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„Effectiveness and Efficiency in Insolvency“

visible and invisible adjusting screws

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MAIN CHALLENGES AND TRENDS IN INSOLVENCY PROCEEDINGS, RESTRUCTURING AND DISCHARGE OF DEBT

Organised by Emil Radev, Member of the European Parliament

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Introduction

- Insolvency Law (IL) has been in existence for almost as long as credit.
- Orderly and effective insolvency systems, at it´s core, could have major role in strengthening a country´s economic and financial system.
- For example, an effective insolvency system provides an important pillar of support for the domestic banking system by enabling banks to curtail the deterioration of the quality of their claims, including claims on the corporate sector, whether through a court-approved restructuring or, where necessary, through an efficient liquidation.
- Insolvency law can be particularly relevant for economies in transition, where it can play a critical rol e in addressing the problems of insolvent state-owned enterprises.
- In the context of financial crises, an orderly and effective insolvency system can provide an important means of ensuring adequate private sector contribution to the resolution of such crises.
- Finally, although insolvency procedures are implemented through the courts, the very existence of an orderly and effective insolvency system establishes incentives for negotiations between debtors and their creditors, which may lead to out-of-court agreements being reached "in the shadow" of the law.

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Definitions and Terminology

- Effectiveness
  means doing the right things, adequate to accomplish a purpose; producing the intended or expected result.
- Efficiency
  means doing things right, perform or function in the best possible manner with the least waste of time and effort.
- Insolvency
  Insolvency is the state of being unable to pay the money owed, by a person or company, on time; those in a state of insolvency are said to be *insolvent*. There are two forms: illiquidity, inability to pay (cash-flow insolvency) and over-indebtedness (balance-sheet insolvency).
- Viable Business
  generates positive cash flows (op/fin) and has sufficient working capital that forecast is going concern.
- Zombie Firms
  are defined as old firms that have persistent problems meeting their interest payment.
- Stakeholder / Participants
  Stakeholder means a person, group or organisation that has interest or concern in an organization. Participants are party in insolvency files.
- Second Chance
  means giving honest but unlucky entrepreneurs/individuals which are over-indebted and/or insolvent a second financial chance for a fresh start.

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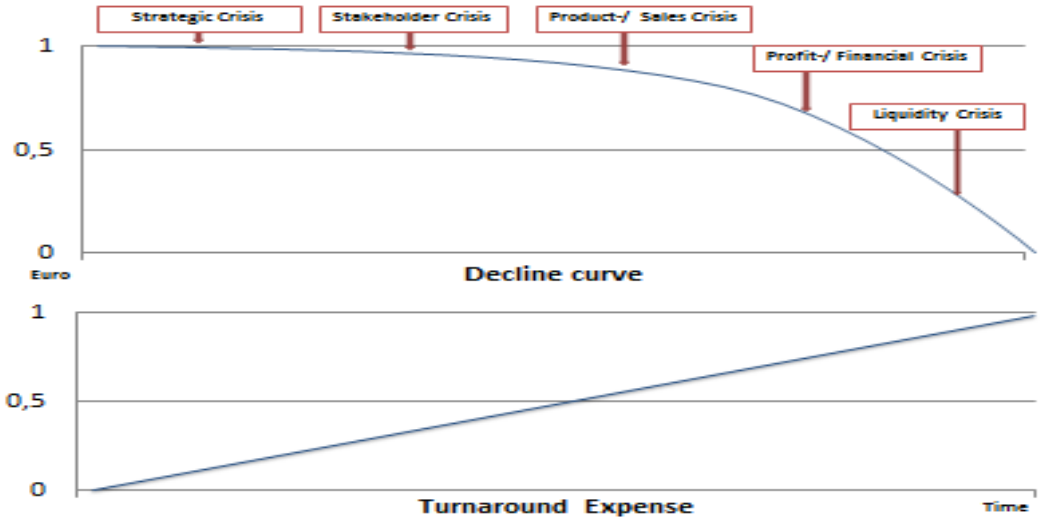
Insolvency as last degree of crisis

