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Insolvency Law as a Catalyst for Growth

1.1 The Role of Insolvency Law in the Real Economy

Insolvency law plays an essential role in the real economy. From an *ex ante* perspective, that is, before a situation of insolvency arises, the *design* of insolvency law affects how debtors and creditors make decisions. For instance, if creditors believe that an insolvency system does not protect their rights or it does not help them maximize their recoveries if their debtors become insolvent, they will rationally become reluctant to extend credit. Therefore, an unattractive insolvency regime for creditors will harm firms' access to finance and the promotion of economic growth.[1] Similarly, an insolvency system that severely punishes honest but unfortunate debtors may discourage individuals from starting a business or taking risks. As a result, it will reduce the levels of entrepreneurship and innovation in a country.[2] Likewise, if an insolvency regime imposes a tough liability regime on the directors of insolvent firms even when it is shown that they acted in good faith, highly qualified managers may be discouraged from serving on corporate boards or they will be incentivized to take suboptimal levels of debt or risk. Alternatively, they will require higher salaries or more protective insurance policies whose costs will be borne by the shareholders and ultimately consumers. Hence, insolvency law has a direct impact on a country's real economy even if borrowers do not eventually become insolvent and the insolvency system

[1] For a summary of the empirical literature on the impact of creditors' rights on firms' access to finance, see John Armour, Antonia Menezes, Mahesh Uttamchandani, and Kristin van Zwieten, 'How Do Creditor Rights Matter for Debt Finance? A Review of Empirical Evidence' in Frederique Dahan (ed), *Research Handbook on Secured Financing of Commercial Transactions* (Cheltenham: Edward Elgar Publishing, 2015) 3–25.

[2] Kenneth Ayotte, 'Bankruptcy and Entrepreneurship: The Value of a Fresh Start' (2007) 23 *Journal of Law, Economics and Organization* 161; John Armour and Douglas Cumming, 'Bankruptcy Law and Entrepreneurship' (2008) 10 *American Law and Economic Review* 303.

is not finally used. As a result, insolvency law can paradoxically be more relevant for solvent than for insolvent firms.[3]

Yet, the *raison d'être* of insolvency law is to deal with a situation of insolvency. Therefore, insolvency law is expected to play an essential role *ex post*, that is, once a situation of insolvency occurs. On the one hand, an efficient insolvency framework should maximize the returns to creditors. By doing so, it will be able to reduce the losses eventually borne by the creditors of an insolvent firm and it will indirectly perform other valuable functions for the real economy such as preventing other situations of insolvency and reducing the levels of non-performing loans ("NPLs") in the banking sector.[4] On the other hand, an efficient insolvency regime should facilitate the reorganization of viable but financially distressed companies as well as the quick liquidation of nonviable firms.[5] Thus, insolvency law will contribute to the efficient reallocation of resources in the economy. Moreover, if a viable firm is saved, insolvency law will also have the ability to benefit employees, suppliers, tax authorities, and other stakeholders.

Additionally, adopting an attractive insolvency framework for debtors and creditors can bring other benefits to a local economy. For instance, a jurisdiction with an efficient insolvency framework for creditors will become a more attractive forum for lenders and financial services.[6] Similarly, an efficient insolvency framework for debtors may increase the number of companies potentially interested in operating or conducting a debt restructuring in a particular jurisdiction. As a result, countries

[3] Michelle J White, 'The Costs of Corporate Bankruptcy: A U.S.–European Comparison' in Jagdeep S Bhandari and Lawrence A Weiss (eds), *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge: Cambridge University Press, 1996) 467–500, 467.

[4] Antonia Menezes, Sergio Muro, and Clara Martins Pereira, 'How Insolvency and Debtor Regimes Can Help Address Nonperforming Loans' (2021) World Bank: Equitable Growth, Finance and Institution Notes <https://documents1.worldbank.org/curated/en/163151612172227669/pdf/How-Insolvency-and-Creditor-Debtor-Regimes-Can-Help-Address-Nonperforming-Loans.pdf> accessed January 24, 2023.

[5] Elena Cirmizi, Leora Klapper, and Mahesh Uttamchandani, 'The Challenges of Bankruptcy Reform' (2012) 27(2) *The World Bank Research Observer* 185. See also Joseph E Stiglitz, 'Bankruptcy Laws: Basic Economic Principles' in Stijn Claesens, Simeon Djankov, and Ashoka Mody (eds), *Resolution of Financial Distress: An International Perspective on the Design of Bankruptcy Laws* (Washington, DC: World Bank Publications, 2001) 1–23.

[6] Aurelio Gurrea-Martínez, 'Building a Restructuring Hub: Lessons from Singapore' (2021) Singapore Management University School of Law Research Paper No. 16 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3940512> accessed January 24, 2023.

can benefit from the job opportunities created in the legal and financial industries, as well as other sources of income generated by increased levels of trade, foreign investments, consumption, and tax revenues.[7]

Therefore, insolvency law can serve as a catalyst for growth. Thus, even though an efficient insolvency system is essential for any country, it becomes even more relevant for emerging economies due to their potential for growth and their greater financial needs. Unfortunately, many emerging economies do not have efficient insolvency frameworks. Sometimes, the existence of inefficient insolvency frameworks is due to the lack of political will to embark on insolvency reforms. In other countries, however, the insolvency legislation has been modernized in the past decades. Yet, the insolvency system does not seem to work effectively. In fact, as shown in Chapter 9, it might not even be used – or at least not very often. This book argues that insolvency law in many emerging economies fails to promote growth because it has not been designed taking into account the market and institutional environment generally existing in emerging economies. Instead, the insolvency legislation of many emerging economies often replicates the laws and practices of other jurisdictions with a totally different market and institutional environment. Therefore, insolvency law in emerging economies needs to be reinvented.

