back to financial health or to realise its assets for the benefit of the creditors without the necessity of a liquidation. Judicial management benefits the company by protecting it from a forced liquidation at the behest of a trigger happy creditor. When a Judicial Manager is appointed he has 60 days to send to the members and the creditors of the company a statement of proposals (i.e. plan) to salvage the company. A meeting of the creditors must be summoned within the 60 day period for the purpose of approving the plan. Where the Judicial Manager's plan has been approved, he must manage the company in accordance with the plan. A Judicial Manager may appoint person to run the company. The corporate entity is still in existence and the business is still running. If the proposals result in a profitable outcome for the company, the economic value for the company will be greatly strengthened.

- Process of drawing up reorganization plans and its effect on the relative bargaining position of stakeholder

Within 60 days of his appointment, the Judicial Manager must send to the Registrar of Companies, and to all creditors, a statement of his proposals (i.e. plan) that would be likely to ensure the survival of the company, or the whole or part of its undertaking as a going concern, or a more advantageous realisation of the company's assets. The Judicial Manager should also send a copy of the statement of proposal to all members of the company, or publish a notice in the local daily newspaper, stating an address to which members of the company should write for copies of the statement to be sent to them free of charge. A meeting of creditors decides whether to

approve the Judicial Manager's plan. At such meeting, the majority in numbers and value of creditors present and voting, either in person or by proxy, whose claims have been accepted by the Judicial Manager, may approve the proposals with modifications. The Judicial Manager must thereafter report the result of the meeting to the court. If the creditors decide not to approve the proposals, the court may order that the judicial management order be discharged. The court also has wide powers to adjourn the creditors meeting or make such interim orders as it thinks fit. Where the Judicial Manager's proposals have been approved, he must manage the company in accordance with those proposals. The creditors may appoint a Committee of Creditors to supervise the Judicial Manager. The Committee may require the Judicial Manager to attend before it and furnish it with such information relating to the carrying out by him of his functions. Where Judicial Manager's proposals have been approved, it is the duty of the Judicial Manager to manage the affairs, business and property of the company in accordance with the proposals. The creditors have a major say in the judicial management. The Judicial Manager takes the place of the board of directors and may exercise all the powers conferred upon the directors by the Companies Act or by the memorandum and articles of the company. Presumably any rights that members might have under the memorandum and articles to interfere with the management of the company would be suspended.

- Corporate governance of the firm during insolvency proceedings and while the firm is in a reorganization process

The Judicial Manager takes into his custody and control all the property to which the company appears to be entitled. The powers of the Judicial Manager are stated in the Eleventh Schedule to the Companies Act. The management of the company will be vested in the hands of the Judicial Manager. In exercising his powers of management, the Judicial Manager must ensure that members and creditors are treated fairly. A member who feels that the affairs of the company have been conducted in a manner which is unfairly prejudicial to the members generally may petition for relief. A Judicial Manager must not allow his interests to conflict with his duties and he should exercise his powers for proper purposes. A Judicial Manager also probably has a duty to the company to act with reasonable skill, care and diligence. The Court also exercises

supervision of the Judicial Manager who may be removed by Order of Court.

- Quantum or other rules for the adoption of a plan

Not Applicable

- Cram down

The approach preferred is consensus among the various stakeholders. Consensus will lend legitimacy to the plan and since it is agreed upon by the parties there would be greater desire on the part of the parties to ensure that the plan succeeds during the implementation stage.

- Any special or favorable treatment of particular stakeholders such as employees.

In a judicial management where the corporate entity is still in existence and the business is still running, the appointment of a judicial manager is unlikely to have the effect of discharging the employees, unlike when a receiver and manager or a liquidator is appointed by the court.

Upon liquidation of a company, the employees' wages, retrenchment payment, provident fund and vacation leave payments have priority over the other unsecured creditors. Employees are given better protection than the other stakeholders.

- Duration of time for the proceedings and their effect on the economic value of the firm as well as welfare of various stakeholders, and statutory limitations on the duration of time for proceedings and their practical effects.

When a judicial manager is appointed he has 60 days or such longer time as the court may allow to send his plan to the members and creditors of the company. A meeting of the creditors must be summoned within the 60-day period for the purposes of approving the plan. For the purposes of the meeting 14 days notice must be given to the creditors. Therefore actually the judicial manager has 46 days to come up with his plan to rescue the company. Judicial time is given

expeditiously so any petition can be heard in the High Court very quickly.

- Course of action that follows non-adoption of a plan or termination of the proceedings, and their impact on the firm's operation and value, as well as on the payoffs to various stakeholders.

If the plan is not adopted, the judicial management order may be discharged by the High Court. If this happens the judicial manager automatically vacates office. If judicial management fails, the next step is to liquidate the company. The firm's operation will come to an end and its assets sold and dividends paid to creditors.

- Availability and convenience of the sale of assets, operations, or the firm itself to a third party during insolvency proceedings

Sale of assets is convenient. A sale can be conducted through auction houses. Generally, the preferred mode of sale is auction.

- Impact of the start of insolvency proceedings on the behaviour of the firm, its creditors, trading partners, and on the value of the firm.

No doubt there is a lot of concern and anxiousness among the various parties. But usually insolvency proceedings are a last resort and creditors and trading partners would be aware at the early stages regarding the financial standing and value of the firm. So by the time insolvency proceedings are started, creditors and trading partners are not caught by surprise. Trading parties may have stopped trading with the firm well in advance of the insolvency proceedings.

- Respective incentives of managers and shareholders, various creditors, employees, and the government in facing the insolvency proceedings, including the incentives of some stakeholders to play protracted waiting games or wars of attrition.

From experience, parties do not play waiting games or wars of attrition. The insolvency regime is well entrenched in Singapore. And since recourse to the courts is very expeditious and efficient, if any stakeholder plays a delaying game, other parties seeking relief can always go to the court. Since hearing

dates are given very fast there is no advantage to play any delaying game. The legal system is well developed and very efficient. This has prevented any war of attrition or unnecessary delay.

- Industrial policy and other policy concerns of the government facing insolvent firms, the likelihood and the mode of the government's intervention in insolvency proceedings.

There is no government intervention in insolvency proceedings. Any insolvency proceeding is purely a commercial matter. The creditor must present a petition to the High Court and the High Court decides whether a company should be liquidated or whether an individual should be declared bankrupt. Insolvency policy is geared towards expeditious administration of both individual bankruptcies and corporate liquidations. For bankruptcies, the Official Assignee's policy is to ensure early discharge of individual from bankruptcy and payments to his creditors. For corporate insolvency, the Official Receiver's priority is to realise and collect all book debts and declare a dividend to the creditors in the shortest possible time. In the course of the Official Assignee or Official Receiver's administration, any complaints of breaches of law against bankrupts or the directors of companies would be investigated and offenders would be prosecuted in court.

V Markets for Ailing Firms and Their Assets

V-1 Markets for the Assets of Financially-Troubled Firms

- How well developed are the markets for assets of firms to be liquidated?

The market is very well developed. Major auction houses can be found in Singapore. Assets are normally liquidated either through private treaty sale, tender or by a public auction. Public auction is the preferred method of sale as it gives transparency to the sale and ensures that the best price is obtained.

Are there any structural impediments to a smooth transaction of assets?

No known structural impediments exist to a smooth transaction of the assets.

- Are there government agencies, state-owned enterprises or financial institutions specializing in the acquisition and sale of the assets of bankrupt firms?

In the case of a company that is wound up, the Official Receiver acquires and sells the assets. In cases of individual bankruptcy, the Official Assignee will acquire and sell the assets. These two government agencies are very well equipped and have a lot of experience in selling assets of bankrupts or wound up companies.

V-2 *Markets for the assets and shares of firms during insolvency proceedings or reorganization*

- How well developed are the markets for assets of firms in reorganization procedures? Are there any structural impediments to a smooth transaction of assets?

No structural impediments exist. Assets are sold to the highest bidder in the open market. Any person or company can bid for the assets. The market is well developed.

- Are there government agencies, state-owned enterprises or financial institutions specializing in the acquisition and sale of the assets of firms in reorganization procedures?

In the reorganisation phase, no government agency is involved. Sale of assets is left to the receiver or the judicial manager. Such sale is conducted in the open market and is based on commercial considerations.

VI *Informal Insolvency Proceedings*

VI-1 *Workouts*

- Legal basis for workouts (e.g. statute/government policy/private agreement)

Workouts are not governed by statute. For companies, this is purely a commercial consideration. However in cases of individual insolvencies, the Official Assignee encourages parties to negotiate an arrangement for their financial difficulties and to use bankruptcy as a last resort. The Official Assignee and Receiver is now actively promoting informal workout as an alternative because a workout based on “consensus” is a reflection of a “win-win” situation and has a greater chance of success during the implementation phase.

