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CAVEAT EMPTOR: WHAT CONSUMERS OF INSOLVENCY LAW REGIMES NEED TO KNOW

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INTRODUCTION

The completion of the EBRD's Legal Indicator Survey ("LIS") on Insolvency, and its Insolvency Sector Assessment ("Assessment") in 2004, provide stakeholders in insolvency cases, or "consumers" of legal systems, with a unique understanding of the extensiveness and effectiveness of insolvency legal regimes in the countries of operations.

Simply stated, the value of an insolvency law regime¹ can be measured on its ability to respond to the interests of its two main stakeholders or consumers – creditors and debtors. If the response is insufficient, the basic purpose of an insolvency regime is fundamentally undermined.

EXTENSIVENESS – THE ASSESSMENT

A detailed analysis of the extensiveness of insolvency legislation – the extent to which such legislation complies with recognised international standards – has been presented by the same authors elsewhere². It is worth repeating, however, that the results of the Assessment underscore the need for significant legislative reform throughout most of the EBRD's countries of operations. The Assessment, which covered 97 fields of inquiry with respect to each country's law, ultimately placed legislation, in accordance with their levels of basic compliance with international standards, in one of five categories. Table 1 shows the results of the Assessment³.

¹ The studies discussed in this article focus exclusively on company insolvencies and therefore necessarily exclude laws and legal systems as they pertain to individual insolvency.

² See for example, *Annex 1.1*, EBRD Transition Report 2004.

³ Assessment is current to all laws in force as at 31st January 2004.

Heading: Table 1 Level of Compliance of Insolvency Laws with International Standards

Very Low	Low	Medium	High	Very High
Lithuania	Azerbaijan	Armenia	Albania	
Turkmenistan	Georgia	Belarus	Bosnia & Herzegovina	
Ukraine	Hungary	Czech Republic	Bulgaria	
	Latvia	Estonia	Croatia	
	Slovenia	Kazakhstan	Moldova	
	Uzbekistan	Kyrgyzstan	Romania	
		Macedonia	Serbia & Montenegro	
		Poland		
		Russian Federation		
		Slovak Republic		

It should be noted that “Very High Compliance” does not necessarily denote a law that is on par with the leading national legislation in insolvency around the world. Rather, it suggests that the legislation meets the threshold tests for a modern, well-functioning insolvency law. Despite this modest standard, however, no law in the region achieved this result, while a number ranked in the “Very Low” category.

Against this backdrop, it was decided to undertake a further step, one that has not been done before in the EBRD’s countries of operations: a comprehensive testing of how well or poorly these insolvency laws, of varying quality, are implemented in practice. This evaluates the ‘effectiveness’ of the laws. Combined together, the two appraisals of extensiveness and effectiveness provide an overall evaluation of the insolvency legal system.

EFFECTIVENESS – THE LIS

The importance to creditors of an effective insolvency system should be apparent. For them it represents the most important, albeit ultimate (and, in its end result, sometimes disappointing), weapon against a debtor that fails to pay a mature debt. The great majority of creditors may never have to use the weapon. However, in that respect the incidence of use of insolvency law by creditors is somewhat immaterial. What is more important is that the insolvency law regime is *known to be effective*. It is this knowledge that helps to create credit discipline and encourage the payment of obligations as they mature. If the insolvency regime cannot effectively be employed by a typical creditor, it is destined to be regarded as an irrelevance. The somewhat dramatic consequence of that will be rampantly ill credit discipline.

For debtors, if an insolvency law provides for the possibility of rescue (rehabilitation and reorganisation), an enterprise that is in financial difficulty or insolvent will have the opportunity to use, and may be encouraged to seek, that remedy. However, an equally, if not more important, question is whether the actual employment of the law in search of such a remedy is *known to be effective*.

For both groups of insolvency law consumers, this knowledge that the law is effective can only follow from the actual employment of the insolvency law - through cases that are brought by creditors and debtors and dealt with under the law. It was these fundamental and basic considerations that led the EBRD to test insolvency law regimes in action.

The ‘test vehicles’ were two hypothetical cases submitted to leading insolvency lawyers in each country – one using a creditor as the driver and the other using a debtor – which are re-printed below. Both were expressed in simple fashion to represent uncomplicated but typical cases that might be expected to be common to any jurisdiction. Each case required a number of questions to be answered that raised issues such as those concerning threshold access, cost, time, procedural formality/complexity and the competence of courts and judges. The aim was to evaluate basic, but critically important, procedures. In the case of a creditor, this involves the initiation of an insolvency case against a debtor to the point at which an effective, final, order is made that subjects the debtor to some form of formal insolvency administration (it does not, however, survey the actual administration of the affairs of the debtor or the results of the administration). In the case of a debtor, the procedure surveyed involves the initiation of a case for reorganisation of the debtor to the point at which the debtor might obtain a formal, final, order that approves or sanctions a plan of reorganisation (again, it does not survey the outcome of the plan).

EBRD LEGAL INDICATOR SURVEY 2004

HYPOTHETICAL 1: Creditor-Initiated Proceedings

The client (‘C’) is a local supplier of goods in your country. One of the client’s customers, a local privately owned, limited liability manufacturing company (‘D’), has failed to pay a debt in the local currency equivalent to €10,000 due to the client as a result of cash flow problems. The debt is more than 30 days overdue. There is no dispute regarding the underlying transaction that gave rise to the debt and the debtor has no valid defence for the non-payment of the debt.

The client now asks for your professional advice on:

- any action the client can take under the insolvency law of your country to deal with the apparent insolvency of the debtor; and
- the process that will be involved in obtaining an effective final order against the debtor

[NB “**effective final order**” means the making of an order or the pronouncement of a judgment which has the effect that the affairs of the debtor will be thereafter administered under the insolvency law, whether by way of bankruptcy, liquidation or some other form of insolvency process. It does not mean to the end of such processes]

HYPOTHETICAL 2: Debtor-Initiated Proceedings

The client ('C') is a local, privately-owned, limited liability manufacturing company in your country. Historically, the client traded successfully for a number of years and presently employs around 100 staff. The client is now experiencing major cash flow difficulties and expects that, within the next month, it will not be able to pay debts owed to a number of its creditors as those debts become due for payment and that its financial position will continue to deteriorate.