1.2 The Economic Function of Corporate Insolvency Law

1.2.1 Introduction

Once a situation of insolvency arises, an efficient corporate insolvency regime should perform two primary functions. First, it should provide a variety of tools to minimize the destruction of value associated with a situation of financial distress.[8] Second, it should facilitate the efficient allocation of the debtor's assets.[9] The following sections will explain the strategies generally used by insolvency law to pursue these goals. If this *ex post* function of insolvency law is effectively achieved, insolvency law will

[7] Ibid.

[8] It has been estimated that the costs of financial distress represent 10–20 percent of the value of the firm. See Gregor Andrade and Steven N Kaplan, 'How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed' (1998) 53 *Journal of Finance* 1443.

[9] Michelle J White, 'The Corporate Bankruptcy Decision' (1989) 3(2) *Journal of Economic Perspectives* 129.

be able to perform various socially desirable goals, including the maximization of the returns to creditors, the reorganization of viable but financially distressed companies, the reallocation of assets of nonviable firms towards more productive activities, and the promotion of financial stability. Moreover, from an *ex ante* perspective, it will be able to promote greater levels of entrepreneurship, innovation, access to finance, and economic growth.

1.2.2 *Corporate Insolvency Law as a Mechanism to Minimize the Destruction of Value*

When a company becomes financially distressed, value can be destroyed as a result of several factors. First, when debtors are unable to pay their debts, creditors become entitled to enforce their claims and ultimately seize the debtor's assets. Therefore, the initiation of enforcement actions by creditors may end up destroying the going concern value of economically viable firms.[10] For that reason, insolvency law generally responds by imposing a moratorium (or "stay") that stops creditors from initiating legal actions against the debtor.[11] Moreover, by replacing all the creditors' individual enforcement actions with a single procedure, insolvency law also has the ability to reduce collection costs.[12]

Second, a situation of insolvency may incentivize key employees to abandon the firm. Similarly, suppliers may decide to terminate their business relations with the debtor, and lenders will unlikely be willing to keep extending credit to financially distressed firms – even if they are economically viable. As these circumstances can destroy value, insolvency law intervenes by adopting a variety of responses. For instance, when a company is subject to a formal insolvency or restructuring proceeding, many insolvency laws allow new suppliers, employees, and other contractual parties to obtain a priority – usually in the form of administrative expenses. In fact, in some jurisdictions such as the United States and Singapore, debtors can obtain new financing by providing lenders with various forms of priority that may range from an administrative expense priority to new liens, junior liens, and

[10] Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Washington, DC: Beard Books, 2001 [Cambridge, MA: Harvard University Press, 1986]) 16–17.
[11] Ibid.
[12] Ibid.

even senior liens.[13] These rules, generally known as debtor-in-possession ("DIP") financing or rescue financing provisions,[14] provide viable but insolvent firms with the opportunity to keep financing their operations and pursue new investment projects with a positive net present value ("NPV").[15] Thus, an insolvency proceeding can serve as a liquidity provider for viable but financially distressed firms.[16]

Third, debtors facing financial trouble may have incentives to engage in various forms of opportunistic behavior that can destroy or divert value at the expense of the creditors. This opportunistic behavior may include the transfer of assets to related parties, borrowing money in an irresponsible manner, and investing in risky projects in a last-ditch attempt to rescue the insolvent firm.[17] It may also include actions seeking to keep nonviable firms alive by, for example, failing to take corrective actions in the event of financial distress or by postponing an inevitable liquidation once a company has initiated a restructuring or insolvency proceeding.[18] In order to address these problems, insolvency law responds through a variety of mechanisms. For instance, it often imposes special directors' duties when a company becomes factually insolvent but it is not yet subject to a formal insolvency proceeding – that is, when the company is in the so-called "zone of insolvency."[19] It also facilitates the avoidance of certain transactions that took place prior to the commencement of an insolvency proceeding.[20] Additionally, once the debtor is

[13] In the United States, see Bankruptcy Code, s 364. In Singapore, see Insolvency, Restructuring and Dissolution Act 2018, ss 67 and 101.

[14] While the term "DIP financing" is more generally used in the United States, the expression "rescue financing" is used in other jurisdictions such as Singapore. For the purpose of this book, both terms will be used interchangeably.

[15] Aurelio Gurrea-Martínez, 'Debtor-in-Possession Financing in Reorganization Procedures: Regulatory Models and Proposals for Reform' (2023) 24(3) *European Business Organization Law Review* 555, 556–557.

[16] Emphasizing this feature of insolvency proceedings, at least in countries like the United States where debtors can obtain DIP financing, see Kenneth Ayotte and David A Skeel Jr, 'Bankruptcy Law as a Liquidity Provider' (2013) 80 *University of Chicago Law Review* 1557.

[17] John Armour, Gerard Hertig, and Hideki Kanda, 'Transactions with Creditors' in John Armour, Luca Enriques et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 3rd ed (Oxford: Oxford University Press, 2017) 111.

[18] As explained in Chapters 5 and 6, these problems can be exacerbated in the context of micro- and small enterprises as well as large companies with controlling shareholders.

[19] For an analysis of the different types of directors' duties in the zone of insolvency generally existing around the world, see Chapter 5.

