COMPARATIVE OVERVIEW OF ASIAN INSOLVENCY REFORMS IN THE LAST DECADE

by Soogeun Oh

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by Soogeun Oh*

1) Introduction

History has shown that insolvency laws were developed amid economic turmoil because the magnitude of the insolvent debtors’ unpaid debts acted as the pressure on the development of the insolvency law. Economic crisis let people realise that insolvency law is necessary in addition to normal creditor-debtor relationship laws. The US insolvency law evolved while being enacted, repealed and re-enacted four times during the economic downfalls of the 1800’s.¹ Many economies in transition in Central and Eastern Europe must have developed insolvency laws in the 1980’s as they first had insolvent firms which were not seen in the planned economy.² Latin American countries also reformed their insolvency laws when economies were in such bad shape that sovereign states were on the edge of bankruptcy in the early 1990’s.

East Asian countries are not exempt from a similar history. When the Asian financial crisis hit the region in the late 1990’s, the existing insolvency systems were blamed for standing in the way of eliminating unpromising and insolvent firms from the market and not efficiently restructuring promising but insolvent firms. Therefore, insolvency reforms followed in the aftermath of the economic crisis.³ Efforts were exerted to improve insolvency law and practice by updating out-of-date insolvency laws, introducing reorganisation proceedings, creating insolvency courts and promoting out-of-court workout. Insolvency reforms were a trend even in countries out of the direct reach of the economic crisis.⁴ Most countries in the region revised their existing insolvency laws or enacted new legislation.
Insolvency reforms focused on corporate reorganisation, which was labelled a “restructuring revolution” by Lampros Vassilleu.5

East Asian countries have carried out insolvency reforms with different styles and paces during the last decade because every country has a different economic and judicial background. Moreover, economic development and judicial stability in the region varied widely. East Asia contains not only some of the richest countries in the world but also some of the poorest. Rule of law is a fundamental principle in some countries, but it is still shaky in other countries. Some countries have over one hundred years of history in insolvency law and practice, but other countries have not heard of it till recently. In this regard, it is not easy, if not impossible, to draw common features from insolvency law reforms in East Asian countries.

Such differences, however, provide an opportunity to compare: insolvency law and practice as one of the competing schemes regarding the creditor debtor relationship; why judicial insolvency proceedings are frequently used in some jurisdictions and not in others; what makes insolvency reforms successful; and which policy measures should be prioritised to build an efficient and effective insolvency system.

Through legislative reforms, states have desired to effect the following changes: increased creditor confidence in implementation of their claims; increased entrepreneurship and fresh starts; decreased insolvency cases; and easier out-of-court debt rescheduling. Improvements can be noted in some areas, but not in others. It is time to evaluate those insolvency reforms, identify what was achieved (and what was not), and draw lessons for future tasks.

This paper analyses insolvency reform in East Asian countries over the past decade and finds factors for success and failure in light of the above-mentioned goals. Chapter II tracks insolvency law reforms in East Asian countries in order to figure out the features of reforms in each country. Chapter III deals with the analytical framework of debt settlement mechanisms as a basis for the analysis of insolvency law reforms. The structure of debt settlement mechanisms and incentive structures are also explained. Chapter IV evaluates each insolvency reform and finds causes of success and failure. Chapter V concludes with suggestions of future tasks for enhancing the efficiency and effectiveness of insolvency mechanisms.

Five East Asian countries are selected as the main targets of analysis: China, Indonesia, Japan, Korea, and Thailand. Indonesia, Korea and Thailand were countries severely hit by the Asian financial crisis in 1997 and 1998. Japan is the most industrialised country in the region and China is one of the transition economies. The soundness and effectiveness of the judicial system is different from one country to another. Japan and Korea
have a relatively reliable judicial system, but others are in doubt. All of them have statutes on insolvency, but they have different levels of experience in insolvency practice. The insolvency reforms of other countries beyond these five will be mentioned as necessary.