The business is basically sound but accounting, financial and other advice is that before the client can return to a profitable position, the client will require:

- a general reduction of debt owed to all non-bank creditors (for example, a 30% reduction);
- an extension of the time for payment of the reduced debts (for example, in 12 months time); and
- a rescheduling of bank financing commitments (for example, deferring repayments of principal for 12 months and a reducing of interest payable)

Some creditors are pressing for payment and are threatening to take enforcement action. In attempting to negotiate an arrangement as indicated above, the client will require protection (for example, a stay or suspension of all legal actions against the client and its assets)

The client now asks for your professional advice on the action it can take under the insolvency/reorganisation laws of your country to get to the stage at which a formal arrangement that embraces the above proposals will take effect.

[NB “**arrangement**” means a reorganisation/ restructuring/ composition or similar process and “**take effect**” means such court or other approval or confirmation as may be required under your law]

This article presents the results of the survey. It also marries these LIS results with the findings from the Assessment. The end result of that marriage is to provide a view and a consideration of both the extensiveness and the effectiveness of those insolvency systems.

Methodology

The methodology employed in the 2004 LIS⁴ followed upon the successful methodology employed in 2003. This involved working with leading insolvency practitioners in 25 of the EBRD’s 27 countries of operations⁵ and providing them with the two hypothetical cases above, based upon which they were asked to answer a series of questions.

To suggest that an insolvency law system is binary, that it is either “effective” or “ineffective”, is to oversimplify a complex and varying group of factors, some of which may work better than others within a given system. To understand how effective or ineffective a legal regime is, the chief consumers of that regime need to know how its individual elements regime link together to form a complete system.

⁴ For a detailed discussion of methodology, please see EBRD Transition Report 2004, *supra* note 2.

⁵ No participants for Tajikistan were identified and insufficient practical experience made it impossible to obtain reliable data for Turkmenistan. As such, results for these two countries are not available.

To this end, the LIS sought to identify the most critical questions that stakeholders would want answered about the practical functioning of a given regime (See Table 2)⁶:

Table 2: Factors Influencing the Effectiveness of Insolvency Regimes

<p>Access and Degree of Formality - How straightforward is my entitlement to commence an insolvency proceeding?</p>	<p>Application of Rule of Law -Is the judge bound to clear and transparent rules?</p>
<p>Bankruptcy Administration/Creditor Involvement/Trustee Competence - Are creditors generally kept well-informed and will I have a high level of confidence in the functionaries appointed during the insolvency process?</p>	<p>Complexity – Is this procedure going to be so complex that it will be of little value to me?</p>
<p>Cost - How expensive is this going to be?</p>	<p>Creditor Involvement - Are creditors kept well informed of the restructuring plan and are meetings of relevant stakeholders relatively easy to organise?</p>
<p>Court Identification and Experience - How easy is it to determine in which court I should bring my proceeding and how specialised are the judges who are likely to hear my case?</p>	<p>Debtor Protection - As a debtor seeking to reorganise, will I be given some early and continuing protection from my creditors to try to arrange my affairs?</p>
<p>Judicial Predictability/Competence - Is the behaviour of a judge in determining whether or not to grant the relief I am seeking likely to be so variable and inconsistent that it will make the process highly unpredictable and uncertain? How susceptible is this process to influences such as political intervention, bribery and corruption?</p>	<p>Management of Debtor - As a debtor seeking to reorganise, how much confidence can I have in the functionary that is likely to be appointed to oversee my restructuring?</p>
<p>Speed - How long will it take me to get access to the system and to obtain the relief I am seeking? How easy is it for parties adverse in interest to me to frustrate, unduly delay or prevent the process?</p>	

⁶ Each of the elements below were measured using one or more questions asked to practitioners in response to the cases provided. As a result, the answers to the questions posed by these elements often represent the composite result of numerous, more detailed questions.

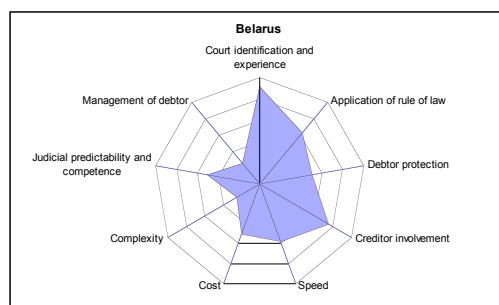
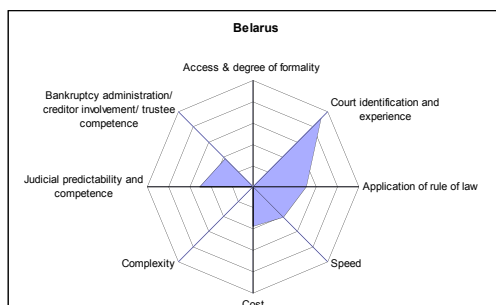
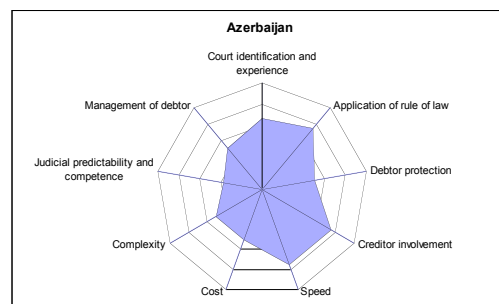
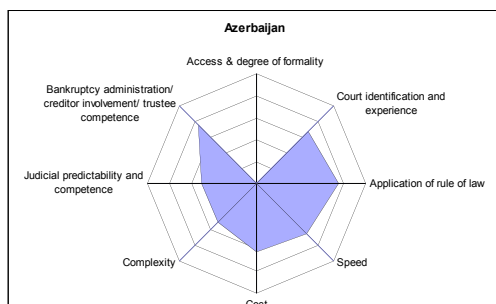
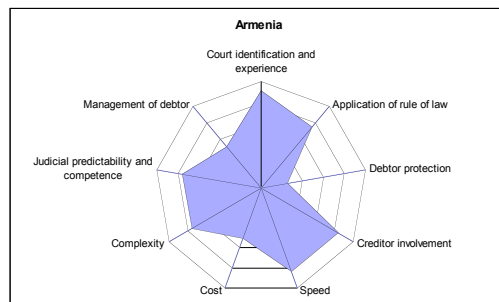
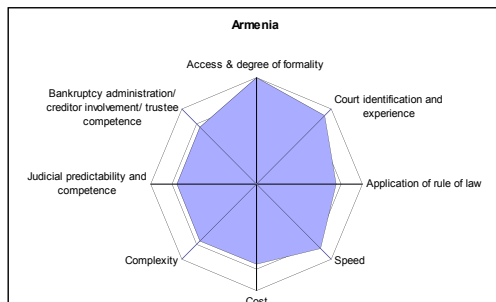
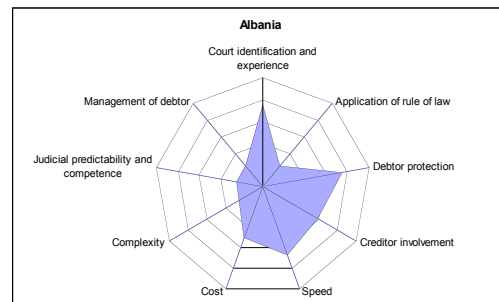
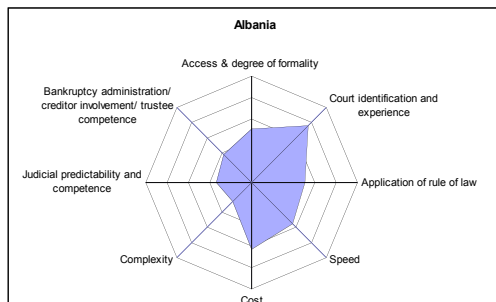
RESULTS