[20] Aurelio Gurrea-Martínez, 'The Avoidance of Pre-Bankruptcy Transactions: An Economic and Comparative Approach' (2018) 93(3) *Chicago-Kent Law Review* 711.

subject to a formal insolvency proceeding, most jurisdictions around the world require the appointment of an insolvency practitioner ("IP") to monitor or even replace the directors in the management of the debtor's property and business affairs.[21] Moreover, creditors generally enjoy certain powers and decision rights during the procedure. By adopting these strategies, insolvency law seeks to minimize the value potentially destroyed by the opportunistic behavior of debtors.

1.2.3 Corporate Insolvency Law as a Mechanism to Promote the Efficient Allocation of Resources

An efficient corporate insolvency framework should also facilitate the efficient allocation of resources in the economy. This function is achieved by making sure that the debtor's assets are put to their best use.[22] If a company is not economically viable, this goal will be achieved by liquidating the company and reallocating the debtor's assets towards more productive activities.[23] If a company has a viable business but it is run by incompetent or unreliable managers, an efficient corporate insolvency framework should facilitate the sale of the business as a going concern. Finally, when a company's assets are worth more if they are kept together under the current management team, an efficient corporate insolvency regime should provide the right tools to facilitate the survival and effective reorganization of the insolvent company.

[21] The United States is one of the few jurisdictions around the world that does not require the appointment of an IP in a formal reorganization procedure. In a Chapter 11 reorganization procedure, the appointment of an examiner or a trustee is very rare and it typically takes place in cases of fraud or mismanagement. See US Bankruptcy Code, s 1104.

[22] White, 'The Corporate Bankruptcy Decision' (n 9); John Armour, 'The Law and Economics of Corporate Insolvency' (2001) ESRC Centre for Business Research University of Cambridge, Working Paper No. 197 <www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp197.pdf> accessed January 24, 2023.

[23] For an analysis of the concept of viability, and why nonviable or economically distressed firms should be liquidated while viable but financially distressed firms should be reorganized, see Michelle J White, 'Does Chapter 11 Save Economically Inefficient Firms?' (1994) 72 *Washington University Law Quarterly* 1319; Douglas G Baird, 'The Hidden Virtues of Chapter 11: An Overview of the Law and Economics of Financially Distressed Firms' (1997) Chicago Working Paper in Law & Economics No. 43, 9–10 <https://chicagounbound.uchicago.edu/law_and_economics/527/>; Armour, 'The Law and Economics of Corporate Insolvency' (n 22); Alan Schwartz, 'A Normative Theory of Corporate Bankruptcy' (2005) 91 *Virginia Law Review* 1199, 1200–1201.

Insolvency law uses a variety of mechanisms to facilitate the reorganization of viable but financially distressed firms. First of all, it provides an adequate forum for negotiations. On the one hand, an insolvency proceeding usually requires the involvement of independent and reliable third parties (e.g., insolvency courts and IPs) that can facilitate an environment of trust between debtors and creditors. On the other hand, debtors subject to an insolvency proceeding are generally required to provide information to the creditors.[24] By doing so, the asymmetries of information between debtors and creditors can be reduced, increasing the likelihood of achieving a successful reorganization if the debtor is indeed an economically viable firm that, by being kept alive, can make the creditors as whole better off.

Second, insolvency law provides several tools to facilitate the approval of a reorganization plan. These tools generally include the possibility for a majority (or qualified majority) of creditors to impose a plan on dissenting creditors within a class, often known as *intra-class* cramdown or, simply, "majority rule."[25] In some jurisdictions such as the United States, Singapore, the United Kingdom, the Netherlands, Germany, Spain and China, debtors can also impose a plan on dissenting *classes* of creditors where certain requirements are met. This latter practice is generally known as *cross-class* cramdown or just "cramdown." By providing these tools, insolvency law minimizes holdout problems, encourages *ex ante* bargaining, reduces negotiation costs, and facilitates the approval of value-enhancing reorganization plans that can save viable but financially distressed firms.[26]

An insolvency system that can effectively minimize the destruction of value while putting the debtor's assets to their best use can generate various *ex post* benefits for the real economy. First, it will save viable businesses that would otherwise be shut down. Hence, insolvency law will be able to preserve jobs, business relationships, tax revenues, and other positive externalities created by keeping viable firms alive. Second,

[24] For analysis of disclosure requirements existing in some debt restructuring procedures, see Wai Yee Wan and Casey Watters, 'Mandatory Disclosure in Corporate Debt Restructuring via Schemes of Arrangement: A Comparative Approach' (2021) 30(S1) *International Insolvency Review* S111.

[25] The existence of a majority rule replaces the unanimity rule that generally governs workouts. See Jose Maria Garrido, *Out-of-Court Debt Restructuring* (Washington: World Bank Studies, 2012) 12.

[26] Aurelio Gurrea-Martínez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) *European Business Organization Law* 829, 838–839.

by liquidating nonviable businesses, insolvency law will serve as a valuable mechanism to reallocate resources towards more productive activities. Thus, it can contribute to the competitiveness of the economy. Third, minimizing the destruction of value and putting the debtor's assets to their best use will help reduce the potential losses borne by creditors. In the context of financial creditors, this goal can reduce the level of non-performing loans in the banking sector and thereby promote financial stability.[27] From the perspective of nonfinancial creditors, and particularly nondiversified creditors highly exposed to the debtor's default, maximizing their recoveries in insolvency reduces the risk that the creditors themselves become insolvent. Therefore, it will also reduce the likelihood of observing an increase in the number of insolvency proceedings initiated by the creditors affected by a situation of insolvency of their debtors.[28] Finally, if an insolvency system is efficient *ex post* and therefore manages to maximize the returns to creditors, it will incentivize lenders to extend credit at a lower cost. Thus, from an *ex ante* perspective, insolvency law can serve as a powerful mechanism to facilitate firms' access to finance and the promotion of economic growth.