In reality, several factors affect the performance of insolvency law. Rational (or profit-oriented) creditors, a transparent accounting regime, well-developed financial markets, and judges with high moral standards are all necessary for the best outcome of insolvency proceedings. These factors should be dealt with when evaluating insolvency reforms in order to grasp the “big picture”. However, these are not the subject of discussion here. This paper, rather, focuses on the contents of legal reforms because it has been found that some factors play a critical role in the overall mechanism of the creditor-debtor relationship.

Information on the insolvency laws of each country was mainly collected from published literature. Facts on insolvency law and practice come from OECD reports and Asian Development Bank reports and other collections of country reports. Evaluation of the current systems of each country follows findings of the OECD Report (2001), the SERI Report (2003) and the World Bank Report (2005). Unclear facts or issues were identified and cleared in close consultation with local experts.

2) Major insolvency reforms in East Asian countries

a) China

The insolvency law of China does not have a unified insolvency statute. Instead, different laws and rules supplement each other. Applicable laws in insolvency cases are divided into two categories depending on the ownership structure of the target firms: state-owned enterprises (SOEs) or non-SOEs. SOE insolvency cases are governed by the 1986 Law of the People’s Republic of China on Enterprise Insolvency–Interim Implementation (SOE Insolvency Law). The SOE Insolvency Law is supplemented by two important judicial interpretations. The 1991 Opinions on Several Issues Regarding the Enterprise Insolvency Law, issued by the Supreme Court of China, provides detailed rules on SOE insolvency. The 2002 Opinions of the Supreme People’s Court Concerning Certain Issues in the Trial of Enterprise Insolvency Proceedings (2002 Opinions) applies to both SOE and non-SOE insolvency proceedings. In spite of these supplements, the SOE Insolvency Law is still outdated and unclear in many respects including the scope of application.
One important feature in SOE insolvency proceedings is the Capital Structure Optimisation Programme (CSOP). The CSOP applies to SOEs located in 111 Chinese major cities and puts SOE insolvency cases into the central planning process supervised by the National Development and Reform Commission. The CSOP also gives top priority to employee resettlement payment. The CSOP makes SOE insolvency proceedings more politically oriented.

Chapter 19 of the 1991 Civil Procedure Law, which has only eight brief articles, mainly governs non-SOE insolvency. Non-SOEs include enterprises that are not owned by the state, for instance, foreign invested companies, privately owned companies and collective enterprises. In addition to the 2002 Opinions, the 1992 Opinions on Several Issues Regarding the Civil Procedure Law provide supplementary rules.

There are other laws that apply to insolvency cases. Chapter 8 of the Company Law applies to liquidation cases of companies established under the Company Law. The 1996 Foreign Investment Enterprises Liquidation Procedures, promulgated by a foreign investment regulator, authorise the Ministry of Commerce to control non-insolvency liquidation of foreign invested companies. Specialised laws and regulations apply to privately owned companies and collective enterprises. In addition, the 2002 opinions govern the insolvency of financial institutions. Several municipal governments have also promulgated local rules applicable to insolvency cases handled in the provinces. However, no Chinese law provides for insolvency of a natural person, sole proprietorships or partnerships without legal person status.

The Chinese government has been preparing a draft bill for the new insolvency law since 1994. In 2004, the draft bill of the unified insolvency law was submitted to the 10th session of the Standing Committee of the Nation People’s Congress (the national legislature). After heated debate, especially about the priority to be accorded to insolvency claims by employees, the draft bill was passed on 27 August 2006. It will be effective from 1 June 2007.