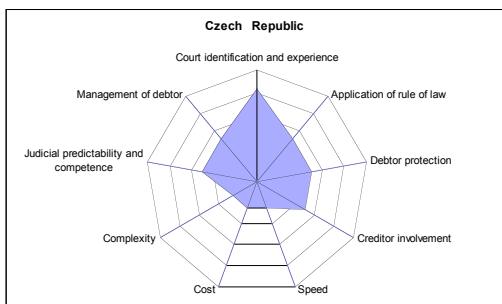
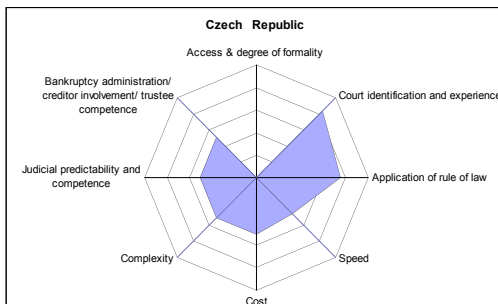
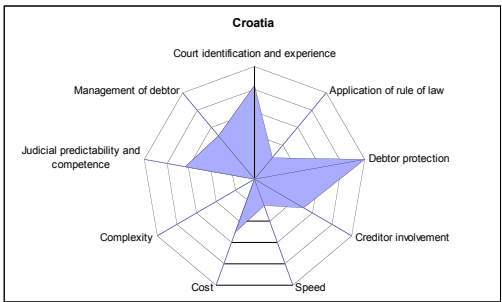
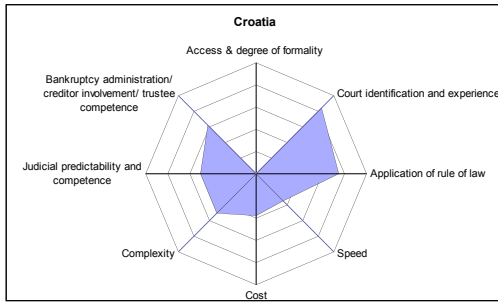
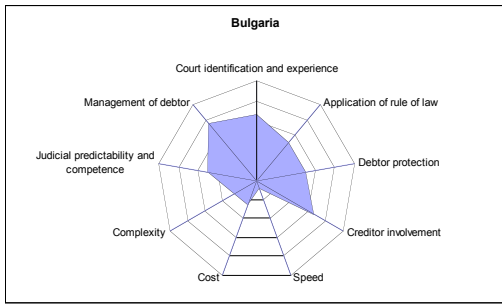
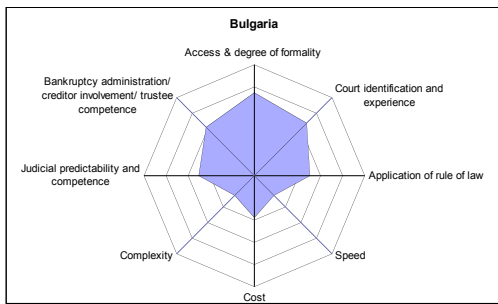
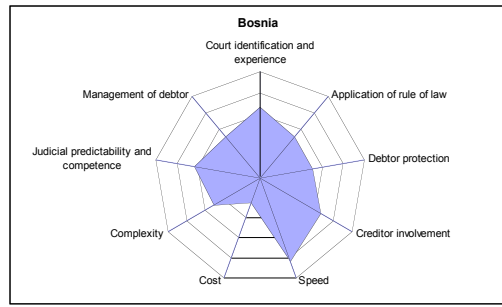
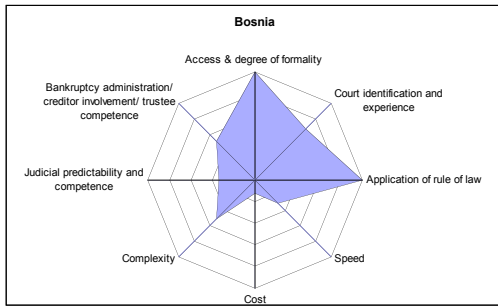
The results in the above categories are presented for each country in the graphs contained in Table 3. The more full the “web” of each graph is, the more effective the insolvency regime.