- Who initiates the process? What is the role of these organizations?

The workout process should be initiated by both the debtor and the financiers. The role of the debtor and financier would be to negotiate an arrangement for the financial difficulties between them and to arrive at an arrangement that would benefit both parties. In the event of any deadlock, the Official Assignee and Receiver encourages parties to seek the assistance of qualified and experienced mediators to assist the parties. The Official Assignee and Official Receiver are also prepared to assist parties at the workout process.

- Please draw a flow-chart of the workout process

Not applicable.

- Relationship between workouts and formal insolvency proceedings

- Does, or could, this relationship preclude the use of formal insolvency proceedings, or does it offer another channel to resolve disputes before resorting to formal insolvency proceedings?

This relationship does not preclude the use of formal insolvency proceedings if the workout process cannot be started or breaks down. Workout is an alternative channel available to parties without resorting to formal insolvency proceedings.

- What are the practical advantages for resorting to workouts, from the efficiency perspective and also from the perspective of some stakeholders?

A workout presents the parties with a greater range of sophisticated refinancing instruments and other commercial techniques which could be used to restructure their debts. A successful outcome would be of greater benefit to all the parties than by resorting to formal insolvency proceedings. This would mean not only that stakeholders like shareholders and employees do not lose their investments or their jobs, but the creditors end up being paid more than what they would receive in a general liquidation. The economy and the government benefit generally through the continued existence of the company generating income, employment and tax revenue through business operations.

- Statistics and cases, before and after the economic crisis

This information is not available.

VI-2 *Composition Agreement*

- How often is this used by debtors?

For individual bankruptcies, debtors, before being made bankrupt, can enter into a voluntary arrangement with the creditors. If this is successful, the debtor avoids bankruptcy. Unfortunately, this has not been successful because the formal process is costly and lengthy. The Official Assignee is also now encouraging other simple composition agreements like debt settlement agreements or plans between debtor/creditors to avoid bankruptcy.

- How do they secure the agreement?

Both the debtor and creditor must negotiate. An agreement will be secured if the creditor has assurance of payment even if by monthly instalments. Mediators may be appointed to assist parties to secure an agreement.

VI-3 *Other schemes employed to resolve systemic insolvency/non-payment*

- Have schemes such as netting processes for enterprise debts or London club style procedures for private bondholders in private companies of a specified nationality been employed in your country? Any other schemes worth mentioning?

Nil

VII **General Information on Bank Insolvency Regimes**

- A general description of insolvency regimes for failing banks

Under the Banking Act (Cap 19), any bank which is insolvent must inform the Monetary Authority of Singapore (MAS). On being informed MAS may –

- (a) require the bank concerned forthwith to take any action or to do or not to do any act or thing whatsoever in relation to its business as MAS considers necessary;
- (b) appoint a person to advise that the bank is in proper conduct of its businesses; or
- (c) assume control of and carry on the business of that bank or direct some other persons to assume control of and carry on the business of that bank.

MAS also has the power to present a petition to the High Court for the winding up of the bank by the High Court.

In the event MAS assumes control (as stated in (c) above) of the business of a bank, MAS shall remain in control of, and continue to carry on, the business of that bank in the name of and on behalf of the bank until such time as MAS is satisfied that the reasons for which it assumed control of the business have ceased to exist, or that it is no longer necessary for the protection of the depositors of the bank that it should remain in control of the business. In the event MAS assumes control, the bank must submit its business to the control of MAS and shall provide MAS with such facilities as MAS may require to carry on the business of the bank. MAS may, in the interest of the depositors of a bank, apply to the High Court

for an order staying the commencement or continuance of any proceedings by or against the bank in regard to any business of the bank. Such an order shall be valid for a period not exceeding 6 months.

- A brief summary of statistics on failing banks and how they have been taken care of.

Nil

VIII Problems, Future Tasks, and Trends

- What are the main problems with the current insolvency mechanisms, overall and specific, in terms of efficiency and fairness?
- In particular, how does the current system provide distorted incentives to some stakeholders that result in inefficient outcomes in both the static and dynamic sense?

The focus of our insolvency laws is to balance the interests of both the creditors and debtors. No distorted incentive schemes exist that benefit some stakeholders resulting in inefficient outcomes. As a general rule, secured creditors have a first bite at the cherry but the insolvency mechanism has for the other stakeholders established a fair and equitable system for the ranking of their claims and the distribution of assets to them.

- Are there other elements other than insolvency proceedings themselves that have critical deficiencies, such as the governance problem of banks and other financial institutions in Korea?

No, but generally corporate governance, transparency and greater disclosure of financial/corporate information in a timely manner have emerged as important and relevant issues.

- What needs to be done to improve the effectiveness and efficiency of overall as well as individual insolvency proceedings?

Constant review of the laws relating to insolvency is vital to ensure that insolvency proceedings remain simple, effective and easy to

administer. Cumbersome and archaic procedures that hinder insolvency proceedings must be reviewed and repealed. Active steps are being taken to modernise our insolvency laws, practices and procedures. Serious consideration is also given to measures to avoid insolvency except as a measure or remedy of last resort. In Singapore, we are constantly reviewing our legislations to strengthen our insolvency regime. We are also of the view that informal insolvency mechanisms or processes have a place and should be developed and encouraged. Our objective is to place more emphasis on the “rescue” of individuals and financially troubled firms. A company is worth more if it is preserved as a on-going concern and Singapore’s entrepreneurial climate is enhanced, encouraging technopreneurial activity if failure among individuals is tolerated.

- What changes have been made since the onset of the crisis? How do you evaluate their results?

In individual insolvency, the bankruptcy laws were amended in 1999 to give greater opportunity to bankrupts to rehabilitate themselves and to facilitate a bankruptcy regime that would be more positive towards individuals who were bankrupt due to misfortune or through genuine failure of their business. In 1999 many changes were made to bankruptcy laws in Singapore to encourage technopreneurial activity and to enhance Singapore’s entrepreneurial climate. The implementation of individual bankruptcy rehabilitation plans allow bankrupts to pay up the amount due to their creditors and at the same time to quickly get out of bankruptcy quickly. This can be a win-win situation both for creditors and bankrupts alike, as creditors pay dividends and bankrupts can be discharged quickly to start their life on a fresh footing.

- What are the current activities in this area, and what are the likely directions for the insolvency proceedings for the future?

Rescue of both individuals and corporations remains our main focus. If rescue is not possible, rehabilitation of individuals in bankruptcy is our next area of focus. We are of the view that the insolvency regime should not stifle, but rather, assist in encouraging or promoting entrepreneurship. We are encouraging parties to resort to ‘workouts’, and to use bankruptcy as a remedy of last resort. Moving ahead, cross-border insolvency issues are also an area that we are studying. The Prime Minister of the

Republic of Singapore Mr Goh Chok Tong at the 4th Asean Law Ministers Meeting said, “The financial crisis of July 1997 was a dramatic lesson in globalisation. It did not only expose bad economic practices and inadequate policies. It also holds lessons for our legal institutions. Following the crisis, it is increasingly clear that we need to support our economic growth with a more transparent and consistent legal regime laying down guidelines and standards for corporate governance. For example, clear business laws such as those governing bankruptcy and insolvency will encourage foreign investments and funds to move into our countries. The lack of such laws will be a major disincentive for commercial lending, which is necessary for economies to grow.” We will also be studying how we can further strengthen our business laws, including those governing bankruptcy and insolvency, so as to promote economic development.

COUNTRY REPORT FOR THAILAND

by
Wisit Wisitsora-At

Chapter I Overall Economics Conditions and the Extent of the Debt Crisis

The recent economic crisis that culminated in the flotation of the Thai baht in 1997 exacerbated the debt problems among the Thai corporates that borrowed from overseas by causing hefty foreign exchange losses. The high interest rate policy aimed at stabilizing the baht during the crisis drove many firms into trouble. The closing down of 56 finance companies also affected a large group of debtors as their closure worsened the liquidity problem of these debtors. This led to a sharp increase in non-performing loans. The loss of confidence among foreign investors and the resulting outflow of capital caused the authorities to maintain a high interest rate policy for a long period of time. Furthermore, the sharp economic slowdown resulted in less consumer spending which hurt the entire economy. Non-performing loans continued to increase before stabilizing in mid-1999.

Thailand's bankruptcy law in 1997 was considered unsuitable to deal with the large amount of bad debts as there was no regime for reorganization and the process of liquidation in bankruptcy was time-consuming. Several amendments to the law were enacted in 1998 and 1999 to speed up the process and to include into the system a reorganization procedure. A specialized bankruptcy court was also established to more efficiently deal with bankruptcy and reorganization cases.