The new bankruptcy law, the Enterprise Bankruptcy Law, which replaces the 1986 SOE Insolvency Law, applies to bankruptcy cases of enterprises regardless of the legal nature of the enterprise: state-owned enterprises; privately owned enterprises; or foreign investment enterprises. A debtor or a creditor can apply for a reorganisation proceeding. It recognises the priority of secured claims over labour claims and tax claims, as well as general unsecured claims. Payment of claims is made according to the following order: secured claims; bankruptcy expenses and joint interest debts; unpaid employees’ salaries and basic social insurance premiums;
outstanding taxes; and ordinary unsecured credits. But, employees with claims on salaries and social insurance premiums, and agencies with claims on outstanding taxes form a separate voting class respectively in providing consent to a reorganisation plan. The new insolvency law adopts cram down. The UNCITRAL Model Law on Cross-Border Insolvency was not adopted. Instead, the new law provides that the validity of any bankruptcy proceeding commenced in accordance with this law shall extend to the properties of the debtor outside of China. But inbound cases can be recognised when: there are relevant treaties or reciprocal relations; the bankruptcy proceeding outside China does not violate state sovereignty, national security and social public interests; and the bankruptcy proceeding outside China does not harm the lawful rights and interests of creditors in China.

Insolvency proceedings in China have not earned credibility in general from observers due to their lack of transparency and equal treatment. Political and social concerns have come before economic and legal considerations in many cases. The Chinese government has tried to establish reorganisation proceeding that could save ailing SOEs, but foreign creditors have been more interested in compulsory execution systems which could ensure their security rights. It has been observed that the “rule of man” rather than “rule of law” prevails in the area of bankruptcy as well.13

b) Indonesia

Though Indonesia has had its Bankruptcy Ordinance since 1906, (inherited from Netherlands Indies legislation), the ordinance was seldom used and not amended until 1998 when Indonesia enacted a new insolvency law under IMF conditionality in the form of an emergency regulation. The new law has two tracks of insolvency proceedings: liquidation in bankruptcy and voluntary debt compromise. For the first time, it introduced private sector involvement (a private bankruptcy receiver and a private voluntary debt compromise administrator), and publication of insolvency law opinion. Though the 1998 Bankruptcy Law got the spotlight in the middle of the economic crisis, it was perceived more as a prod to debtor-creditor negotiations outside of court rather than a channel to bankruptcy proceedings through judicial institutions.14 The Indonesian government also established the Jakarta Initiative Task Force, the Financial Sector Policy Committee and the Oversight Committee to facilitate out-of-court corporate restructuring. There was a minor revision of the Bankruptcy Law in 2004.

Commercial courts have been set up to cope exclusively with insolvency cases by the 1998 Bankruptcy Law. But the number of cases handled by the Commercial Court during the first years of its operation (September 1998 to December 2003) shows the weakness of judicial insolvency proceedings.
Judges in the commercial courts have not been trained enough to handle business matters sophisticatedly and, after some training, they are transferred to other positions. It is reported that the number of cases filed in the Commercial Court has been decreasing.

Table 1: Insolvency cases in Indonesia

<table>
<thead>
<tr>
<th>Cases Filed</th>
<th>353</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cases Granted</td>
<td>114</td>
<td>32%</td>
</tr>
<tr>
<td>Cases Declined or Refused</td>
<td>205</td>
<td>58%</td>
</tr>
<tr>
<td>Cases Settled</td>
<td>24</td>
<td>7%</td>
</tr>
<tr>
<td>Cases Turned into Voluntary Debt Compromise</td>
<td>10</td>
<td>3%</td>
</tr>
</tbody>
</table>

The poor performance of the new insolvency law was not unexpected. Judicial practices have hindered the progress of insolvency practice under the new law. Indonesian courts have been criticised for limited stare decisis, poor information sharing of court decisions and other precedents, corruption, and interference from various sectors including the administration. If this continues, it is highly unlikely that the new insolvency law will be respected as it should be.