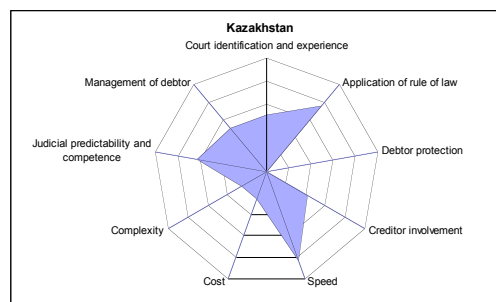
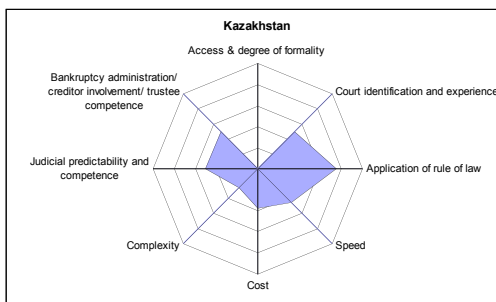
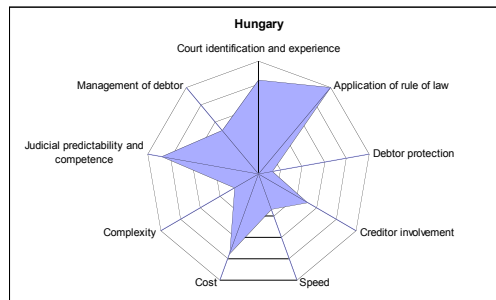
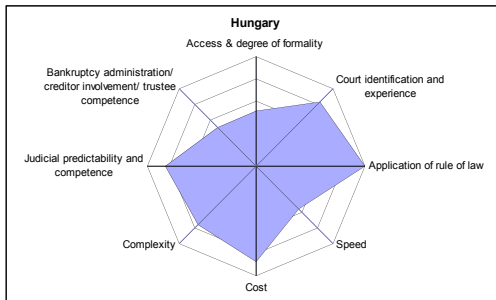
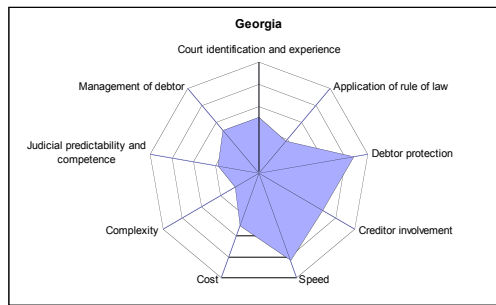
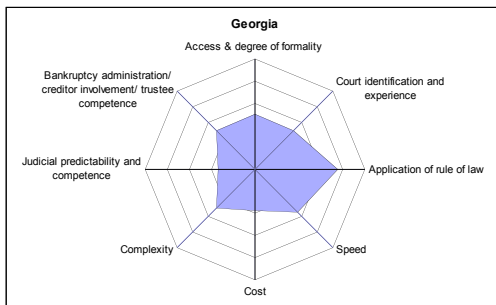
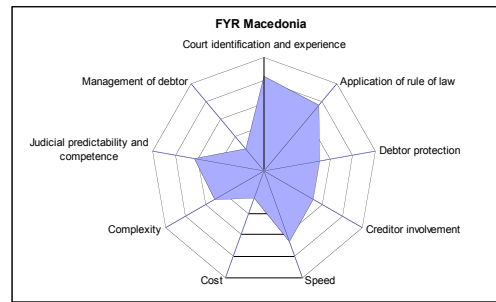
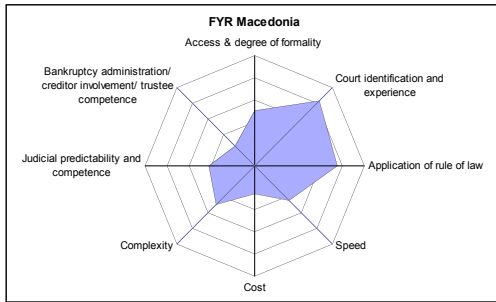
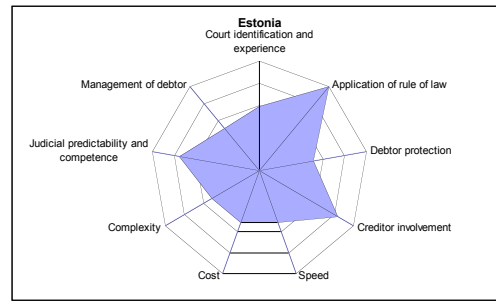
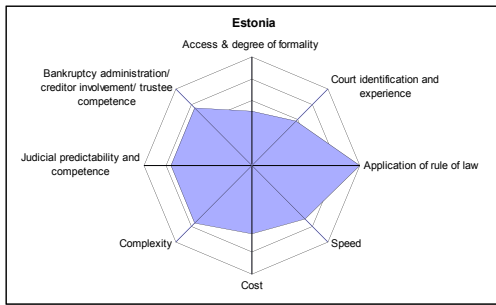
Table 3: Effectiveness factors in Insolvency Legal Regimes

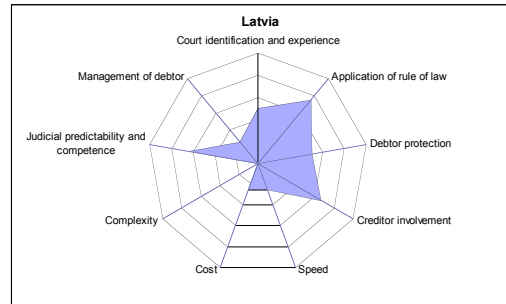
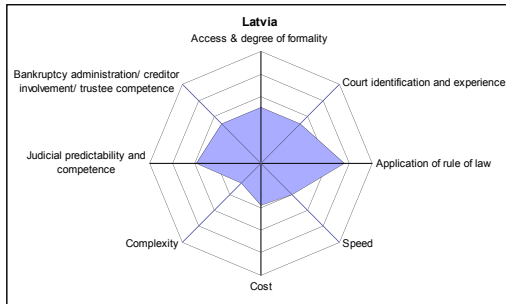
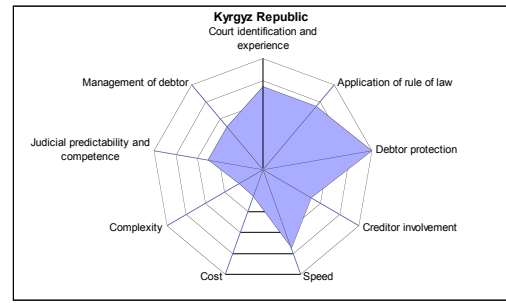
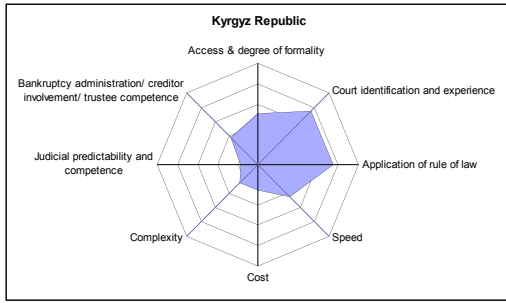
Factors in Creditor Initiated Insolvencies