Chapter II Characteristics of Debtor-Creditor Relationship

As in many other countries in Asia the lending practice in Thailand concentrated more on collateral rather than on an analysis of cash flows. More often than not, Thai banks and finance companies in their lending required personal guarantees from owners and directors of the borrowing entities. One of

the reasons this condition was accepted by the debtors might be the precedent that personal guarantees were not normally called upon for settlement of debt. Another reason might be the difficulty in differentiating the interests of the directors and owners of the borrowing companies who were often the same persons or a closely related group of persons. Another weakness in the lending practice in Thailand was the emphasis on personal relationship.

Outstanding Non-Performing Loans (NPLs) of financial institutions Billion Baht

	1999					
	Jun.	Jul.	Aug.	Sept.*	Oct.*	Nov.*
1. Private Commercial Bank ¹	1,222.69	1,215.09	1,208.86	1,157.01	1,132.84	1,100.97
(% of total credit)	41.02	40.86	40.67	38.80	37.95	36.37
2. State-owned Commercial Bank	1,173.33	1,175.72	1,154.24	1,151.10	1,138.55	1,083.12
(% of total credit)	70.23	70.07	68.62	65.58	65.27	64.10
3. Foreign Bank	86.75	91.64	93.95	81.81	78.90	74.28
(% of total credit)	12.57	12.97	13.43	11.53	11.48	10.92
Sub-total (1+2+3)	2,482.77	2,482.45	2,457.04	2,389.92	2,350.29	2,258.37
(% of total credit)	46.48	46.33	45.89	43.88	43.39	41.84
4. Finance Companies	168.072	169.473	161.904	150.15	105.835	102.307
(% of total credit)	67.25	68.18	67.22	62.26	56.10	54.49
Grand total (1+2+3+4)	2,650.84	2,651.92	2,618.95	2,540.07	2,456.12	2,360.68
(% of total credit)	47.41	47.30	46.81	44.66	43.82	42.27

* Preliminary

Note ¹ Radanasin Bank is included since Nov. 99 when it became private bank as UOB Radanasin Bank Public Company Limited
Source: CDRAC

Commercial banks in Thailand have long enjoyed state protection in the tradition of the monetary authorities guaranteeing the banks' liabilities to prevent a run on banks. In recent years they have been forced to increase their capital base to deal with heavy losses from non-performing loans. As for non-bank financial institutions, the help provided by the government was somewhat limited. Criticisms were levied against these financial institutions for their reliance on lending, before the economic crisis, to many non-tradable businesses such as real estate projects in Thailand.

Net Change of NPLs of Financial Institutions

Billion Baht

	1999					
	Jun.	Jul.	Aug.	Sept.*	Oct.*	Nov.*
1. Private Commercial Bank ¹	-79.73	-7.60	-6.23	-51.85	-24.17	-31.87
(%)	-6.12	-0.62	-0.51	-4.29	-2.09	-2.81
2. State-owned Commercial Bank	+3.45	+2.40	-21.48	-3.14	-12.55	-55.43
(%)	+0.29	+0.2	-1.83	-0.27	-1.09	-4.87
3. Foreign Bank	+1.77	+4.89	+2.30	-12.13	-2.92	-4.62
(%)	+2.08	+5.63	+2.52	-12.92	-3.57	-5.85
Sub-total (1+2+3)	-74.51	-0.31	-25.41	-67.12	-39.63	-91.92
(%)	-2.91	-0.01	-1.02	-2.73	-1.66	-3.91
4. Finance Companies	-4.01	+1.40	-7.57	-11.75	-44.32	-3.53
(%)	-2.33	+0.83	-4.47	-7.26	-29.51	-3.33
Grand total (1+2+3+4)	-78.52	+1.08	-32.98	-78.87	-83.95	-95.45
(%)	-2.88	+0.04	-1.24	-3.01	-3.30	-3.89

* Preliminary

Note¹ Radanasin Bank is included since Nov. 99 when it became private bank as UOB Radanasin Bank Public Company Limited
Source: CDRAC

In normal times, banks may have the luxury of waiting for the problem of a debtor to become critical before stepping in. However, in a situation of a nationwide systemic economic crisis, banks are forced to react more quickly, partly as a result of the impending pressure on banks to raise capital to absorb heavy losses. The actions commonly taken by banks are the freezing of lending, the calling of loans, the call for more collateral, and if not complied with, the taking of legal actions. Debtors in Thailand regard bankruptcy filing with aversion. The reason is that Thai society views bankruptcy as a stigma and for a person to be forced into bankruptcy is an immense loss of face to him/her and his/her family.

Regime for Property Right Protection

In principle, in the process of liquidation the estate of a debtor will be collectively disposed and proceeds of the sale will be distributed to creditors. Generally secured creditors rank first followed by creditors with priorities, such as taxes and wages claims. The rest will be distributed *pari passu* to the

remaining creditors. Any residual proceeds will be returned to the debtor or, in the case of a liquidated company, to shareholders.¹

In a civil case, creditors normally do not have to share the proceeds fetched from the sale of the seized property. However, if there is more than one judgment creditor, they may have to share the proceeds proportionately.

Chapter III Formal Insolvency Mechanisms

I. Overview and Procedure

Formal insolvency mechanisms are currently governed by the Thai Bankruptcy Act 1940. This legislation went through four amendments, i.e. Bankruptcy Act (No.2) 1968, Bankruptcy Act (No.3) 1983, Bankruptcy Act (No.4) 1998 and Bankruptcy Act (No.5) 1999. Basically, there are two mechanisms provided by the current law. The first one is the liquidation or bankruptcy procedure and the second is the reorganization or rehabilitation procedure.

The law was comprehensively amended in 1998 and 1999 due to the need for reform in the bankruptcy law. The reorganization procedure and some other changes are the result of the effort by the government to modernize the system. To strengthen the changes made to the law, the Thai parliament also approved the establishment of a specialized bankruptcy court.

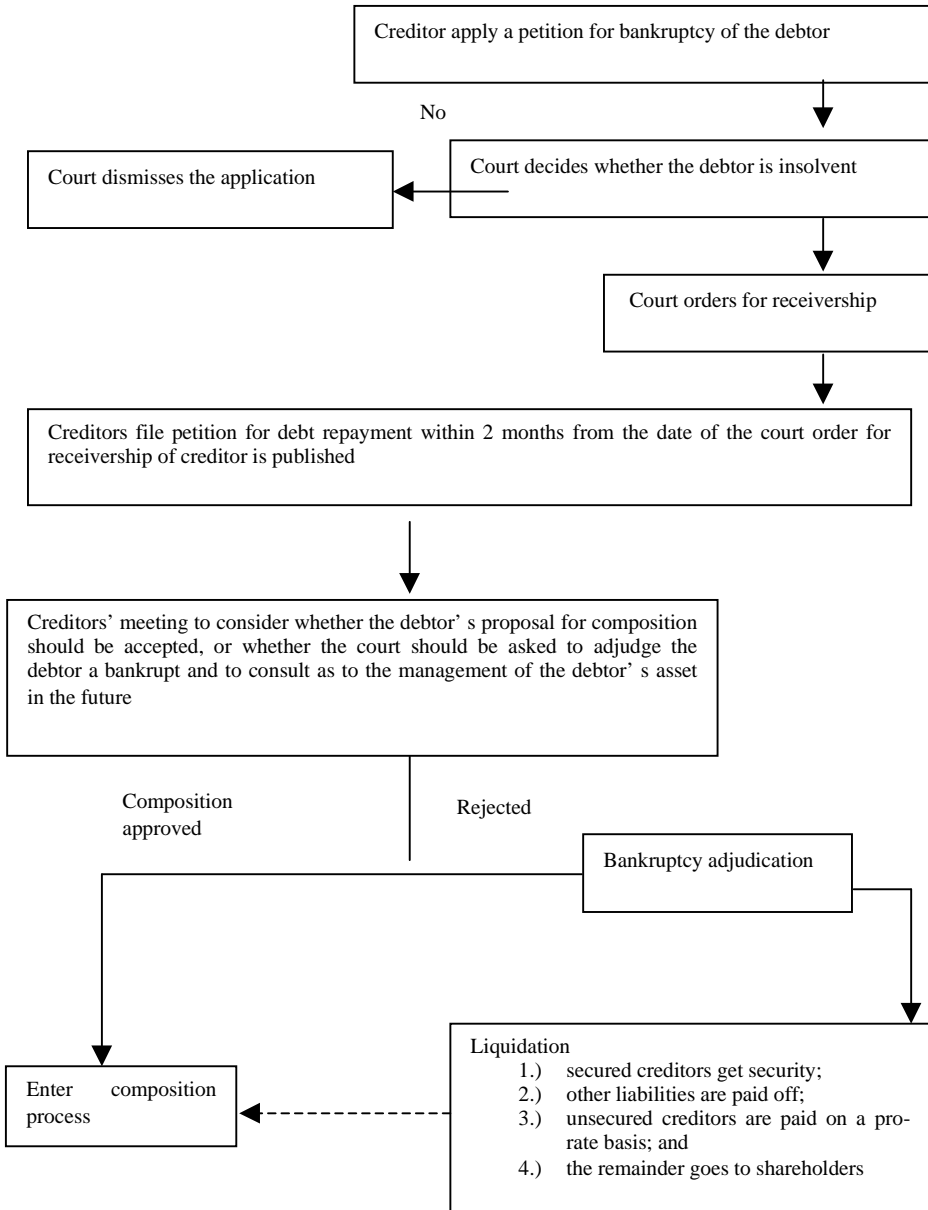
The details of each procedure are shown below.