Regarding the debtor-creditor relationship, the most serious problem is that compulsory execution is not implemented properly. Debtors are not afraid of being put into compulsory execution because they believe that court procedures can be delayed if wanted. Creditors are also aware of this fact and are reluctant to apply for compulsory execution. Difficulties are not only in the opening of the process. It is also very hard to detect property eligible for compulsory execution. The compulsory execution procedure is slow and costly. Moreover, its outcomes are often unpredictable. For these reasons, a voluntary negotiation is preferred over law enforcement to secure creditor’s interests, even though the recovery rate through voluntary negotiation is lower than the security’s face value.
c) Japan

Since 1996, Japan has pushed for comprehensive insolvency law reform. When insolvency reforms started, there were five insolvency related laws: the Bankruptcy Act; the Composition Act; the Corporate Reorganisation Act; the company arrangement procedure under the Commercial Code; and the special liquidation procedure under the Commercial Code. The Composition Act was repealed in 2000 as the Civil Rehabilitation Act was enacted in 1999. The Bankruptcy Act and the Corporate Reorganisation Act were amended in 2003 and 2004 respectively, and a special act on cross-border insolvency was enacted in 2000.

The Japanese insolvency procedures seemed to be complicated: two liquidation types (bankruptcy and special liquidation procedures) and four reorganisation procedures (civil rehabilitation, corporate reorganisation, company arrangement, and compulsory composition under the Bankruptcy Act). The unification of insolvency laws was discussed but not carried out because the government wanted to have legislation on the rehabilitation of small and medium-sized enterprises first. Insolvency law reforms were based on comprehensive study and preparation by scholars and practicing lawyers. The revision of the insolvency laws went through public discussions and hearings before it went to the floor of the national legislature which passed the bill unanimously without partisan issue.

Even though insolvency laws are not unified and there is no specialised insolvency court either, nobody considers the insolvency procedures of Japan unreliable or ineffective. The number of insolvency cases has increased during the reform period as shown in Table 2. Insolvency reforms in Japan, instead of changing the structure of overall insolvency procedures, have focused on supplementing and strengthening weaknesses identified in insolvency practices.

Another important fact, which should be viewed as a part of insolvency reforms along with legislative reform, is that judges have adopted a flexible approach in admitting and proceeding cases. The Japanese courts, for example, have opened the door to new civil rehabilitation proceeding by interpreting the meaning of “evident proof of rehabilitation”, which is a requirement for the commencement of the proceeding, much more flexibly than before. This generous construction has resulted in a rapid increase in applications for the proceeding. New legislation and judges’ positive attitudes seem to be a timely response to the needs of society and pave the way for a better and more efficient judicial framework for insolvency cases.
Table 2: Insolvency cases in Japan

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Reorganisation</td>
<td>88</td>
<td>37</td>
<td>25</td>
<td>47</td>
<td>88</td>
<td>63</td>
<td>45</td>
</tr>
<tr>
<td>Composition</td>
<td>361</td>
<td>231</td>
<td>42</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Bankruptcy (Business Firms)</td>
<td>5595</td>
<td>4573</td>
<td>6268</td>
<td>8070</td>
<td>9471</td>
<td>8951</td>
<td>220 201</td>
</tr>
<tr>
<td>Bankruptcy (Consumer)</td>
<td>105 468</td>
<td>123 915</td>
<td>139 590</td>
<td>160 741</td>
<td>214 996</td>
<td>242 849</td>
<td></td>
</tr>
<tr>
<td>Civil Rehabilitation</td>
<td>n/a</td>
<td>n/a</td>
<td>662</td>
<td>1 110</td>
<td>1 093</td>
<td>941</td>
<td>712</td>
</tr>
<tr>
<td>Individual Rehabilitation</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>1 732</td>
<td>6 054</td>
<td>15 001</td>
<td>19 552</td>
</tr>
<tr>
<td>Wage Earner Rehabilitation</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>4 478</td>
<td>7 444</td>
<td>8 611</td>
<td>6 794</td>
</tr>
</tbody>
</table>

**d) Korea**

Korea enacted three insolvency laws in 1962: the Bankruptcy Act; the Composition Act; and the Corporate Reorganisation Act. They were modelled after the corresponding Japanese acts, but were not frequently used until the economic crisis of the late 1990’s. Amendments to insolvency laws were introduced first in 1981 in response to criticism of forum shopping. Though the judges and the courts had been highly respected among the public sector, their management of insolvency cases came under fire by the public. The Supreme Court of Korea issued the Regulation on Case Management of Corporate Reorganisation in 1992 and 1996 in order to make the commencement criteria clear and to prevent malpractice of receivers and major shareholders.