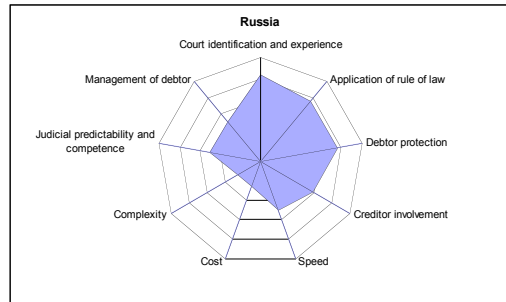
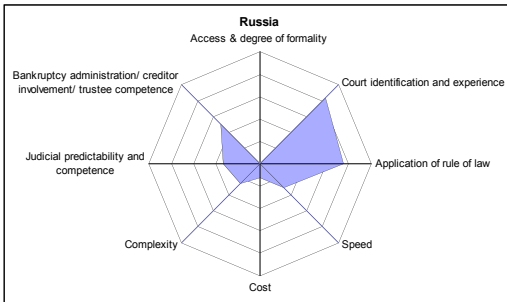
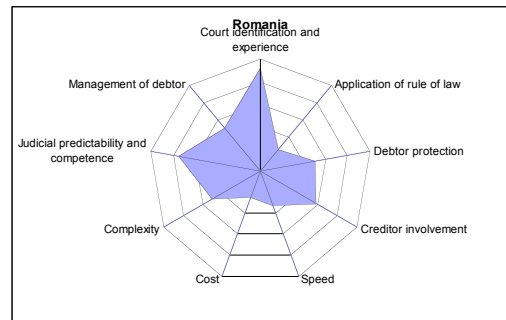
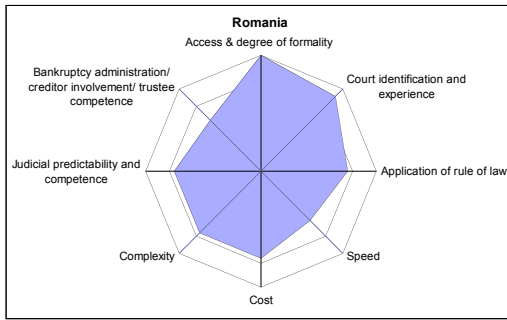
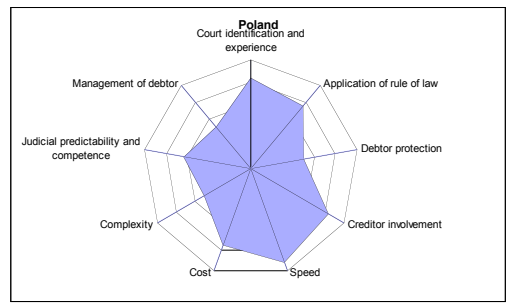
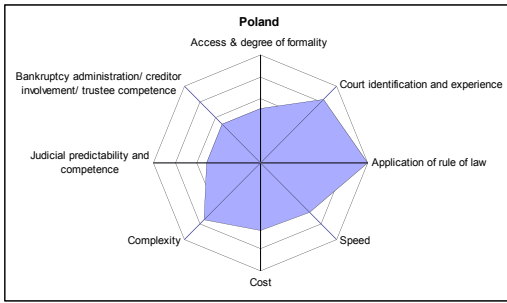
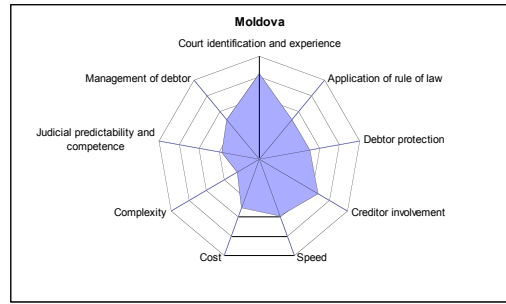
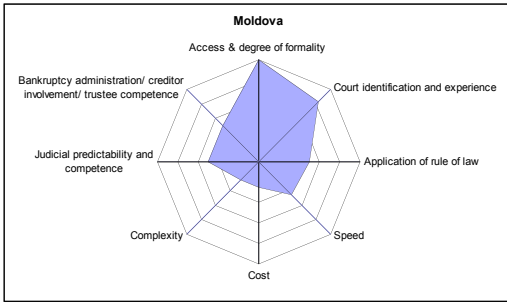
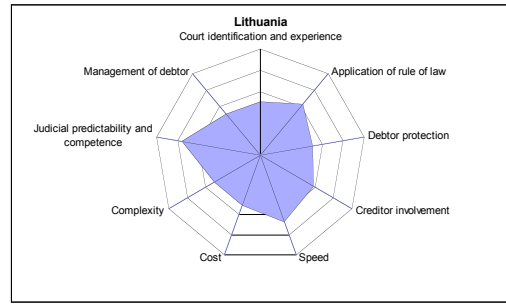
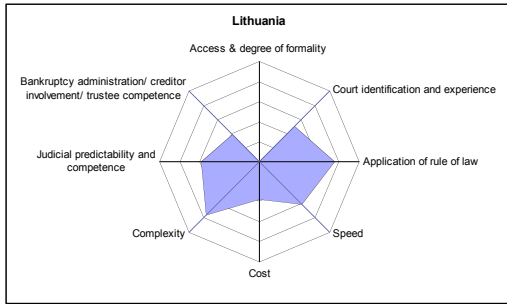
Factors in Debtor initiated insolvencies