- Insolvency is no sudden event. The descent of a healthy firm is often a slow one.
- Losses are realized before debtor files for insolvency; DCF are negativ. Value = 0,00 €
- Insolvency only discloses dysfunktional structures and set a new benchmark (liquidation) value for the new process. Insolvency is not reason for realized losses and debtors inability to satisfy creditors. „Don´t shoot the messenger“. „Value losses“ arise from valuation rule change (DCF to liquidation value).
- Delay in commence of the turnaround/reengineering process increase costs.
- Bankruptcy is not the cause of financial distress; it is our institutional remedy.
- IL is a „collective debt-collection device“ and on contrary a „collective loss-distribution tool“.



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General Objectives

- Recent experience has demonstrated the extent to which the *absence of orderly and effective insolvency procedures* can exacerbate *economic and financial crises*. Without effective procedures that are applied in a predictable manner, creditors may be unable to collect on their claims, which will adversely affect the future availability of credit.
- Once one eliminates obviously improper tactical uses of non bankruptcy procedures (e.g. such from information asymmetry) stakeholders (directors) of a firm therefore, are likely to delay too long in filing a bankruptcy petition.
- Without orderly procedures, the rights of debtors (and their employees) may not be adequately protected and different creditors may not be treated equitably and in a predictable manner.
- In contrast, the consistent application of orderly and effective insolvency procedures plays a critical role in *fostering growth and competitiveness* and may also assist in the prevention and resolution of financial crises: such procedures induce greater caution in the incurrence of liabilities by debtors and greater confidence in creditors when extending credit or rescheduling their claims.

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General Objectives

- The first overall objective is *the allocation of risk among participants in a market economy in a predictable, equitable and transparent manner*.
- *Predictability*. The relevant risk allocation rules should be clearly specified in the law and they should be consistently applied by the individuals and institutions that are charged with implementing them. When the rules or their application are uncertain, such uncertainty erodes the confidence of all participants and undermines their willingness to make credit and other investment decisions.
- *Equitable Treatment*. A common feature of all insolvency proceedings is their collective nature. Equitable treatment does not require equal treatment, e.g. (granting of security). IL must address the problem of fraud and favoritism that often arises in the context of financial distress. An independent insolvency expert, for example, issue statements that can calm markets effectively and execute the “par conditio creditorum”.
- *Transparency*. Insolvency deals with a fiduciary administration who is converting debtors assets to their creditors. Therefore the “insolvency expert” must be independent, competent and efficient.

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General Objectives

- Insolvency law is to protect and maximize value for the benefit of all interested parties and the economy in general.
- *Best protection* are *losses which don´t occur* because company finished an effective turnaround / reengineering process before become over-indebted or illiquid or exit the market by liquidation. There should not be any protection for zombie firms, which typically exit in a competitive market, because they carry adverse implications for productivity growth by delaying the initiation of restructuring and increase the length of insolvency proceedings while after consuming scarce resources. "*Barriers to exit are barriers to entry*".
- The achievement of the value maximization objective is often linked to the fulfillment of the objective of equitable risk/chance allocation. The liquidation value is the limit. Benchmark is the "pareto optimum".
- The obvious reason for an alternative liquidation is to aggregate additional value of the assets even if business is dismembered.

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Logic and Limits of Bankruptcy Law

- Insolvency proceedings should commence upon illiquidity and upon over-indebtedness. Debtor isn´t able to meet his obligations. The debtor is out of cash and not creditworthy. “Grab Law”, first come first serve, is not able to satisfy all claimants. That justifies transfer of control and power of disposal to the creditors.

- Proper commencement is important to protect participants from fraud, wrongful trading and erosion of resources.