Legislative reforms were accelerated by the economic crisis. Insolvency laws were amended in 1998, 1999 and 2001 to enhance transparency and expedite insolvency proceedings. The Corporate Restructuring Promotion
Act was introduced in 2001 to provide a statutory basis to structured workouts. The Individual Debtor Rehabilitation Act was enacted in 2004 for consumer bankruptcy. Following and keeping pace with these legislative works, a unified insolvency law had been prepared since 1999 and was finally enacted in 2005. As the unified insolvency act came into effect on 1 April 2006, four then existing insolvency laws were repealed. The Corporate Restructuring Promotion Act was repealed at the end of 2005.

The new insolvency law provides for a rehabilitation procedure, a liquidation procedure, a consumer rehabilitation procedure, and cross-border insolvency. Though automatic stay was not adopted, protection of the insolvency estate is enforced by a newly introduced comprehensive injunction order. To ensure the finality of payment and settlement systems, the application of the insolvency law is waived in currency, securities and financial transactions. The rehabilitation proceeding, which applies to any type of legal entity, allows the continued control of incumbent management as a default rule to induce early application.

The establishment of a specialised insolvency court had been considered since the 1998 amendments, but it was not put into effect for two reasons: specialisation issues and case loads. Specialisation in insolvency law cannot be achieved through a specialised court because judges, under the current system of judge rotation, work for the court for only two or three years. When the insolvency court was considered, the number of insolvency cases was not big enough to maintain a separate court. Instead of a specialised insolvency court, an insolvency division was established in the district courts with elite judges. The insolvency division of the Seoul Central District Court, in particular, has set guidelines for case management and has created precedents. It also published practice guides so that the general level of insolvency practice could be enhanced in a relatively short period of time.

Changes in the attitudes of judges have had an enormous impact on insolvency practices. Many reorganisation cases were pending for over 10 years before insolvency law reforms. Through the economic crisis in the late 1990’s and insolvency reforms, judges have come to share the idea that early termination of reorganisation cases through mergers and acquisitions (M&A) is the best way to maximise the value of debtor firms. M&A is the only solution that provides new money and new governance structures that can reduce agency costs incurred by the management of the receiver and the supervision of the court. Currently, the average period for pending cases at the court is less than three years.

Another example that affected practices was discharge. Judges were very reluctant to render the discharge to the bankrupt for several reasons: discharge might cause moral hazard among debtors; discharge might
contradict payment orders; and most of the debtors might be personally responsible for over-indebtedness. It took more than 30 years for the Korean court to render a decision to discharge a debtor for the first time after the introduction of discharge. Currently, the discharge ratio to bankruptcy decision goes up to 95%. That explains the drastic increase in personal bankruptcy cases.

Table 3: Insolvency cases in Korea

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reorganisation</td>
<td>79</td>
<td>52</td>
<td>132</td>
<td>148</td>
<td>37</td>
<td>32</td>
<td>31</td>
<td>28</td>
<td>38</td>
<td>35</td>
</tr>
<tr>
<td>Composition</td>
<td>13</td>
<td>9</td>
<td>322</td>
<td>728</td>
<td>140</td>
<td>78</td>
<td>51</td>
<td>29</td>
<td>48</td>
<td>81</td>
</tr>
<tr>
<td>Bankruptcy (Firm)</td>
<td>12</td>
<td>18</td>
<td>38</td>
<td>117</td>
<td>230</td>
<td>132</td>
<td>170</td>
<td>108</td>
<td>303</td>
<td>162</td>
</tr>
<tr>
<td>Bankruptcy (Individual)</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>350</td>
<td>503</td>
<td>329</td>
<td>672</td>
<td>1335</td>
<td>3856</td>
<td>12317</td>
</tr>
</tbody>
</table>

Note: The number of bankruptcy cases was not divided into firm and individual until 2000.

e) Thailand

Thailand has had a unified insolvency law since 1940. The 1940 Bankruptcy Act has been amended several times since its enactment, but the 1998 amendments changed the entire shape of the insolvency law. The 1998 amendments introduced a corporate reorganisation proceeding, and the 1999 amendments added issues dealing with corporate reorganisation proceedings. The 2000 amendments changed the status of the official receiver from an officer of the court to a private entity. The 2004 amendments provide for an automatic discharge against individual debtors after three years from bankruptcy adjudication.