1.3 Factors Affecting the Design of Insolvency Law

1.3.1 Introduction

While insolvency law seeks to solve similar economic problems across jurisdictions, the intensity of these problems and the desirability of a particular insolvency response depend on a variety of country-specific and firm-specific factors. These factors include divergences in corporate ownership structures, debt structures, levels of financial development, firm size, sophistication of the judiciary, credibility and expertise of insolvency practitioners, efficiency of insolvency proceedings, and the political economy of insolvency law.

[27] Menezes et al., 'How Insolvency and Debtor Regimes Can Help Address Nonperforming Loans' (n 4).

[28] For an analysis on the potential domino effects of corporate insolvency, see Arata Yoshiyuki, 'An Empirical Analysis of the Propagation of Corporate Bankruptcy' (2018) RIETI Discussion Paper Series 40 <www.rieti.go.jp/jp/publications/dp/18e040.pdf>; Efraim Benmelech, Nittai Bergman, Anna Milanez, and Vladimir Mukharlyamov, 'The Agglomeration of Bankruptcy' (2019) 32(7) *The Review of Financial Studies* 2541.

1.3.2 Corporate Ownership Structures

In small companies and large firms with controlling shareholders ("controlled firms"), the shareholders are often involved in the management of the company. Even if they are not part of the board of directors, they have incentives to closely monitor the managers. This situation, along with the fact that the shareholders have the ability to appoint, remove, and remunerate the directors, will incentivize the directors to act in the interest of the shareholders. While this alignment of incentives between directors and shareholders can be desirable for solvent companies,[29] it can entail certain risks when a firm becomes insolvent.

As mentioned in Section 1.2, the shareholders of financially distressed firms may have incentives to engage in various forms of behavior that can destroy or divert value at the expense of the creditors. Hence, as the directors are still appointed and removed by the shareholders (when they are not the shareholders themselves), a situation of insolvency in small companies and large controlled firms will increase the risk of opportunism of shareholders vis-à-vis creditors. As a result, insolvency responses empowering directors by providing them with broad discretion in the zone of insolvency or adopting a DIP model for the governance of insolvency proceedings can be riskier for creditors. Therefore, all else being equal, more interventionist responses restricting the power of corporate directors, such as the imposition of a duty to initiate insolvency proceedings once a company becomes insolvent or the mandatory appointment of an IP during a formal insolvency proceeding, may be more justified in small companies and large firms with controlling shareholders.[30] In the absence of these responses, even if the directors do not ultimately seek to favor the shareholders at the expense of the creditors, the higher risk of shareholder opportunism may make lenders more reluctant to extend credit, harming firms' access to finance and the promotion of economic growth.[31]

[29] In fact, making sure that the directors act in the best interests of the shareholders has traditionally been the primary concern in corporate law. See, e.g., Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305; Lucian A Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118(3) *Harvard Law Review* 833.

[30] Aurelio Gurrea-Martínez, 'Towards an Optimal Model of Directors' Duties in the Zone of Insolvency: An Economic and Comparative Approach' (2021) 21(2) *Journal of Corporate Law Studies* 365.

[31] Ibid.

In contrast, in large companies with dispersed ownership structures, generally found in the United Kingdom and the United States,[32] the management is typically separated from the shareholders. Therefore, as the shareholders may not have a significant influence on the management, the directors will not have the same incentives to act in the best interests of the shareholders. In that context, it could be argued that, since the remuneration of managers often includes stock options and other forms of equity-based compensation,[33] the interests of managers and shareholders are aligned. Nonetheless, while the shareholders only have their investments at risk, the managers may also jeopardize their jobs if the company ends up in an insolvency proceeding and is ultimately shut down. Therefore, managers should have incentives to avoid excessive risk-taking in the zone of insolvency.[34] Additionally, the fact that managers may need to seek employment elsewhere if the company is liquidated should discourage them from engaging in any opportunistic behavior. Thus, the risk of opportunism of shareholders vis-à-vis creditors will be lower. As a result, all else being equal, insolvency responses providing greater powers and discretion to managers, such as the adoption of a DIP model or more flexible duties in the zone of insolvency, may be more justified in companies with dispersed ownership structures.

1.3.3 Debt Structures

When a company has a dispersed debt structure, as typically observed in the context of large companies in the United States,[35] creditors face

[32] See Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'Corporate Ownership around the World' (1999) 54 *Journal of Finance* 471. In the United States, however, see Clifford G Holderness, 'The Myth of Diffuse Ownership in the United States' (2009) 44 *The Review of Financial Studies* 1377.

[33] John Armour, Luca Enriques, Henry Hansmann, and Reinier Kraakman, 'The Basic Governance Structure: The Interests of Shareholders as a Class' in John Armour, Luca Enriques et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 3rd ed (Oxford: Oxford University Press, 2017) 66–67.

[34] Testing this hypothesis in Sweden and showing that managers indeed have incentives to avoid excessive risk-taking in the zone of insolvency, see B Espen Eckbo and Karin S Thorburn, 'Control Benefits and CEO Discipline in Automatic Bankruptcy Auctions' (2003) 69 *Journal of Financial Economics* 227.