A. Bankruptcy Cases

In general, the bankruptcy of individuals, partnerships and companies is concerned with the realization of the assets subject to the bankruptcy charge, and with the distribution among all administration, for the benefit of these creditors under the bankruptcy law. The law in this area is solely governed by the Bankruptcy Act (BA) B.E. 2483 (1940 AD). The term "execution" itself is never mentioned in the Act, but instead it is called "administration of the bankrupt's property". The officer in charge of the said process is called an official receiver who, by law, must be a qualified lawyer and recruited by the Ministry of Justice.

¹ Please refer to the details of distribution in bankruptcy cases.

Liquidation



1. Receiving Order

The administration does not commence until a receiving order is made against a debtor. To obtain such order, a creditor will have to file a bankruptcy petition against the debtor and demonstrate to the court that it has satisfied the required grounds under BA ss. 9, 10. The trial for the issue will be set and the outcome will depend upon the evidence. (BA s. 14). Once the receiving order is made against a debtor, he will, by the effect of the order, cease the control of his assets which, by law, is vested in the official receiver.

It should be noted that at this time the debtor is not yet bankrupted by law, albeit not far from it. It is the obligation of the official receiver to proceed further, that is to forthwith advertise the order, call for the first creditors' meeting and make a public examination of the debtor in court. (BA ss. 28, 31, 42, 43)

2. Meetings of Creditors

The first creditors' meeting is crucial for the debtor since the creditors are to decide whether the debtor should be adjudicated bankrupt. (BA s. 31) The debtor may submit a proposal in the meeting of creditors to settle the issue which, in order to succeed, will need a special resolution in favor of it, i.e. a resolution by a majority of creditors whose claims equal three-quarters of the total claims of creditors who are present at the meeting personally or by representation and have voted on such resolution. (BA s.6). The proposal is forbidden if it is against the principle of *pari passu*, i.e. proportionate distribution. Unless the proposal is successful, the case will be redirected to the court and a bankruptcy order will then be made.

Other creditors meeting may be called by the official receiver at such time as may be proper, as required by law or court order or demanded by the required numbers of creditors. (BA s. 32)

3. Composition and Realization of Assets

The debtor may propose a composition to the creditors' meeting during this time, but it requires a special resolution.¹ If the debtor fails to secure a composition, the court will adjudicate the debtor a bankrupt.

¹ Special resolution requires the support of at least three-quarters of the value of debts and the majority in the number of creditors attending and voting.

It is the responsibility of the official receiver, with assistance from the creditors, to undertake the gathering of all assets which are distributable under bankruptcy law. The power of the official receiver in this respect is far wider than that of the executing officers. The process may involve seizures of property in a similar manner to the enforcement of judgment in civil cases. However, property belonging to third parties may also be seized if it is, by consent of the owner, in the possession or disposition of the debtor in the normal course of trade or business under circumstances which create the view that the debtor is the owner of the property when the petition in bankruptcy was filed against the debtor. (BA s. 109 (3)).

Further, the official receiver is entitled, under BA ss. 118 and 119, to claim payment of money or demand the delivery of property from the bankrupt's debtors. The aforementioned claim or demand will have to be in the form of a written notice informing such person what he will be deemed to be indebted as such unless he submits a written denial to the official receiver within 14 days from the date the notice takes effect.

When the denial is submitted, an investigation will be carried out by the official receiver to determine whether or not the bankrupt's debtor is actually indebted to the bankrupt. If the official receiver believes so, a second notice will then be served upon the bankrupt's debtor and he, if objecting to it, must apply to the court for a hearing on such issue within 14 days.

In the case where there is no objection from the bankrupt's debtor or where the court has made an order against him, if the demand or court order is not complied with accordingly, the official receiver is empowered to apply for a writ of execution against such a person and enforce it in the same manner as in civil cases.

The work of the official receiver also includes the recovery of assets disposed by the bankrupt to third parties. The official receiver may apply by motion to the court to nullify the transfer of property on the following grounds:

1. Fraudulent transaction under BA s. 113.
2. Transaction made within 3 months preceding the petition with the intention to prefer some creditors under BA s. 115. (The qualified time for transaction made with insiders is one year.)

The property may be sold by the official receiver in any manner which shall be convenient and most beneficial to the creditors. However, a sale other than by auction will require the approval of the creditors' committee except as permitted by law. (BA s. 19, 123)

4. Distribution

To be entitled to dividends of the assets of the bankrupt, every unsecured creditor is required to submit a formal claim, known as a proof of debt, to the official receiver within 2 months from the date of publication of the receiving order. (BA s. 91). The claim has to show that the debt in question is provable under BA ss. 92-94. Secured creditors can submit a formal claim only if he has complied with one of the conditions under BA s. 96.

The official receiver will, without delay, examine all the claims and subsequently report his opinions to the court which will finally decide whether each claim should be dismissed or allowed in full or in part. (BA s. 104-107)

Preferential debts and expenses of the official receiver have priority over other claims and will be paid out in the order stated in section 130. Ordinary debts rank equally among themselves and will be paid out on a *pari passu* basis, i.e. ratable proportionate. Payments must be made at all times not exceeding 6 months from the date of the bankruptcy order unless the court permits an extension of time. (BA s. 124)

5. Termination of the Administration

The debtor can be released from bankruptcy in three major ways: a composition after bankruptcy, a discretionary discharge and an automatic discharge. The first two actually came with the 1940 Act whereas the third was newly included into the Act by the Bankruptcy Act (No.5) 1999. In short, a bankrupt will be automatically released from bankruptcy three years after the date of adjudication. A bankrupt that wants to be released before the three-year period expires may try to reach a compromise with creditors through a composition process after bankruptcy or may apply to the court for a discretionary discharge order. It is to be noted that claims based on debtor's fraudulent conduct and tax claims cannot be discharged.

B. *Reorganization or Rehabilitation*

The process of business reorganization under the new law is a hybrid of US Chapter 11 reorganization and the Judicial Management of the Singaporean law. In short, this reorganization could be described as court-supervised formal attempts to restructure the finances of a financially distressed enterprise. The new provisions contain very detailed reorganization procedures. The law is intended to prevent business from being driven into unnecessary bankruptcy because of temporary liquidity problems. In order to solve the problems, the law