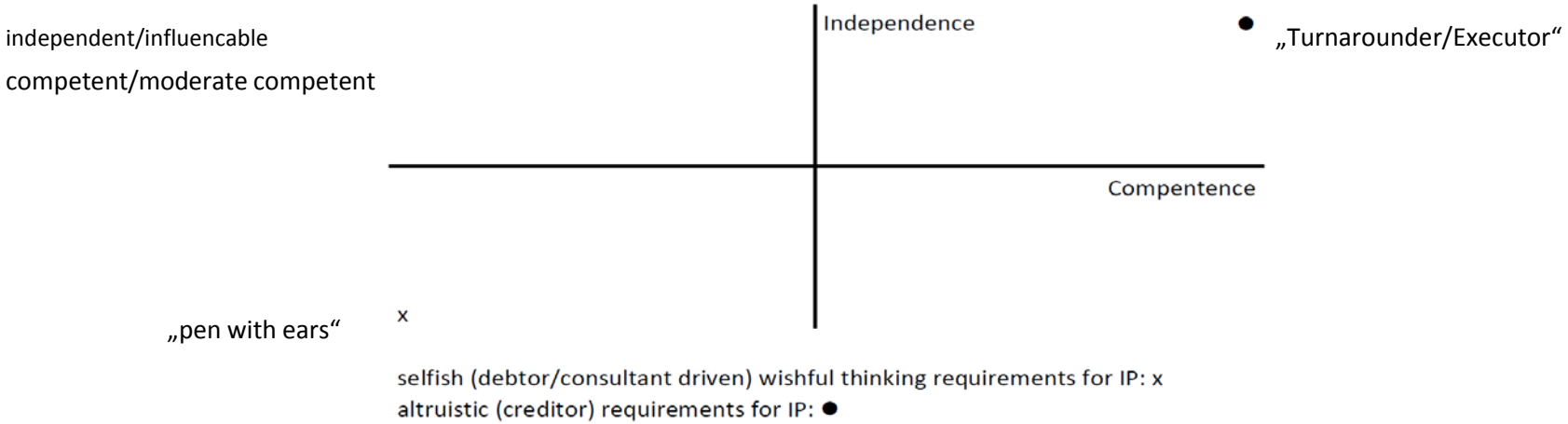
- Over-indebtedness is an effective early warning tool. If a company is over-indebted and realizies further losses the risk of ongoing business shifted to the creditors whether they credit consensual or involuntary.

- In general: debts/losses must not be distributed to participants if debtor reorganizes/reengineers business or exit the market before over-indebtedness or illiquidity. Than approaches of fraud and wrongful trading are absent.

Logic and Limits of Bankruptcy Law

- IL is an ancillary parallel system of collective debt collection /loss distribution law, which meet personal liability of stakeholders by liquidation or aggregating additional value by reengineering /restructuring business.
- Which are the crucial rules for a IL and/or a preventive restructuring framework?
- Successful business is „knowledgedriven“.
- How to deny access to preventive framework, when the reasons are blatantly to gain a rule change to cash out their advantages from information asymmetry?
- What are the drivers for a „rule change“.

Preferred skills for an IP/Administrator:



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Logic and Limits of Bankruptcy Law

- Because bankruptcy´s procedures are different from non bankruptcy procedures, it is virtually necessary to eliminate the problem of strategic uses of non bankruptcy proceeding.
- You should avoid the fact that non bankruptcy procedures, precisely because it has specialized procedures to respond to a common pool problem, inevitably will create strategic incentives unassociated with solving that problem.
- Focus on the „special intangbile *symbiotic relationship“ (triangel)* between *reliable and competent consultants* and *insolvency experts/adminstrators*. If there´s a lack of independent, competent IP (and/or a *reliable legal framework*) there`s no reason for the debtor to mandate a reliable consult. They prefer selfish and dubios „fraud advice“ (dig a hole, cover the assets, wait until gras is green and than dig up), because they hope that they could stay in driver seat without harm.
- Requirements for a reliable decision are know from business judgement rule: Fully informed disinterested judgement, on rational belief in good faith.
- Informationinsider like to cash out/ keep advantages of information asymmetry.
- Interim and or new financing should not be proteced against void if the sucess of the rehabilitation plan is not highly probable. So the interests of the new financier could be balanced between own returns and the interest in the reliable turn around.