[35] John Armour, Brian R Cheffins, and David A Skeel Jr., 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2002) 55 *Vanderbilt Law Review* 1699, 1763–1783.

greater coordination problems.[36] Likewise, the existence of multiple creditors increases the risk of experiencing the type of holdout problems that insolvency law seeks to solve.[37] Therefore, in companies with those features, the imposition of a moratorium stopping creditors from enforcing their claims or the adoption of cramdown provisions will be especially needed to protect viable but financially distressed firms. Similarly, other rules often provided by insolvency law, such as the possibility of creating a committee of creditors or appointing an insolvency practitioner, will also be more justified when companies have dispersed debt structures.

In contrast, when a company has a concentrated debt structure with a few creditors, as generally occurs in small and medium-sized enterprises as well as in large firms mainly relying on bank finance, creditors will be in a better position to coordinate their actions.[38] Moreover, debtors will be able to interact more easily with their creditors. Hence, negotiating and reaching an out-of-court agreement will be more feasible.[39] As a result, a duty to initiate insolvency proceedings, or the existence of insolvency provisions *requiring* the creation of a committee of creditors or the appointment of an insolvency practitioner, will generally be less desirable in companies with concentrated debt structures.

1.3.4 *Level of Financial Development*

In countries with developed financial systems, such as the United States, the United Kingdom, Hong Kong and Singapore, viable but financially distressed debtors usually have more financing options. Therefore, the type of underinvestment problem that insolvency law seeks to minimize

36 Armour et al., 'Transactions with Creditors' (n 17) 140–141.

37 Anthony J Casey, 'Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy' (2020) 120 (7) *Columbia Law Review* 1709.

38 These types of debt structures are found in most jurisdictions around the world. In fact, even large companies based in countries with developed capital markets such as the United Kingdom often have concentrated debt structures. See Armour et al., 'Corporate Ownership Structure and the Evolution of Bankruptcy Law' (n 35).

39 Stuart Gilson, Kose John, and Larry Lang, 'Troubled Debt Restructurings: An Empirical Study of Reorganization of Firms in Default' (1990) 27 *Journal of Financial Economics* 315; Edward R Morrison, 'Bankruptcy's Rarity: An Essay on Small Business Bankruptcy in the United States' (2008) 5 *European Company and Financial Law Review* 172, 176–180.

can often be less significant.[40] However, in countries without developed financial systems, companies generally face greater financing needs. Therefore, the underinvestment problems usually existing in a situation of insolvency will be exacerbated. As a result, the implementation of various strategies to incentivize lenders to extend new credit, for example by providing them with a priority for the new financing, will be even more justified.

1.3.5 Firm Size

The costs of insolvency proceedings for micro- and small enterprises ("MSEs") are generally prohibitive.[41] Additionally, MSEs have certain features that may undermine the desirability of insolvency proceedings. For example, MSEs usually have simple financial structures comprising a few creditors.[42] Therefore, it will be easier for MSEs to negotiate and reach an informal agreement with their creditors.[43] As a result, a formal insolvency proceeding might not be needed. Even if an insolvency proceeding is needed, either for the liquidation of nonviable MSEs or the reorganization of viable MSEs unable to reach an out-of-court agreement, the procedure needs to be significantly simplified.[44] Thus, the size of a firm may affect the optimal design of insolvency proceedings.

1.3.6 Sophistication of the Judiciary

In countries with a sophisticated judicial system comprising efficient, reliable, independent, competent, predictable, and well-equipped courts,

[40] An underinvestment problem generally occurs when companies cannot pursue value-creating investment projects. For an analysis of this problem and how certain insolvency provisions can contribute to mitigate it, see George G Triantis, 'Theory of the Regulation of Debtor-in-Possession Financing' (1993) 46 *Vanderbilt Law Review* 901.

[41] Edward R Morrison and Andrea C Saavedra, 'Bankruptcy's Role in the COVID-19 Crisis' (2020) Columbia Law and Economics Working Paper 624, 6–7 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3567127> accessed January 24, 2023.

[42] Morrison, 'Bankruptcy's Rarity' (n 39) 176–180.

[43] Ibid.

[44] Suggesting the promotion of workouts for viable MSEs and the implementation of simplified insolvency proceedings based on a system of auctions, see Aurelio Gurrea-Martínez, 'Implementing an Insolvency Framework for Micro and Small Firms' (2021) 30 (S1) *International Insolvency Review* S46. Advocating for the adoption of a modular approach in the design of insolvency proceedings for micro-, small, and medium-sized enterprises, see Riz Mokal et al., *Micro, Small, and Medium Enterprise Insolvency: A Modular Approach* (Oxford: Oxford University Press, 2018).

the involvement of judges in insolvency proceedings can be value-enhancing.[45] Indeed, judges can act as reliable intermediaries that, apart from facilitating negotiations and a fair process, may have the knowledge, credibility, and experience to make certain decisions that can add value for the benefit of debtors, creditors and society at large. Therefore, in jurisdictions with sophisticated judicial systems, such as the United States, the United Kingdom, and Singapore, the involvement of courts in insolvency proceedings can be justified. Unfortunately, many jurisdictions around the world – and certainly most emerging economies – do not have a judicial system that meets all the conditions that this book will identify as a "sophisticated judiciary," that is, a judiciary that is efficient, reliable, predictable, independent, competent, and well-equipped. In some jurisdictions, the weaknesses of the judicial system derive from the lack of an independent, predictable, and reliable judiciary. In other countries, judges may be independent, but they may not have the competence or experience needed to handle insolvency disputes. Finally, there are jurisdictions with independent, reliable, and competent courts, but the judicial system is not very efficient or the judges do not have the resources to effectively handle insolvency proceedings. Regardless of the weakness, in the absence of some of these features making a judiciary "sophisticated," the involvement of courts in insolvency proceedings should be reduced.