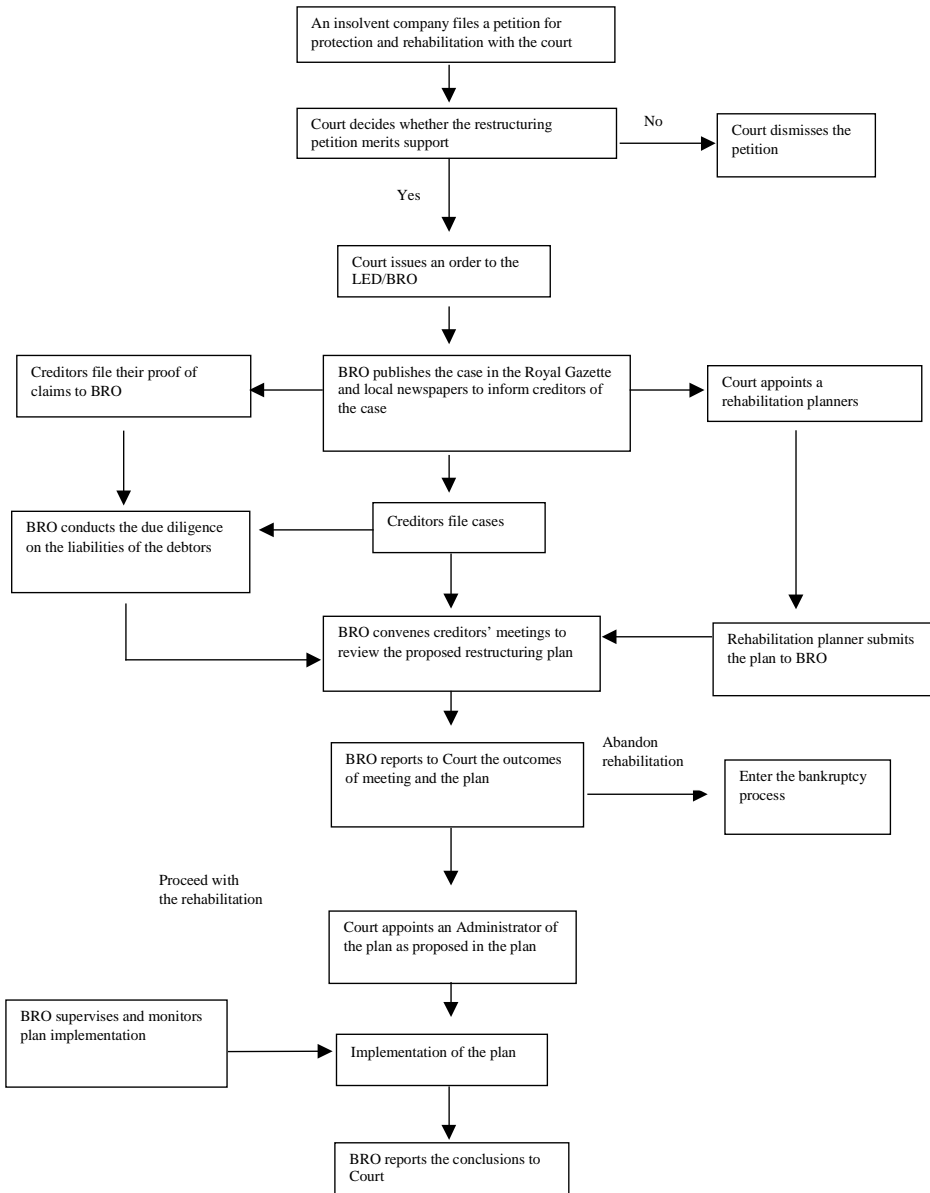
subjects indebted enterprises to a reorganization proceeding if a creditor or the debtor files a petition with the court and if the debtor owes at least 10 million baht to one or more creditors. Reorganization is provided for companies both private and public, and for other enterprises as may be provided by ministerial regulations. None of the regulation is yet in existence.

Upon filing the petition, the moratorium or automatic stay under section 90/12 will come into effect and will prevent secured and unsecured creditors from pursuing their debts, enforcing their civil judgment or filing a bankruptcy petition against the debtor. A court trial will be set to decide if the reorganization order is to be issued. It is stated very clearly in the law that the trial must be conducted in a speedy manner in order to prevent any delays. If the court is satisfied that the debtor is insolvent and has the potential of achieving success as a restructured business, the court will issue the reorganization order. Once the reorganization order is issued, the court will have to appoint a planner to form a reorganization plan. The planner will also have the power to run the business during the reorganization under the supervision of the official receiver and the court.

The proposed plan must be put to a vote by creditors within 3 months after the appointment order and must be approved by a special resolution of creditors with a certain qualified majority. The only creditors who have a right to vote are those who have filed their proofs of claim with the official receiver of the business reorganization within one month from the date of the publication of the appointment of the planner order. If the plan receives the approval of creditors, it will then be submitted to court for confirmation. Motions against the confirmation may be filed with the court on the basis that there is an unfair treatment of creditors.

The details of each plan could vary depending upon the problems and status of the business. The plan can provide for a composition, as well as a capital reduction or increase. The time limit for the plan is five years but may be extended by the court. If the process fails to help the business, the court could declare the enterprise bankrupt and liquidation under the bankruptcy law will follow.

Rehabilitation



1. Automatic Stay

Moratorium or automatic stay is the major element of the reorganization law in every jurisdiction. The question is to understand the scope of the automatic stay in each country since it varies very much from one to another.

The Thai automatic stay has a very wide scope and will come into effect at the very beginning. Section 90/12 provides that upon the acceptance of the reorganization petition by the court, the so-called "automatic stay" will be effective. This does not depend on whether or not it is the petition from the debtor or creditors like in the US jurisdiction.

The stay will have the effect to both secured and unsecured creditors. The stay will freeze all civil suits and bankruptcy actions against the company. Secured creditors will not be able to enforce payment of debt against the asset, which is security, unless allowed by the court. This approach is in line with the concept of adequate protection in many jurisdictions. The court can allow the enforcement against security if it can be shown that there is no sufficient protection of the rights of secured creditors.

During the stay but before the reorganization order is issued, the existing management can still have control over the company subject to the limitation that it can only conduct the ordinary course of business. To do something further than the ordinary course of business, the management will need a leave of the court.

The stay will be effective until (a) the expiration of the period of time for implementation of the plan, (b) the date on which the plan is accomplished successfully, or (c) the date on which the court dismisses the petition, disposes of the case, repeals the order for a business reorganization, cancels the business reorganization, or issues a receiving order.

2. Management

With the concept of appointing someone as a planner, the law has to balance the interest of the shareholders and creditors reasonably. The concept under the US Chapter 11, i.e. giving priority to the debtor to form a plan, and both the concept under the English Administration, i.e. appointing an independent licensed practitioner to take control over the company, influenced the Thai legislation.

Although section 90/16 provides that the Minister of Justice may prescribe ministerial regulations relating to the registration and qualifications of the planner, up to now there are still no such regulations. The debtor may have the

edge over creditors if it proposes someone as the planner. The law provides that if there is more than one person proposed as the planner, the one proposed by the debtor should be the planner, except if there is a vote, at the creditors' meeting, amounting to two-thirds of the debt value of the creditors attending and voting deciding otherwise. Therefore, to this extent, it is correct to say that management may or may not change hands during the forming plan period.

Once the plan is completed and submitted to the creditors' meeting, there might be another possible change of the management. The one who will have the power to run the business in accordance with the plan is called a plan administrator. The plan must state who is the plan administrator. It is understood that the planner and the plan administrator may not be the same person.

The plan administrator must prepare a plan implementation report and submit it to the official receiver every three months. The removal of the plan administrator for wrongdoing or fraud can be done by a court order. Creditors may change the plan administrator through amending the plan. In any case, the plan administrator will cease control of the company once the court orders the end of rehabilitation. Who will take over depends upon the outcome of the rehabilitation. If the outcome is a successful one, the current holder will regain control of the company. On the other hand, if the plan fails, the official receiver will come to have the control.

3. The Plan

The new law does give the plan formed within its scope additional advantages in comparison to the one done for the purpose of an informal workout. First, the interest of equity holders seems to be very much limited. All the powers relating to the decision-making on the future of the company is now shifted to creditors. This includes the powers to decide to reduce or increase the capital. Conversion of debts into equity is also allowed.

The credit given to the company under the plan does enjoy a priority right over existing unsecured debts. It is very unfortunate that the concept of superpriority was not adopted by this legislation.

For cases filed with the court prior to 22 April 1999, the plan is deemed to be accepted by the creditors if the court receives a special resolution, i.e. a resolution by a majority of creditors whose claims equal three-quarters of the total claims of creditors present at the creditors' meeting in person or by proxy and voting on such resolution. For cases filed after the said date, the procedure

for voting is very different since creditors will be classified into groups and some groups may be crammed down to accept the plan.

4. Classification of Creditors and Cram Down

A special resolution was required for rehabilitation under the Bankruptcy Act (No.4) 1998. It has proved to bear great difficulty since a major creditor or a group of small creditors may vote down the plan for their own personal interest. The Bankruptcy Act (No.5) 1999 amends the vote by adopting a new approach, classification of creditors. Under the new law, creditors will be classified into groups. The groups stated by the law are as follows:

1. Major secured creditors.
2. Minor secured creditors.
3. Unsecured creditors.
4. Subordinated creditors.

Major secured creditors refer to secured creditors whose secured debts reach at least 15% of the total debts. Each of these major secured creditors will be classified as a group. All other secured creditors will then form another group, the minor secured creditors.

Unsecured creditors are obliged by the law to have at least one group. However, if the planner thinks fit, he or she may divide the unsecured creditors into different groups on the condition that every unsecured creditor in a group must have the same nature of the claims.

A subordinated creditor is a creditor who will receive any dividends after their senior creditors under some agreement will be paid in full, and therefore has very little interest under insolvency law.

A plan is considered to be approved by creditors if

- a) all the affected groups approve the plan with a special resolution of each group, or
- b) there is a special resolution from one affected group and their claims are more than 50% of the total debts approving the plan.