The Bankruptcy Court (specialised in bankruptcy cases with exclusive jurisdiction), was created in 1999 pursuant to the Court Act. Specialisation in bankruptcy does not, however, seem to be as successful as expected because judges work for the Bankruptcy Court for only two to three years under the rotation system of the judiciary. Along with insolvency reforms, the amendments to the Civil Procedure Code were incorporated in 1999 to
improve the issuance of execution orders (including their delivery procedures) and to restrict abusive or inappropriate applications.

The number of liquidation proceedings has steadily increased since the 1998 amendments. It seems that the court and insolvency proceeding are increasingly gaining confidence.

Table 4: Insolvency cases in Thailand

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liquidation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td>1 321</td>
<td>1 660</td>
<td>1 118</td>
<td>835</td>
<td>968</td>
<td>1 591</td>
<td>2 209</td>
<td>4 778</td>
</tr>
<tr>
<td>Legal Person</td>
<td></td>
<td></td>
<td>549</td>
<td>604</td>
<td>746</td>
<td>922</td>
<td>657</td>
<td>965</td>
</tr>
<tr>
<td><strong>Reorganisation</strong></td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>9</td>
<td>79</td>
<td>61</td>
<td>52</td>
<td>50</td>
</tr>
</tbody>
</table>

Insolvency law and practice in Thailand can be viewed as evolving steadily. The Thai government has tried to improve judicial procedures. The bankruptcy court handled mainly small and medium-sized firms with financial difficulties well enough to restructure about 30% of total non-performing loans of financial institutions. But the transparency of insolvency proceedings and the credibility of the court decisions have deteriorated as a result of recent cases. In the case of Thai Petrochemical Industry, the court rejected the plan decided by the creditors’ meeting and virtually ordered the creditors’ meeting to nominate a person appointed by the government. In the Natural Park case, the court approved a plan under which creditors were to be repaid less than what they could get. It has been reported that doubtful claims appeared, were approved at the last moment, and changed the formation of creditors in some cases. Political connections seem to influence court decisions. These are, of course, not purely insolvency matters but general judicial problems. It is another example of how the efficiency of insolvency proceeding cannot go beyond the general level of judicial practice.
3) Analytical framework

a) Value maximisation

Non-insolvency laws, including civil law, civil procedure law and civil enforcement law, generally govern the creditor-debtor relationship. In most jurisdictions, a creditor has the right to enforce claims against the debtor’s property when debts are not repaid eventually. If the right of a creditor to enforce claims against the debtor’s properties can be exercised properly, a creditor can minimise concerns and other transaction costs because they can collect claims through compulsory execution procedures. A debtor might do their best to repay in order not to have their properties taken away. Moreover, a creditor and a debtor may reschedule debts when due debts are not repaid in the assumption of compulsory execution. Therefore, it is in the interest of the creditor and the debtor that the compulsory execution system work properly.

This compulsory execution system, however, has the weakness that every procedure is carried out on an individual basis. Creditors are forced to compete with each other upon a debtor’s default on a first-come, first-served basis. Individual enforcement usually results in a piecemeal sale of debtor’s properties, so the realised value of the debtor’s business is normally less than its total value as a whole, and the debtor’s business is no longer afloat. Bankruptcy proceedings were introduced as a collective collection procedures that replace an individual collection proceeding, and aim at equal treatment of similarly situated creditors. The sale of a business as a whole is also possible under the bankruptcy procedure. The value of a debtor’s property increases in a formal bankruptcy proceeding.