1.3.7 Credibility and Expertise of Insolvency Practitioners

In countries with an independent and highly qualified body of insolvency practitioners, the mandatory appointment of an IP can often be justified on the basis that these professionals can create value by adding credibility and expertise to the insolvency proceeding. However, many jurisdictions do not have a large body of independent and highly qualified IPs. Therefore, due to the fees charged by IPs, the mandatory appointment of these professionals can often end up doing more harm than good for the creditors. As a result, countries should carefully assess whether the appointment of an IP is justified in every insolvency proceeding. Additionally, even if an IP is appointed, the role and powers of these actors should be reduced if they do not meet certain requirements in terms of competence, credibility and

[45] Kenneth Ayotte and Hayong Yun, 'Matching Bankruptcy Laws to Legal Environments' (2009) 25(1) *The Journal of Law, Economics, and Organization* 2.

experience. This goal can be achieved through a variety of strategies, including the empowerment of creditors at the expense of IPs and the adoption of a governance model of insolvency proceedings that allows the managers of the insolvent firm to keep running the company even if an examiner is potentially appointed to monitor the debtor. Additionally, in the absence of a significant pool of highly qualified insolvency practitioners, the appointment of an IP should be exclusively decided by debtors and creditors, especially in countries with weak institutional environments.

1.3.8 Efficiency of Insolvency Proceedings

The efficiency of insolvency proceedings, at least in terms of speed of the procedure and recovery rates obtained by creditors, significantly differs across jurisdictions. For example, while countries like the United States and Germany have relatively efficient insolvency proceedings, many jurisdictions have lengthy insolvency proceedings that generally provide creditors with very low recovery rates.[46] As a result, the initiation of insolvency proceedings may end up being detrimental for both debtors and creditors. For this reason, the use of such inefficient proceedings should be minimized. This can be achieved through a variety of strategies, including not imposing a duty to initiate insolvency proceedings,[47] favoring out-of-court restructurings and hybrid procedures,[48] and relying more on contractual and market-based mechanisms.[49]

1.3.9 Political Economy of Insolvency Law

The design of an insolvency regime often reflects different goals and political economies. For instance, in various countries around the world,

[46] See World Bank, 'Doing Business Report 2020: Resolving Insolvency' <www.doingbusiness.org/en/data/exploretopics/resolving-insolvency/good-practices> accessed March 10, 2023.

[47] Gurrea-Martínez, 'Towards an Optimal Model of Directors' Duties in the Zone of Insolvency' (n 30) 365–395.

[48] For an analysis of the definition, goals and features of hybrid and out-of-court proceedings, see Garrido, *Out-of-Court Debt Restructuring* (n 25).

[49] Oliver Hart, Rafael La Porta, Florencio Lopez-de-Silanes, and John Moore, 'Proposal for a New Bankruptcy Procedure in Emerging Markets' in Richard Levich (ed), *Emerging Capital Flows* (Boston: Kluwer, 1998) 401–419; Ayotte and Yun, 'Matching Bankruptcy Laws to Legal Environments' (n 45).

such as Mexico, France and Ecuador, the insolvency legislation clearly favors employees over other creditors.[50] In India, the creditor-oriented insolvency reform adopted in 2016 was justified, at least in part, by the need to create an efficient insolvency proceeding that, by promoting a quick reorganization of viable companies and the swift exit of nonviable businesses, could facilitate access to credit and the competitiveness of the economy while reducing the levels of NPLs in the banking sector and promoting investor confidence.[51] In many countries in the Middle East and Asia, individuals do not have access to an effective discharge of debts as a result of a variety of factors including culture and religion.[52] Other jurisdictions, such as Singapore, have embarked on insolvency reforms with the purpose of strengthening their position as an international hub for debt restructuring.[53] Meanwhile, many insolvency reforms around the world have taken place because countries sought to improve their positions in international rankings such as the World Bank's Doing Business Index,[54] or because an insolvency reform was a condition to obtain financing from international organizations.[55] Finally, many insolvency reforms are often implemented as a response to a specific crisis, as it was observed in the 1990s and early 2000s in Asia, in various

[50] This feature can be observed in several aspects of the procedure. For example, in France, employees get paid ahead of any other creditors, including secured creditors. In Mexico and Ecuador, in addition to enjoying a preferential treatment in the ranking of claims, employees are not even subject to the moratorium existing in reorganization procedures.

[51] For an analysis of some of the goals and principles that inspired the 2016 Insolvency and Bankruptcy Code, see Bankruptcy Law Reform Committee, 'Interim Report of the Bankruptcy Law Reform Committee' (2015) <https://msme.gov.in/sites/default/files/Interim_Report_BLRC_3.pdf> accessed August 22, 2023; Insolvency and Bankruptcy Board of India and International Finance Corporation, 'Understanding the IBC: Key Jurisprudence and Practical Considerations' (2020) International Finance Corporation, 11–14, 18 <https://ibbi.gov.in/uploads/whatsnew/e42fddce80e99d28b683a7e21c81110e.pdf> accessed 22 August, 2023.

[52] See Chapter 3.

[53] Gurrea-Martínez, 'Building a Restructuring Hub' (n 6).