The law not only lowers down the required resolution to approve the plan as we can see in (b), but also changes the rule for confirmation of the plan. Judges will have to observe three objective principles shown below if there is a motion from any creditor objecting the plan.

1. Non discrimination treatment within a group.
2. Absolute Priority rules if the plan is not passed by type (a) resolution.
3. Best Interest Rule.

II. Insolvency Test

For bankruptcy or liquidation, the petitioner must prove the insolvency of the debtor. The term insolvency has no definition provided by the law but the petitioner may rely upon certain presumption to trigger the mechanism. Normal grounds for the presumption are the failure to pay debts after a statutory demand¹ set by a creditor or the fact that the debtor cannot satisfy debts after an enforcement of a civil court order. Debtors may not be adjudicated bankrupt if he or she can prove that his or her assets exceed liabilities.

In the Rehabilitation procedure, although insolvency is required as a threshold for filing, a presumption can work in the same manner to trigger the mechanism. Further, the law allows a consensual case to proceed without any hearing and therefore without any proof of insolvency. In the rehabilitation case the court now tends to allow rehabilitation and accepts the valuation of the assets as the measure for considering a contested case. In one case the court allowed a company to be reorganized even though its balance sheet was positive after it had been shown that if the company stopped operating would lose tremendous property value.²

III. Deliberation Procedure

1. Claims

In both liquidation and rehabilitation, all creditors will have to file proof of claims with the official receiver. The difference between the two procedures is the time frame, i.e. in respect of a bankruptcy, creditors must file their proof of claims within two months from the date of the receiving order, whereas in

¹ Written demands must be served on the debtor twice before a bankruptcy filing and there must be at least 30 days in between each.

² Re Srithai Superware (1999).

respect of a rehabilitation creditors must file proof of claims within one month from the date of the reorganization order.

Debtors, creditors and the planner have the right to object to the claims, and if there is an objection, the official receiver will have to inquire upon the matter and rule accordingly. A late filing can only be allowed by a court order and the ground for doing so is a *force majeure*. Once the court allows a late filing, such creditor will be treated as if the claim had been filed in time. However, it is extremely rare for the court to permit late filings.

Basically, all true claims are allowable in bankruptcy. The main exception is a claim that is unenforceable under civil law, such as a debt arising out of gambling. In the past, debt which the creditors advanced to the debtor with the knowledge that the debtor was insolvent, was not provable. But after the amendment to the Bankruptcy Act in 1999, such debt, if advanced for the purpose of allowing the debtor to continue its business, will be deemed to be provable.

Sections 130 and 130 bis provide the clear rule for priority in bankruptcy. Generally secured claims rank first, followed by the administrative expenses of the official receiver. Unpaid taxes and wages claims rank further below and are ranked equally. Wages claims were junior to unpaid taxes before the amendment in 1999, but it is not the case today. Below these are the general unsecured creditors who will receive dividends on *pari passu* basis. Section 130 bis provides the clear rule for subordinated creditors, who will generally come last among creditors. Should there be anything left, it will go to equity holder.

2. *Avoidance Power*

Avoidance of transaction can happen in two manners.

1. Fraudulent transfer
2. Preferential transfer

A transfer is fraudulent, and will be revoked, if it is made to transfer any property during the time that the debtor is insolvent. It is the burden of the applicant to prove the intention of the parties. However, if the transaction is made one year prior to the insolvency filing or without consideration or undervalued, the burden is shifted to the debtor and the transferee to prove the negative.

Preferential transaction can be revoked by the court on a motion made by the official receiver or planner if it is made within three months prior to the insolvency filing. In case of a preferential transaction made to an insider, the said period is extended to one year.

In the case of bankruptcy, only the official receiver may apply for a revocation of the fraudulent or preferential transfers. In case of rehabilitation, the power extends to the planner and plan administrator.

3. *Executory Contract*

There is only one rule for the person representing the estate to reject a burdensome contract. In the case of bankruptcy, the official receiver has to reject the contract within three months after he become aware of it. Basically, the official receiver will ask the creditors' committee to give a recommendation on the action.

In the case of reorganization, the power is vested with the creditors and this matter will be recommended in the plan by the planner. If the plan is approved, the plan administrator will have to reject the contract within two months.

There is no rule regarding the assumption of contracts in bankruptcy law. Ipso facto clause tends to be considered as not valid and there is no need for the assumption rules as required in some jurisdictions.

IV. *Management and Insolvency*

Basically, insolvency does not constitute a criminal offence in Thailand. Directors of companies still owe fiduciary duty to the shareholders and must inform the shareholders if the equity of the company depreciates to one-third of the previous value. Failing to do so can lead to a compensation to be paid. To bring the case, shareholders may rely upon the law of torts. Due to the fact that most companies in Thailand are family owned, it is rare to see any action raised by shareholders.

The company law prevents the shareholders and directors from being personally liable in insolvency. The practice of Thai banks somehow forces stakeholders to give personal guarantees on loans to ensure their personal liabilities.

V. *Disclosure Procedure*

Information is to be clearly disclosed under the provisions of the bankruptcy law. In the bankruptcy case, the debtor must go through a process of a public examination where judges, official receiver and creditors can examine the debtor's information. Also after the receiving order, the debtor must inform the official receiver of the details of all assets and liabilities. He or she must also surrender books and trade records within seven days from the day of the order. Creditors have a right to examine claims filed with the official receiver and also have a right to object to them.

In a rehabilitation case, a planner will take control of the company, so the debtor must surrender records to the planner, not to the official receiver. However, there is no public examination in respect of rehabilitation.

Basically, the court can summon any party to give information pertaining to the case.

Although the law may provide the channel to gaining information, it is very rare to receive information from the debtor in bankruptcy cases. Most information will normally be collected through the investigation by the official receiver. In reorganization, information is more reliable due to the keeping of books and records. If there are problems with the bookkeeping the planner may retain professionals to assist.

VI. *Reorganization/Composition Plan*

1. *Content of the Plan*

Currently, there have been eight plans submitted to the creditors' meeting. Five plans were approved and three plans failed. The methods of restructuring seem to consist of various tactics. Generally, rescheduling of debts is very common. This sometimes can come in the form of converting debts into long-term bonds. Debt-equity swaps are seen in many cases as well as the sale of equity. In one plan, there was a sale of the whole operation to a newly set-up company instead of the sale of shares.

Creditors normally rank above stakeholders in the normal judicial enforcement process and in the plan. However, the plan can allow stakeholders to receive some benefits even though creditors may sustain losses, if allowed by the majority of creditors. This is the case where new capital is provided by the stakeholders. In most cases inflation is not taken into account in the plan.

2. *Post-confirmation Procedure*

After a plan has been approved by the court, the person named in the plan as a plan administrator will take control and proceed in accordance with the plan. Plan administrators can be anyone prescribed in the plan. Remuneration of the person is fixed by the plan as well as his or her authority.

The plan administrator can be dismissed by a court order if he or she commits any fraud. The work is generally supervised mainly by the creditors' committee and the official receiver. Reports on the work must be filed with the official receiver every three months.

VII. *Statistics*

Types/year	1994	1995	1996	1997	1998
Bankrupt firms	n.a.	n.a.	294	381	476
Liquidation (Individuals)	N/A.	N/A.	1,473	1,321	1,660
Composition	N/A.	N/A.	N/A.	N/A.	N/A.
Reorganization	0	0	0	0	9
Others					

Ratios

Ratio/year	1998	1999
No. of orders for opening/no. of filings	3/11	19/19
No. of confirmation of the plan/ no. of orders for opening	5/8	N/A.
No. of recovered firms/ no. of confirmation of the plan	N/A.	N/A.

Average time between the process

From the filing to provisional measure	Promptly
From the filing to the order of opening	3 weeks
From the order of opening to the confirmation of the plan	5 months
From the order of confirmation of the plan to the closing of the proceedings *	5 years

* The closing of the proceeding refers to the end of the period specified under the plan and does not reflect any efficiency of the system since the court is involved very little at this stage.

Statistics on Reorganization Cases

	Apr.98- Oct.98	Nov.98- Mar.99	Apr.99- Oct.99	Nov.99- Current
No. of filings	9	9	12	3
Reorganization orders	3	7	12	Still pending
Plans approved by creditors	3	2	Still pending	Still pending
Plans rejected by creditors	0	3	Still pending	Still pending
Plans being prepared	0	2	12	0
Amounts of debts (million baht)	51,595	39,459	45,363	4,119
Amounts of debts restructured (million baht)	44,312	6,743	N/A.	N/A.

Source: Business Reorganization Office, Ministry of Justice. Data as of 18 November 1999.