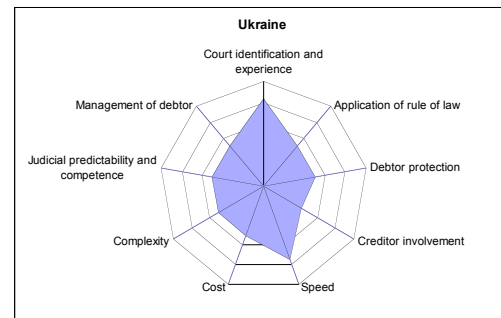
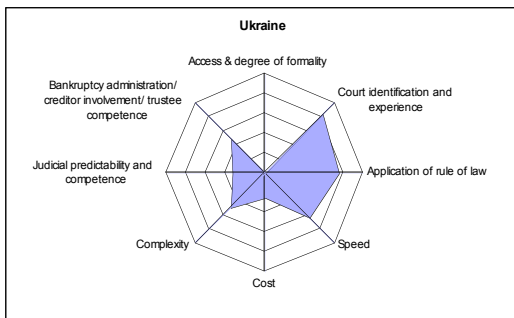
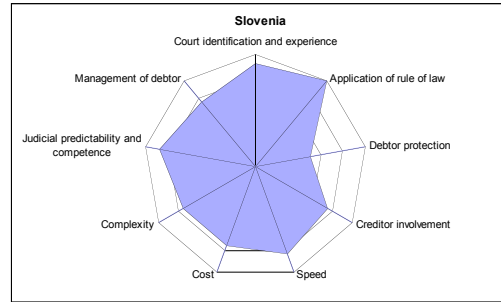
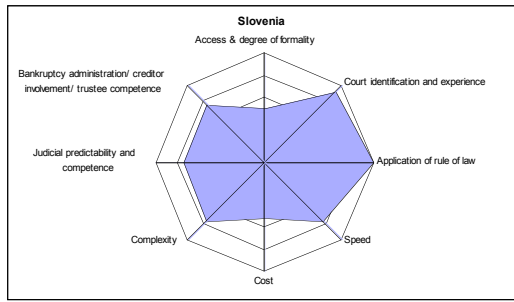
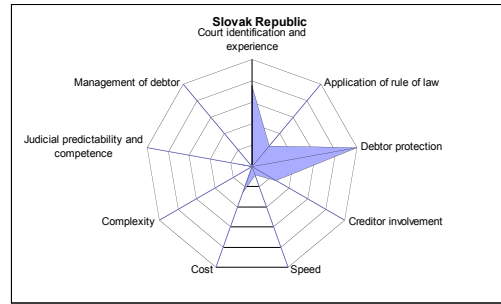
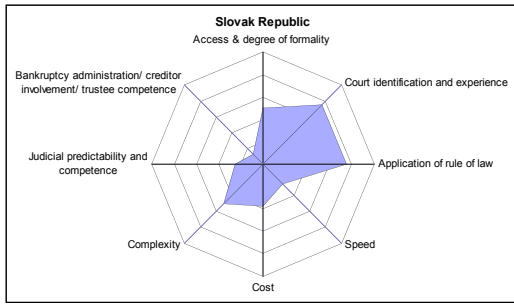
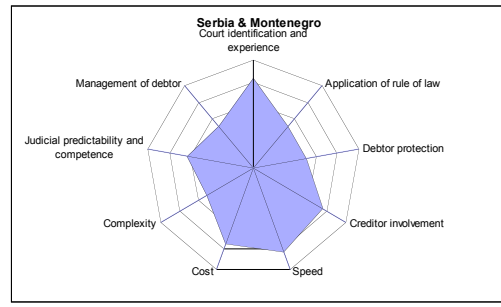
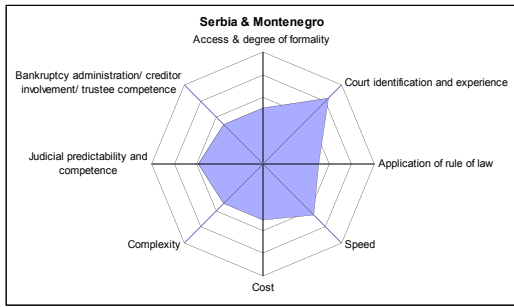


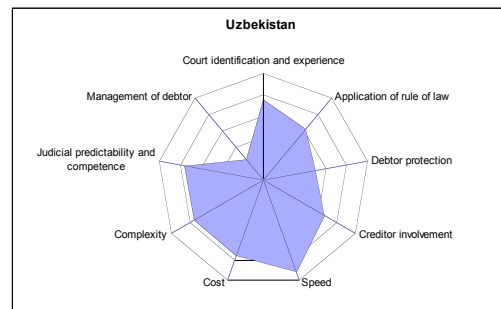
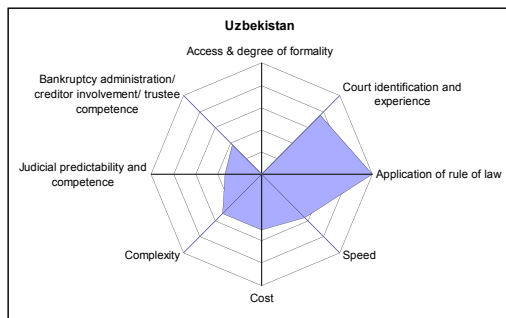












Conclusions and Trends

Based on these results, some reasonably clear conclusions and trends may be identified:

- Only four countries (Armenia, Poland, Azerbaijan and Slovenia) have processes that could be regarded as reasonably fast by both debtors and creditors. In some countries, such as Slovakia, it may take as long as one year to obtain an ‘effective final order’.
- The level of predictability and transparency across the entire region, particularly with regard to the judiciary, is extremely low.
- Only three countries (Armenia, Poland and Slovenia) achieved results that consistently demonstrate a quick, efficient and transparent system for both debtor and creditors.
- Overwhelmingly, most countries have more effective systems for debtors to access than for creditors. This may be due in part to the fact that creditors are typically required to give notice to debtors when commencing a proceeding. This makes such proceedings inherently more contentious and time consuming.
- European Union member states performed, on average, no better than non-member states (despite generally performing well on the Assessment). It needs to be appreciated, however, that all of these member states only recently acceded to membership of the EU and may be expected to need time to adjust. However, considering that these states are expected to respond to the challenges that are inherent in membership of the EU (for example, the application of a sophisticated EU Regulation on cross-border insolvency), it is apparent that they will need to greatly improve in their ability to effectively apply their respective insolvency law regimes.
- Certain results of the LIS that may initially appear counter-intuitive when compared to the findings of the Assessment, such as the relatively high score

of Uzbekistan in debtor-initiated matters or low score of Bulgaria⁷, are in fact consistent with some of the EBRD's own experiences as a creditor in the region.

In general, the results of the survey leave a lot to be desired. They point to a general failure of the law and its operation to properly serve the interests of its two main consumer groups. In some instances the law and its application are regarded as so ineffective that creditors, for example, would never be encouraged to use it.