[54] Criticizing the adoption of an insolvency reform with the purpose of improving a country's position in the World Bank's Doing Business Index, see Gerard McCormack, 'Why "Doing Business" with the World Bank May Be Bad for You' (2018) 19 *European Business Organization Law Review* 649.

[55] For example, this was one of the reasons behind the insolvency reforms that many Asian countries implemented after the Asian financial crisis. See, *e.g.*, International Monetary Fund, 'Recovery from the Asian Crisis and the Role of the IMF' (June 2005) IMF <www.imf.org/external/np/exr/ib/2000/062300.htm> accessed January 24, 2023.

European countries after the 2008 financial crisis, or more recently in many jurisdictions around the world during or in the aftermath of the coronavirus ("COVID-19") pandemic.[56]

1.4 Maximizing the Potential of Insolvency Law in Emerging Economies

1.4.1 Introduction

Insolvency law seeks to solve similar economic problems across jurisdictions. As has been mentioned, however, the intensity of these problems and the desirability of a particular insolvency response depend on a variety of country-specific and firm-specific factors. As will be shown in Chapter 2, there are many similarities among emerging economies. Some of these similarities, such as the prevalence of MSEs and large controlled firms, can also be found in most advanced economies.[57] Yet, there are other features that are more prevalent in emerging economies. For the purpose of this book, one of the most important features is the existence of a weak market and institutional environment.

When it comes to the design of insolvency law, Chapter 3 will show that there are also many similarities across jurisdictions, even between advanced economies and emerging markets. This is often the result of a variety of factors, including legal origins, geographical location, undesirable legal transplants and the adoption of "international best practices" that do not take into account a country's market and institutional environment. It will be argued that the lack of an insolvency framework tailored to the specific features of emerging economies has contributed to the failure of insolvency law in these countries, as evidenced by the low usage of insolvency proceedings in most emerging economies, and more generally by the inability of the insolvency system to deliver the expected

[56] Antonia Menezes and Akvile Gropper, 'Overview of Insolvency and Debt Restructuring Reforms in Response to the COVID-19 Pandemic and Past Financial Crises: Lessons for Emerging Markets' (March 9, 2021) World Bank <https://openknowledge.worldbank.org/handle/10986/35425> accessed January 24, 2023.

[57] MSEs represent the majority of firms in most countries around the world. See Gurrea-Martínez, 'Implementing an Insolvency Framework for Micro and Small Firms' (n 44). The prevalence of controlled firms can also be observed in most jurisdictions. See Adriana de la Cruz, Alejandra Medina, and Yun Tang, 'Owners of the World's Listed Companies' (2019) OECD Capital Market Series, Paris <www.oecd.org/corporate/ca/Owners-of-the-Worlds-Listed-Companies.pdf> accessed January 24, 2023.

outcomes in terms of creditor recoveries, reorganization of viable companies and quick liquidation of nonviable firms.[58] As a result, insolvency law fails to serve as a catalyst for growth in countries where promoting this goal is more urgently needed.

1.4.2 *Building Blocks for the Design of Insolvency Law in Emerging Economies*

A well-functioning insolvency system generally requires an attractive insolvency law for debtors and creditors, a strong institutional environment, and a developed restructuring ecosystem comprising a qualified body of lawyers, insolvency practitioners, bankers, investors, and other relevant actors.[59] Unfortunately, as will be shown in Chapters 2 and 3, these elements – or some of them – are not generally found in emerging economies. Moreover, while amending an insolvency legislation can be relatively feasible, building a strong institutional environment and a developed restructuring ecosystem is certainly complex. It generally requires time, resources and political will to embark on legal, educational, and institutional reforms whose benefits will only be shown in the long run. For that reason, while these reforms are implemented, this book suggests an insolvency framework for emerging economies taking into account the *current* market and institutional environment existing in these countries. The proposed approach for the design of insolvency law in emerging economies is based on *three premises* that are derived from the reality existing in these countries, as will be shown in Chapters 2 and 3.

[58] Some of these weaknesses, such as the low recovery rate received by creditors in many emerging economies, were identified in the "Resolving Insolvency" index of the World Bank's Doing Business Report before this publication was suspended in 2021. See World Bank, 'Doing Business Report 2020: Resolving Insolvency' <www.doingbusiness.org/en/data/exploretopics/resolving-insolvency/good-practices> accessed March 10, 2023. As explained in Chapter 9, the low usage of the insolvency system can often be due to the existence of an insolvency system that has proven to be unattractive to debtors, creditors or both.

[59] See Gurrea-Martínez, 'Building a Restructuring Hub' (n 6). See also Kannan Ramesh, 'Party Autonomy and the Search for Nodal Jurisdictions in Cross-Border Insolvency' (February 6, 2021) *Texas International Law Journal Symposium* <https://static1.squarespace.com/static/571cb81f86db43188990d82a/t/602cebf8688a4a6f750ac18b/1613556730419/Justice+Kannan+Ramesh_Party+Autonomy+and + the+Sear ch + for +Nodal+Jurisdictions+TILJ.pdf> accessed January 24, 2023.

The first premise is that emerging economies have a weak market and institutional environment. As a response to this reality, this book argues that the involvement of courts, insolvency practitioners, and public authorities should be minimized in insolvency proceedings in emerging economies. As discussed in Chapters 4 to 8, this goal can be achieved by adopting several strategies such as reducing the power and discretion of courts and insolvency practitioners, promoting market and contractual solutions led by debtors and creditors, and empowering creditors in insolvency proceedings.