VIII. Effect of Insolvency Proceedings on the Efficiency and Welfare of Creditors and Debtors

To be able to enter the reorganization procedure, a firm must be considered to have viability. The term viability is not restricted to the viability of the firm and includes the viability of the business or operation. The law is intended to prevent companies with no chance of a successful restructuring to enter the procedure, and gives the court the power to decide at the beginning if the procedure should be allowed for the firm. The court is usually lenient; instead of basing its consideration on the cashflow projection, it normally allows cases to proceed if there is some evidence that creditors may gain more through the process. The reorganization filing of a firm may affect the value of the company and the value of its shares. However, the trading in the company shares is normally suspended by the Stock Exchange of Thailand well before the filing.

With respect to the negotiation during the plan preparation, it was seen in some cases that stakeholders could still bargain during the process. Plans for some companies still allow shareholders to retain some equity even though creditors agree to a haircut. The bargaining power relates to the types of business which may be very local or to the need for the stakeholders' expertise or to the new injection of some cash by the stakeholders. It is also seen in some cases that stakeholders may not want to stay on to bargain. These cases were normally

controlled and reorganized by independent accounting firms. In this respect, bargaining is left to the creditors.

Plans tend to give more favorable treatment of employees. This may be because the priority rules under bankruptcy allows wages claims to rank above ordinary debts. In most cases, employees will receive 100 per cent of unpaid wages. Plans to rehabilitate any firms in agriculture normally try to protect planters or growers of the raw material as well.

The crucial period which will affect the economic value of the companies most is the period of the time between the filing and the confirmation. The average time for the period is around 5 months. Firms struggles to continue their business during this time and may experience a depletion in the number of customers. Once the plan is confirmed, we have seen that confidence generally returns leading to an improvement in the firm's performance.

When an assets sale was attempted during the insolvency process, it was seen that the planner sought to fetch the highest price by retaining brokers to find buyers if the value of the assets to be sold, such as a factory, was believed to have a high value. In the case where the sale concerned parts of equipment, asset valuation and a specific sale were more preferred. The sale can only proceed with a leave of the court and it may take a while before the court gives its approval.

The management of the firm during reorganization is to be transparent whether or not the debtor is in possession. This is a result of greater involvement of the court and official receiver in trying to keep good governance in place.

During the time of insolvency, trade creditors normally react very quickly to the change in the status of the company and many will not extend credit to the company but promptly ask for a cash payment for any supply. Only a well-prepared company that has negotiated with their creditors well beforehand can minimise the negative impact.

The government has so far left the bankruptcy process to the market and keeps its intervention in any reorganization cases to a minimum. The only intervention in the process is the formatted mechanism to expedite informal workouts under the supervision of the Bank of Thailand. This helps the creditors and debtors to proceed more quickly to reach a decision on debt restructuring. Despite such encouragement from the authorities, some debtors are still prolonging the process due to the fear of losing control of the business. The more influential the debtor is, the worse the situation becomes.

IX. Market of Ailing Firms and Their Assets

With the shrinking of domestic purchasing power, it has become more difficult for firms to sell their assets while completed sales have fetched relatively low prices. Foreign investment in certain businesses has had an immensely positive impact on their rehabilitation. Creditors' approval of the plan is required for the sale of the business. Planners normally have a limited time to find a good buyer. In one case the plan avoids the fire sale of the business and allows the plan administrator to carry on the business within some years before attempting a sale to the best bidder.

In a liquidation case, an official receiver is required to conduct an auction unless creditors opt for different methods of sale.

In the case of the liquidation of 56 failed finance companies, the government set up the Financial Restructuring Authority (FRA) to take care of the sale which resulted in an average return of around 28% of the book value of the assets.

Chapter IV Informal Insolvency Proceedings

1. Workouts

Overview

In general, firms may undergo business restructuring by independently negotiating with their banks. In the case of a small firm where there is one main creditor involved, an informal negotiation seems a good way to proceed.

There was no platform for collective informal workout before the Bankruptcy Law was amended in 1998 to allow a court-supervised rehabilitation. The law provides a good backdrop for a formatted mechanism for the government to proceed further to expedite a wider scale of debt restructuring. The Bank of Thailand in 1998 set up the Corporate Debt Restructuring Advisory Committee (CDRAC) composed of members from the Bank of Thailand, the Thai Bankers' Association, the Association of Finance Companies, Foreign Banks' Association, the Board of Trade of Thailand and the Federation of the Thai Industries, to seriously take charge of the informal workouts. An office under the umbrella of the Bank of Thailand was set up as its secretary.

The work of the CDRAC started with the Bangkok Approach announced on 3 August 1998. The guideline is a non-binding and non-statutory framework for

debt restructuring. CDRAC portrayed itself at the beginning as a facilitator and independent intermediary for creditors and debtors.

Later, on 19 March 1999, an Inter-Creditor Agreement was drafted as a binding document to encourage creditors to proceed in a more formatted manner. Most financial institutions under the supervision of the Bank of Thailand signed the Agreement. The failure to comply with the framework can cost a financial institution a penalty of at least 1 million baht but not exceeding 50% of its claims.

Another agreement called the Debtor-Creditor Agreement was produced in March 1999. The Agreement is to be used to bind, upon signing, both debtors and creditors to follow the framework and timeframe set up by the CDRAC. It also stated the need of mediators to be retained to assist the process. Failing parties will each be subject to at least 0.5 million baht penalty but not exceeding 10% of their claims.

Later, a more simplified Agreement was completed on 4 May 1999 and more than 35 commercial banks and financial institutions have signed the Agreement with the Bank of Thailand. The Agreement focuses on small to medium-sized debtors. The CDRAC asked those institutions to submit 15-20 cases per month to undergo the process. The Agreement also forces creditors to be more proactive in dealing with the debt restructuring.

In summary, the CDRAC approach is a formatted procedure. The basic principles of the rehabilitation under the bankruptcy law are followed but to a lesser degree. For example, the automatic stay is replicated by a standstill agreement, whereas the resolution to approve the plan under the law is replaced with an agreement by all parties to accept 75% of the claims as a required resolution to bind everyone. These adjustments were made under a careful study of the bankruptcy law and a good cooperation between the Ministry of Finance and the Ministry of Justice.

The CDRAC encouraged financial institutions and debtors to submit their cases to its jurisdiction and have the work progress in phases. The first group selected by relevant parties and CDRAC to undergo the process consisted of around 300 large companies. Another group of approximately 350 companies were later submitted by financial institutions. The latest movement is to add another group of 900 cases. It should be noted that a large number of cases are being done voluntarily between banks and their customers. The regulations provide that those cases will receive the same incentives regarding taxes and other issues in the same manner as the cases overseen directly by the CDRAC staff.

Process Schedule

1. Call First Meeting of Creditors	Anytime by CDRAC, Debtor or any Creditor under this Agreement
2. Debtor executes Debtor Accession; First Creditors Meeting, Appointment of Steering Committee/Lead Institution; Establishment of Workout Schedule	Within fifteen Business Days of #1
3. Creditors submit claims in writing to Steering Committee/ Lead Institution	Within fifteen days of #2
4. At any creditors meeting of Steering Committee meeting a debtor representative with decision-making authority must appear and answer any and all questions	Continuous
<p>5. Debtor’s “Management”(i.e. directors or authorized officers) must submit at a minimum the following information:</p> <ul style="list-style-type: none"> a) assets, liabilities and obligations the Debtor owes to creditors; b) property given by the Debtor as security to creditors and the date given; c) property of other parties in the Debtor’s possession; d) the Debtor’s shareholdings in other companies or juristic persons; e) names, businesses and addresses of all creditors; f) names, businesses and addresses of the Debtor’s debtors; g) details of the property including payments which the Debtor expects to receive in the future. 	Within 7 days of #2
6. The appointment of an independent accountant and/or other experts shall be carried out as requested by the creditors based on the agreed terms of reference	Within 7 days of #2

Process Schedule (cont.)