As a bankruptcy proceeding is basically a liquidation procedure, it is not appropriate for a debtor whose business is still viable. When the majority of creditors estimate the going concern value to be greater than the liquidation value, they need a legal mechanism that binds dissenting creditors and maximises the value of the debtor’s business. This is a rehabilitation proceeding, which is sometimes called a reorganisation or restructuring proceeding.

If debtors and creditors are rational, they will assess the credit risks that a debtor will bear in the future and will set the terms and conditions of credits. If their estimation turns out to be wrong for any reason, they will reassess future credit risks and reschedule outstanding debts. This private rescheduling is not unusual among creditors and debtors who trust each other, but it is not an easy mechanism to apply in a normal situation for two reasons. The first is information asymmetry. Creditors are not usually well-
informed of the debtor’s financial situation. Creditors must incur expenses in order to collect adequate and timely information regarding a debtor, which creditors are not willing to do. The second is the negotiation expense. To reschedule debts, a debtor and creditor negotiate with each other bilaterally and multilaterally. There is usually a party who tries to hold out or take a “free ride”. Successful negotiation should overcome these obstacles. However, these transaction costs are not easy for a debtor or creditor to meet in a normal debtor-creditor relationship. Insolvency proceedings, whether liquidation or rehabilitation, can save such expenses by providing the information on a debtor to interested parties, and calling for negotiation if necessary.

Though a liquidation proceeding and a rehabilitation proceeding have different sets of rules on debt collection, both are value maximisation proceedings based on compulsory execution. A liquidation proceeding is justified when the total amount of money distributed through the proceeding is larger than that distributed through all individual compulsory execution procedures. This logic applies to a rehabilitation proceeding as well. A rehabilitation proceeding can be justified only when the total amount of money distributed in a rehabilitation proceeding is larger than that in case of liquidation. As such, the total value of the debtor’s property should increase and each interested party should receive greater benefits. Rehabilitation is justified when it assures liquidation value or the best interests of creditors principle.

The insolvency proceeding was designed and adopted in order to maximise benefits to interested parties by maximising the value of debtors’ properties. For value maximisation, a reorganisation law adopts special rules including prohibition of execution of claims, avoidance, assumption or rejection of executory contract, and change of claims. If a debtor and creditors benefit more from a voluntarily rescheduling than a reorganisation proceeding, they will choose private rescheduling. Therefore, from the viewpoint of total benefit, these mechanisms form a hierarchy with a compulsory execution proceeding at the bottom and voluntary rescheduling at the top as in Figure 1.

![Figure 1: Hierarchy of total benefit](image-url)
b) **Choices and competition**

Judicial insolvency proceedings are not the only mechanisms that creditors or debtors can choose. Sales of business or M&A can be a means of debt settlement for a financially ailing firm. A debtor may choose to halt the business and voluntarily liquidate a failing firm. Faced with insolvency, the debtor or creditor may choose the mechanism that is most favourable to them. In some jurisdictions, however, a debtor could ignore the exercise of claims by creditors or judicial proceeding, and a creditor might resort to illegal collection activities. Governmental rescue programmes are also a mechanism for rearranging unpaid debts. Figure 2 shows such options.

**Figure 2: Debt settlement mechanisms**

<table>
<thead>
<tr>
<th>Major Players of Proceeding</th>
<th>Business Dissolved</th>
<th>Business Maintained</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Debtor</strong></td>
<td>Voluntary Liquidation</td>
<td>Ignoring Claims</td>
</tr>
<tr>
<td><strong>Creditor</strong></td>
<td>Compulsory Execution</td>
<td>Structured Workout</td>
</tr>
<tr>
<td><strong>Court</strong></td>
<td>Bankruptcy</td>
<td>M&amp;A Rescheduling</td>
</tr>
<tr>
<td><strong>Government</strong></td>
<td></td>
<td>Rehabilitation</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Government Rescue Programme</th>
</tr>
</thead>
</table>