The second premise is that most emerging economies have inefficient insolvency proceedings as a result of an unattractive insolvency law, an unattractive market and institutional environment, or both. Therefore, the initiation of insolvency proceedings usually ends up being value-destroying. As a response to this reality, this book argues that the usage of formal insolvency proceedings should be minimized in emerging economies. As mentioned in Chapters 4 to 8, this goal can be achieved by adopting various strategies such as the promotion of workouts and hybrid procedures, not requiring corporate directors to immediately initiate insolvency proceedings once a company becomes insolvent, and allowing companies to choose their insolvency forum.

The third premise is that most firms in emerging economies are MSEs and medium and large companies with controlling shareholders. As a response to this reality, the insolvency framework suggested in this book proposes various recommendations to address the particular problems and needs of those firms. Moreover, while MSEs and controlled firms prevail in most countries around the world, emerging economies present some unique features that require different solutions, as discussed in Chapters 6 and 7. For example, it will be argued that some of the challenges faced by MSEs in insolvency can be addressed by promoting workouts and implementing a simplified insolvency framework for MSEs that significantly reduces the involvement of courts and public authorities. For controlled firms, it will be pointed out that the higher risk of opportunism of shareholders vis-à-vis creditors can be partially addressed by requiring the appointment of an IP generally acting as a monitor. Moreover, it will be argued that courts should not be involved in the appointment and removal of IPs. Instead, the power to appoint an IP should be given to debtors or creditors, and creditors should always have the ability to remove insolvency practitioners.

1.5 The Future of Insolvency Law in Emerging Economies and Beyond

1.5.1 The Need to Reinvent Insolvency Law in Many Advanced Economies

This book concludes by pointing out that insolvency law also needs to be reinvented in many advanced economies.[60] Namely, Chapter 9 will argue that insolvency law in many advanced economies has also failed to effectively minimize the destruction of value generally experienced in a situation of insolvency while simultaneously promoting the efficient allocation of the debtor's assets. As a result, many viable firms often end up in a piecemeal liquidation, the assets of nonviable companies are not quickly reallocated towards more productive activities, and creditors cannot maximize their recoveries in insolvency proceedings. These aspects help explain, among other aspects, why insolvency law is not very popular in many jurisdictions, including advanced economies. Even though it will be pointed out that the stigma and bad reputation of insolvency proceedings have some historical and cultural elements, this book argues that the negative connotations of insolvency proceedings have been exacerbated by a legal and institutional reality: the fact that insolvency proceedings in many jurisdictions have proved to be unattractive for debtors, creditors, or both. Therefore, the failure of insolvency law in many advanced economies will also justify the need to rethink insolvency law in these jurisdictions.

Many legal, economic and institutional features generally existing in emerging economies can also be found in some advanced economies. As has been mentioned, one of them is the prevalence of MSEs and large controlled firms.[61]Likewise, many advanced economies have inefficient insolvency proceedings,[62] or they do not have competent and efficient

[60] Advocating for the need to rethink insolvency law in some advanced economies such as Australia, see Jason Harris, 'Rethinking Insolvency Law' (September 20, 2021) *Australian Insolvency Law* <https://australianinsolvencylaw.com/2021/09/20/rethinking-insolvency-law/> accessed January 24, 2023. More extensively, see Jason Harris and Michael Murray, 'The Roles of the State and the Private Profession in the Insolvency System: Do We Have the Right Balance?' (2021) *Australian Academy of Law* <https://academyoflaw.org.au/resources/AAL%20-%20Discussion%20paper%20for%20insol%20r'table%20-%20Murray-Harris%20-%2022.7.21.pdf> accessed January 24, 2023.

[61] See n 54.

[62] For example, Spain is one of those advanced economies that, at least prior to the insolvency reform implemented in 2022, used to have an inefficient insolvency system. See Aurelio Gurrea-Martínez, 'The Low Usage of Bankruptcy Procedures: A Cultural Problem? Lessons from Spain' (2020) 27(2) *University of Miami International and Comparative Law Review* 275.

courts to handle insolvency proceedings.[63] For that reason, it will be argued that many advanced economies can improve the attractiveness of their insolvency system by adopting some of the policy recommendations suggested for emerging economies.

1.5.2 Adjusting the Proposed Insolvency Framework for Emerging Economies

Some emerging economies may not have the weaknesses identified in Chapters 2 and 3, or they may decide to embark on significant reforms seeking to improve their market and institutional environment. If so, the policy recommendations suggested in this book would need to be adjusted accordingly. For instance, if an emerging economy significantly improves the sophistication of its judiciary, the role and powers of judges in insolvency proceedings can be expanded. Similarly, IPs may play a greater role in jurisdictions that manage to develop a sophisticated body of insolvency practitioners. Therefore, the insolvency framework suggested in this book has been designed taking into account the *current* market and institutional environment existing in most emerging economies. However, it needs to be adjusted to the particular features of a country and how those features evolve over time.

1.6 Conclusion

This chapter has emphasized the importance of insolvency law as a catalyst for growth. It has also argued that, even though insolvency law seeks to solve similar economic problems across jurisdictions, the intensity of these problems and the desirability of a particular insolvency response depend on a variety of country-specific and firm-specific factors. Unfortunately, many emerging economies have adopted insolvency laws that usually replicate practices and procedures existing in countries with totally different market and institutional environments. This book argues that these undesirable legal transplants have led to the failure of insolvency law in emerging economies, undermining the ability of insolvency law to reduce poverty and promote growth in countries where achieving these goals is more urgently needed. As a result, insolvency law in emerging economies needs to be reinvented.

[63] As explained in Chapter 3, this problem is observed in various European countries.