7. Debtor submits required information, draft business plan and all further information requested by creditors or independent accountant	Within two months of #2, extendable by CDRAC up to one month maximum
8. Proposed Plan submission to all Creditors by Creditors Committee, Debtor and independent accountant, along with written approval of the proposed plan by the Debtor	Within three months of #2, extendable up to two months maximum with consent of CDRAC If no timely Proposed Plan is submitted, CDRAC will appoint at Debtors' expense a qualified financial advisor to prepare a Proposed Plan within thirty calendar days.
9. Creditors propose amendments to the Proposed Plan	Within 10 Business Days of #8
10. Creditors Meeting to vote in plan, dissenting creditors may submit an alternative Proposed Plan	15 Business Days after #9
11. Second vote on Proposed plan or vote on Alternate Proposed Plan (if necessary)	10 Business Days after #10 (if Sufficient Plan Approval is not achieved under #10)

Summary of Debt Restructuring Cases Reported by Financial Institutions

Creditor		Credit Outstanding		Increase	% Growth
		Oct-99	Nov-99*		
Cases In Process of Restructuring	Billion Baht	1,294	1,259	-35.00	-2.70
	Cases	23,162	28,012	4,850	20.94
Completed Restructuring Cases	Billion Baht	827	910	83	10.07
	Cases	134,822	150,105	15,283	11.34
Grand Total	Billion Baht	2,120	2,169	48	2.28
	Cases	157,984	178,117	20,133	12.74

* Preliminary
Source: CDRAC

Debt Restructuring Reported by Financial Institutions

Classified by Creditor

Creditor	In Process of Restructuring (A)				Completed Restructuring Cases (B)				Total (C) = (A)+(B)			
	Credit Outstanding		Number of cases		Credit Outstanding		Number of cases		Credit Outstanding		Number of cases	
	(Billion Baht)		(Cases)		(Billion Baht)		(Cases)		(Billion Baht)		(Cases)	
	Oct-99	Nov-99*	Oct-99	Nov-99*	Oct-99	Nov-99*	Oct-99	Nov-99*	Oct-99	Nov-99*	Oct-99	Nov-99*
Thai Banks	1,126	1,117	21,407	26,511	720	793	132,505	147,546	1,846	1,910	153,912	174,057
- State-owned Banks	652	632	14,341	19,298	174	202	29,634	34,162	826	835	43,975	53,460
- Commercial Banks	474	484	7,066	7,213	546	591	102,871	113,384	1,020	1,075	109,937	120,597
Foreign Banks & New IBFs	90	87	559	519	61	65	551	608	151	152	1,110	1,127
Finance Companies	77	55	1,187	966	45	52	1,521	1,685	122	107	2,708	2,651
Credit Fonciers	0	0	9	16	1	1	245	266	1	1	254	282
Total	1,294	1,259	23,162	28,012	827	910	134,822	150,105	2,120	2,169	157,984	178,117
* Preliminary												

Source: CDRAC

Debt Restructuring Reported by Financial Institutions

Classified by types of businesses

No.	Types of businesses	In Process of Restructuring				Completed Restructuring Cases		
		Credit Outstanding (Bil. Baht)		No. of cases		Credit Outstanding (Bil. Baht)		No. of cases
		Oct-99	Nov-99*	Oct-99	Nov-99*	Oct-99	Nov-99*	Oct-99
1	Agriculture and forestry	14	13	1,964	2,734	18	21	13,478
2	Mining and Quarrying	4	2	105	105	5	6	349
3	Manufacturing	470	470	3,907	3,987	248	268	8,820
4	Wholesale and retail	124	123	4,641	6,124	114	122	27,791
5	Exports	42	37	304	305	21	26	427
6	Imports	46	47	477	492	21	23	682
7	Banking and Financial Businesses	54	52	308	293	44	52	282
78	Construction	50	45	1,268	1,458	26	28	3,918
9	Real Estate Businesses	237	234	1,920	1,964	135	147	4,148
10	Public Utilities	54	43	658	456	22	26	2,204
11	Services	132	133	1,672	2,302	107	118	11,544
12	Personal consumption	66	59	5,933	7,787	64	72	61,170
13	Leasing	0	0	5	5	1	1	9
	Total	1,294	1,259	23,162	28,012	827	910	134,822
	* Preliminary							
	Note :							

* The category "Others" is retained for reporting details for November 1998 where cases have not been classified by other business sectors

Source: CDRAC

**Debt Restructuring Reported by Financial Institutions
Classified by Region**

Bangkok and Regional Areas	In Process of Restructuring				Completed Restructuring Cases			
	Credit Outstanding (Bil. Baht)		No. of cases		Credit Outstanding (Bil. Baht)		No. of cases	
	Oct-99	Nov-99*	Oct-99	Nov-99*	Oct-99	Nov-99*	Oct-99	Nov-99*
Bangkok	1,185	1,155	12,616	14,585	645	707	43,976	48,104
Central	44	45	3,440	4,084	83	91	34,561	38,458
North	17	16	2,134	3,247	34	41	19,150	21,960
Northeast	29	25	2,600	3,327	33	36	22,053	24,814
South	19	17	2,372	2,769	33	35	5,082	16,769
Total	1,294	1,259	23,162	28,012	827	910	134,822	150,105

* Preliminary
Source: CDRAC

The Progress of Debt Restructuring

	No. of Cases	Credit Outstanding billion baht)
1. Completed cases as at 15/12/99	104	224.7
2. Agreement on Plan, in process of documentation and signing as of 15/12/99	53	210.0
3. Cases in process of debt restructuring as at 15/12/99	291	497.8
4. Cases in process of legal action as at 15/12/99	213	413.1
5. Normal Loans as at 15/12/99	60	159.7
Total CDRAC target cases as at 15/12/99	721	1,505.3

Source: CDRAC

The progress of target debtors under Simplified Agreement approved by CDRAC during June – November 1999

	No. of Cases	Credit Outstanding (billion baht)
1. Target debtors	3,431	215.2
2. Stage of development		
2.1 Debtors in process of signing SA	1,931	190.3
2.2 Creditors to take legal action against non-signatory	252	7.3
2.3 Debtors in restructuring process	1,247	17.6
- Completed cases	569	5.5
- Restructuring in process	562	9.3
- Creditor to take legal action	116	2.7

Source: CDRAC

Relationship between informal and formal workouts

As stated above, the informal workouts under the CDRAC have been designed to use the court-supervised reorganization as its backdrop; therefore, it can be seen that the two procedures can work together. The informal workouts are to be used in order to sound out the situation and should carry on as far as possible whereas the formal workout process will take place once it becomes clear that the restructuring cannot achieve its goal in the informal workouts. The fact that some companies are undergoing the CDRAC format precludes creditors party to the Agreement from commencing a formal reorganization. But creditors who are not bound by the Agreement can still file for reorganization, and if so the informal workout will be transferred to the court-supervised mechanism.

It is also envisaged that in some cases the informal workout will be used as a platform for parties to negotiate and create a pre-negotiated plan for the court-supervised restructuring.

Many think at this stage that debtors tend to prefer the informal to the formal workout since management still maintains its role during the process.

2. *Private Liquidation*

Private liquidation can be done in accordance with the provisions under the Civil and Commercial Code and the Law governing Public Companies. In any case if the liquidator has the knowledge that the assets of the company cannot satisfy all the liabilities, he has the duty to file with the bankruptcy court for liquidation under bankruptcy law.

3. *Composition*

Composition is not available outside bankruptcy.

Chapter V Problem, Future Tasks and Trends

The mechanism provided by the government appears to be working at present. However, recent feedback suggests that a faster pace is required to help put Thailand's economy firmly back on a recovery path. There exists some reluctance among debtors to adjust themselves to a proper restructuring. Many think this is because of the lack of incentives for the debtors to use the system.

Most of the concerns relate to the large amount of losses to be incurred by debtors and creditors.

The pace of restructuring is accelerating, especially under the CDRAC. In the next six months, the process is expected to yield more results. However, some critics think that there is still insufficient write-down and operational restructuring, as many cases, end up as merely the rescheduling of debts. The response to this criticism is that in a number of cases both in court and outside the court system, creditors have begun to accept write-downs and the conversion of debts into equity.

The use of formal restructuring in court is seen to be in decline and the Ministry of Justice is now evaluating the situation. Some essential points are described below.

Enforcement of Security

The recently enacted Civil Procedure Amendments have largely improved the process of enforcing against securities. However, as the amendments have been in force for only a short time, it is too early to make an assessment. Furthermore, the default judgment bill is still pending for Parliament's consideration. This bill is expected to have a major impact on the procedure of enforcing against securities.

The Ministry of Justice is currently preparing another bill to expand the types of securities to cover floating charges. The bill is aimed to reach the Cabinet by the end of this year. This bill is aimed at improving Thai security law.

Incentives to Debtors to use Rehabilitation

The recent decline in the use of the reorganization procedure prompts the need to evaluate the system. Some critics suggest that the system should provide more incentives for debtors to use the system as a protection and for creditors to use it as a leverage. The former argument advocates the idea of moving the system towards the debtor in possession approach, i.e. allowing debtors to have an exclusive right to present a plan and the control of the company during the reorganization. The latter leads to making it easier to prove insolvency, the inability to pay test.

The issues are now under study by the Ministry of Justice and there is no conclusion at this stage.

OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(14 2001 02 1 P) ISBN 92-64-18330-2 – No. 51655 2001