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Logic and Limits of Bankruptcy Law

- In the „old world“ one would expect that consensual deals among creditors outside the bankruptcy process would often be attempted first. The formal bankruptcy process would presumably be used when stakeholder lost confidence and/or debtor is illiquid or over-indebted. Individual advantage thinking in the setting of multiparty negotiations made a consensual deal to costly to strike, which may, however, occur frequently as the number of creditors increases.
- In the „new world“ distressed investors take stakes in general because they are primary interested in their exit either as described as „hold out value“ or „loan to own “ or as „selfish troublemaker“. Interest in turnaround is partially subordinated. They mainly become a „voluntary“ creditor in distress and purchased under par.
- It should be incumbent upon the debtor-company and it professionals to consider carefully how rehabilitation plan is most likely to achieve the goals consistent with important policy considerations designed to promote the debtors prospects for while protecting the interests of other stakeholders involved than to change the venue for COMI.

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Logic and Limits of Bankruptcy Law

- „Pareto maximum “ requires law execution which produces results in predictable, equitable, and transparent manner and fully informed participants (avoiding information asymmetry), to make a decision and risk evaluation free from threat, discrimination and/or unfair pressure.
- Independence, transparency and competence avoids information asymmetry and unfair „rule change “.
- Choice of bankruptcy venue = occasion for forum shopping vers. macroeconomic stakeholder/ consumer protection by preventing increasing losses.
- The financial decline of a firm is likely to be recognized first by the firms managers and principal shareholders.
- Losses that do not arise must not be distributed. There´s a need for early reengineering and in case of failure for liquidation and market exit.
- One should be protected from change of COMI in distress.
- Possibility for adebtor´s driven rule change in distress to gain unfair advantages to stay in the driver seat inevitably will create strategic incentives unassociated with solving that problem.
- The competition of business units creates value, not competition of legals systems.
- A „race to the bottom “ is like a „prisoners dilemma “.

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Requirements

- Legal framework, embedded in the framework of national economies which presents the vital incentives, which produces predictable effects and will be executed sustainable.
  ⇨ Effective measures against delayed filing of insolvency.
  ⇨ Transparency and trust to give the participants opportunity to make a decision fully informed and free from threat or discrimination.
  ⇨ Rules -which are executed- against misuse.
- IL regulates the conflicts of interest. The debtor´s not able to meet his obligations. There is a lack of everything; especially time, money and trust. Lack of trust and time should be compensated by transparency and an independent, competent and efficient ans effective insolvency expert. But the lack of money has to be balanced through a legal framework. The IL must prevail, coordinate and line up conflicting rights and participants.
- Well equipped courts, trained, impartial, competent and professional judges.
- Independent, competent, efficient and effective administrators/legal experts / IPs.

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Conclusion

- It´s all about trust and information.
- Market can degrade in the presence of information asymmetry.
- „Barriers to exit are barriers to entry“.
- Insolvency law is a „collective debt-collection device“ and on contrary a „collective loss-distribution tool“.
- Proper commencement is important to protect participants from fraud, wrongful trading and erosion of resources. In general: debts/losses must not be distributed to participants if debtor reorganizes/reengineers business or exit the market before over-indebtedness or illiquidity.
- Insolvency is no sudden event. Those who blame insolvency as value destroyer ignore that losses have occured before and value decline is based on a „rule change“ from DCF to liquidation.
- Effective and predictable execution of law reduces the individual research and protection expenses and is economically more favourable.
- Independence, transparency and competence avoids information asymmetry and unfair „rule change “.

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Thank you for your attention!

Questions?

Remarks?

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