Issues for Other Stakeholders and Participants in the Insolvency System

It should be observed, of course, that creditors and debtors are not the only persons interested in or affected by the performance of insolvency law systems. Two other groups call for some special comment, since the results have some direct impact upon and relevance for them. They are comprised of the wider commercial sector and the judiciary.

(i) Wider Commercial Sector

For the wider financial/commercial sector, potential credit transactions will be both considered and priced by reference to the effectiveness of, amongst other things, an insolvency law regime. It is true that the great majority of credit transactions may never result in resort to that law, but it would be wrong to suggest that the financial and commercial sectors never had regard, consciously or otherwise, to the backdrop of the possible insolvency of one of the participants in a credit transaction. Both the availability and the cost of credit involve, quite simply, the issue of the effectiveness of the insolvency law. The results of the law in action survey have, therefore, considerable relevance for and importance to that sector. As Frederique Dahan and John Simpson note in their analysis of the EBRD's 2003 Legal Indicator Survey on secured transactions, creditors are deeply interested in how effective a legal system is and desire a high level of certainty in how this system will be applied⁸. The results suggest that in many countries the availability, the extent and the pricing of credit may correlate to the overall effectiveness of the insolvency law system.

(ii) Judiciary

The second category is the judiciary, who may be anticipated to be heavily engaged in the employment of the law. For the judiciary some important elements of the results of the survey are whether it is perceived as competent to handle insolvency cases (which raises the issue of education and training to improve the level of competence), whether it is supported by a court and judicial system that enables cases to be speedily and effectively dealt with and determined (involving a consideration generally of the adequacy of the court system of a country and its response to a basic requirement that insolvency cases must be capable of speedy hearing and determination), and whether they might be open to the influences of political or other persuasion or corruption

⁷ Bulgaria's poor performance in the LIS was particularly surprising given its extremely strong results in the Assessment. The LIS respondents for Bulgaria indicated, however, that many of the beneficial provisions in the Bulgarian insolvency law are simply not being observed or enforced by local courts.

⁸ Dr. F Dahan and J Simpson, "Secured transactions in central and eastern Europe", *Uniform Commercial Code Law Journal*, Vol. 36, No. 3, p. 85.

(which, of course, raises the wider issue of the application of the rule of law). The results in Table 3 with respect to these elements demonstrate that, throughout the countries of operations, the judiciary is often more of an obstacle than a help to the effective functioning of the insolvency regime.

Issues For Law Reformers

Another group of stakeholders with respect to the quality of insolvency systems are the governments, NGOs and international financial institutions engaged in the practise of law reform. For these groups, it is critical to understand how the different elements of insolvency regimes work together. The LIS results provide some interesting correlations and connections in this regard.

(i) “Not so Special After All”

It may be a view commonly held that one way to speed up court processes, lessen or avoid corruptive influences in court proceedings and promote greater transparency and predictability is to create a specialist court to handle cases under particular legislation. Of the 25 countries that were surveyed under the LIS, 19 had established either a special bankruptcy court or a commercial court. Admittedly a ‘commercial court’ is clearly not one that is solely dedicated to jurisdiction in insolvency matters, but it may be anticipated that such a court and its judges would at least be better able to handle insolvency cases than, say, a court of general jurisdiction.

The correlations apparent from the results in Table 3 do not lend credence to this view.

In relation, for example, to **corruptive or other influences** on courts and judges, there is simply no evidence to establish that such influences are lessened because of the use of a special court. That is not to suggest that all such courts are prone to such influence. Of the 19 countries that had special courts, 7 reported ‘low’ corruption but, equally, of the 6 countries that do not have a special court, 3 reported ‘low’ corruption.

Somewhat related to corruptive or other influences is the issue of **predictability and transparency** in relation to court proceedings and behaviour of judges. But only 5 of the 19 countries with a special court recorded ‘high’ predictability/transparency (1 of the 6 countries that do not have a special court recorded a similar score). So, although there is some evidence that predictability/transparency is enhanced through the use of special courts, it is only slight and would not justify a compelling statement to that effect.

As regards **speed** of court proceedings, 7 of the 19 countries with a special court reported ‘high’ results for speed but, at the same time, 3 of the 6 countries without a special court also reported ‘high’ results for speed. Again, the evidence does not justify the conclusion that special courts perform with greater speed than others.

An anticipation of better and more positive results from the employment of special courts than those reflected above is understandable, particularly those relating to speed and transparency/predictability. So, what reasons may explain the largely

negative conclusions and the disappointment in the anticipation? One reason is that, despite the ‘labelling’ of the name or title of these courts, they are not much different in fact from courts of more general jurisdiction because the judges have had little or no training and education to fit the label. Thus, their ability to handle cases, for example, more expeditiously, has not been realised nor has the potential for a greater sense of certainty and predictability.

The above issues point to the continuing need to emphasise proper training, education and experience before courts and judges can be properly expected to perform in an appropriate manner. This is an issue to which further attention is given later in this article.

In relation to **corruption and other influences**, there is probably no reason to suppose that just because a special court is established that it will be free from influences that are capable of permeating the whole of the court system. Unfortunately, corruptive influences are strongly present in many of the countries.

(ii) “Time is Money”

In relation to legal actions and court proceedings, there can be no doubt that the longer the process (a test of **speed**) the greater the **cost**. The results of the survey tend to confirm that statement. Of the 25 countries, 17 scored ‘high’ for speed in both hypothetical cases. In terms of cost, 9 of those 17 countries recorded relatively low cost for the proceedings. The other 8 countries scored ‘low’ for speed, of which only 1 (Hungary) recorded relatively low cost.

The 9 countries that performed well both on speed and cost were Romania, Albania, Armenia, Estonia, Azerbaijan, Uzbekistan, Serbia and Montenegro, Slovenia and Poland. The results of that exercise tend to suggest that if the process is reasonably quick, the costs of the process to the consumer will be lessened. A number of factors can contribute to greater speed.

One such factor is the legislation and rules that require a court to respond within a relatively short period of time (Bulgaria is something of an exception in that respect as disclosed in footnote 7, above).

Another factor is the quality of the court system generally, which involves matters concerning the number of judges, computerised ‘tracking’ of cases, case management handling skills of judges and general administration. Slovenia, for example, has highly developed computer-based case tracking technology that may be easily accessed and used for greater efficiencies.

The concept of ‘case management’ by judges is a technique that needs to be better developed in all countries. Properly employed, it can do two things: First, it places the judge in charge of the progress of a case, such that the judge can impose a timetable, time limits and sanctions for delays and move the case along without any or any significant need for adjournments. Secondly, in the hands of an experienced and competent judge, it can expose the deployment of deliberate delaying tactics and result in an early dismissal of frivolous or unmeritorious defences and objections. Unfortunately, not many of the countries appear to promote such a technique. In

Bosnia and Herzegovina it was reported in relation to both case studies that judges are prone to tolerating delays for a variety of excuses (often frivolous ones, notwithstanding timelines in the relevant legislation).

(iii) “Great Minds Think Alike”

Is it the case that the level of general **‘professionalism’ and competence** will be reflected in both judges and bankruptcy administrators (for example, that if standards are relatively high in one such group, the same will be true of the other)? Such a result would tend to show that the challenge of providing proper institutional capacity to employ and administer an insolvency law is regarded as a holistic exercise rather than one of piecemeal and fragmented development. It might also suggest that in countries where there is some evidence of it, education, training and experience is being employed across the board.

The results tend to suggest that the answer to this question is ‘yes’. Some 16 countries scored ‘high’ in judicial predictability and competence and, of them, 6 also scored ‘high’ in the area of bankruptcy administrator/trustee competence. The 6 countries are Croatia, Romania, Bulgaria, Armenia, Estonia and Slovenia. This is also reflected in the responses to a question that was asked of survey participants: namely, ‘having regard to the cost, time and predictability [of this process], how likely are you to recommend that [your client use the process]? In 5 of these 6 countries the answers were positive (Croatia being the exception).

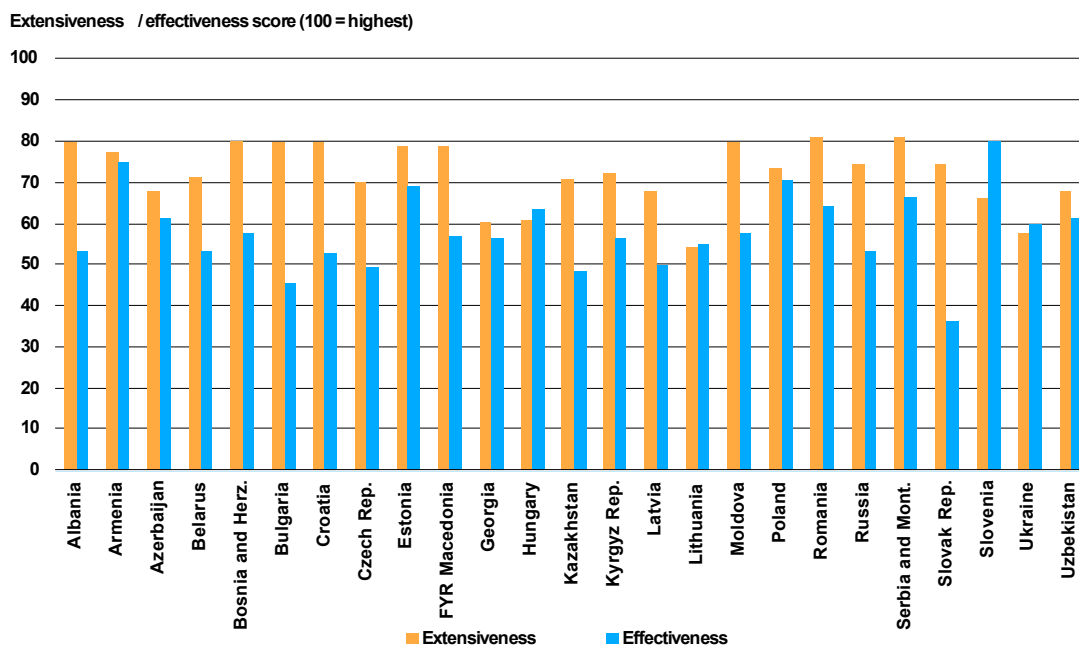
By comparison, of the 9 countries that scored ‘low’ in the area of judicial competence, 8 of them recorded a similarly low score in the area of bankruptcy administrator/trustee competence. The majority of respondents to the case studies in those countries were also somewhat negative about encouraging clients to commence the relevant processes.

(iv) Do 1 + 1 Really Make 2?

Finally, it is instructive to compile all of the data collected in the LIS and the Assessment and examine overall performance in each study. Table 4 illustrates the comparative scores of each country in each study⁹:

Table 4: Extensiveness and effectiveness of insolvency legal regimes

⁹ Sources: EBRD Insolvency Sector Assessment Survey, 2003-04 and EBRD Legal Indicator Survey, 2004. The extensiveness score is based on an expert assessment of the insolvency laws in each country. The effectiveness score refers to the findings of the Legal Indicator Survey. Scores are calculated as a percentage of the maximum score. Data for Tajikistan and Turkmenistan were not available.



This graph illustrates two matters of importance: First, there is a clear correlation between the relative quality of a country’s insolvency legislation and the relative effectiveness of its insolvency regime. That is particularly true of Armenia, Estonia and Poland. This suggests that the foundation of a good law can be a prerequisite to an effectively functioning system. Indeed, an effective regime in any area of law commences with appropriate and adequate written laws. Absent an adequate law, implementation will likely suffer.

The second finding is that most countries have better insolvency legislation than they do the means or capacity to implement such legislation. This is commonly referred to as the ‘implementation gap’, and underscores the need for legal reform to go beyond legislative reform and extend into implementation-capacity assistance. This can include such varied activities as the training of insolvency judges and administrators, the development of standard-form documents or ‘precedents’ for practical use, or the creation of a secured charges registry system. Each of these forms of implementation assistance has been undertaken in the past by the EBRD.

CONCLUSION

The EBRD insolvency studies aim to, among other things, help the principal consumers of insolvency regimes navigate through the difficult and variable pathways of insolvency systems in the Bank’s countries of operations. They also aim to provide law reformers, including the EBRD itself, with a roadmap to build better, more extensive insolvency systems that function effectively. One thing that is clear from these studies is that far greater attention has to be given to judicial systems. The most essential part of an insolvency regime (the effective commencement of procedures for relief under the regime) depends, in every country, upon the efficient, predictable and reliable behaviour of judges. In too many instances there is a failure to deliver. That problem, as discussed earlier in this report, is the product of a variety of factors and will require constant and patient encouragement and assistance.