These mechanisms are not value neutral. They can be classified into four categories in the light of social costs and benefits. Different colours can be applied according to the social desirability of debt settlement mechanisms. The category of “red choices” is illegal activities, which do not comply with laws on debt collection. The category of “yellow choices” is government rescue programmes including rescue loans, tax incentives and administrative supports. The category of “blue choices” is legal mechanisms including insolvency and non-insolvency proceedings, which involve voluntary
liquidation, compulsory execution, bankruptcy, and rehabilitation proceeding. The category of “green choices” is legitimate and voluntary transactions among a debtor and creditors, which include structured workouts, M&A, sales of business and individual rescheduling. These four categories can be called choices because they are, after all, choices that are made by or among interested parties.

The red choices must obviously be eliminated but, unfortunately, they are not unusual in some jurisdictions. Yellow choices pose some difficult issues. The government might take measures to save a failing firm or an industry that is important in the economy when there is the potential in the system or when the government’s industrial policy is closely linked to the failure of the debtor’s firm. “Too big to fail” is a frequently used slogan. Government intervention in debt settlement, however, used to result in a distortion in the distribution of resources in competitive markets; unpromising firms stayed in the market, and creditors and debtors were more interested in currying political favour than assessing and managing risks. So, yellow choices are less desirable than blue choices, which are subject to market principles in most cases.

Blue choices are part of the judicial system. It is noteworthy that the social usefulness of each scheme differs as shown in Figure 3. Green choices are most cost effective and maximise benefits. Since blue choices and green choices produce larger societal benefits, insolvency policies should encourage interested parties to choose blue or green instead of red or yellow.

**Figure 3: Choice structure of debt settlement mechanisms**

<table>
<thead>
<tr>
<th>Green Choices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Rescheduling</td>
</tr>
<tr>
<td>Voluntary Winding-up</td>
</tr>
<tr>
<td>M&amp;A, Sales of Business</td>
</tr>
<tr>
<td>Structured Workout</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Blue Choices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rehabilitation Proceeding</td>
</tr>
<tr>
<td>Liquidation Proceeding</td>
</tr>
<tr>
<td>Compulsory Execution</td>
</tr>
</tbody>
</table>
It is worth mentioning that individual rescheduling between a debtor and a creditor can occur as a result of a red choice when the normal collection process does not work properly. A creditor is actually forced to negotiate with a debtor to collect less proceeds than through a judicial collection process. Evidently, this kind of individual rescheduling is not one of the green choices.

The fact that parties can choose one among various choices means that these mechanisms are competing with each other. Liquidation or rehabilitation proceedings are also one of them and can be used only if they have greater merits than the other mechanisms. For example, if a governmental rescue programme is available, debtors and/or creditors tend to be dependent on it. Moreover, ignoring creditors’ claims is an attractive option to a debtor if it is possible. Only when illegal activities are banned and a governmental rescue programme is not available, can debtors and creditors consider blue or green choices.

Only if compulsory execution proceeds expeditiously, and debtor’s properties are realised and properly reflect the market value of debtor properties at public auction, can debtors and creditors establish a legal relationship based on the assumption that they can rely on compulsory execution in case of default. If a more favourable mechanism, for example reorganisation, is available, they will use that instead of compulsory execution. Liquidation, rehabilitation and voluntary restructuring proceedings are legitimate alternatives. Compulsory execution is a basis of other debt settlement mechanisms.

The core of compulsory execution is the public sale of debtor properties. This is the same in other debts settlement mechanisms. Liquidation is a collective public sales proceeding of debtor’s properties. Rehabilitation is a more complex sales procedure. There are three possible buyers in a reorganisation proceeding: a debtor, creditors and new investors. When new investors invest money and obtain shares, they actually buy the debtor’s properties for their investment. When creditors swap their claims for equity, they also buy the debtor’s properties. When claims are changed (or
impaired), debtor’s properties are sold to a debtor for nothing. An actual reorganisation plan uses all or some of these methods. A debtor and creditors agree with a reorganisation plan because they can derive more benefit through the reorganisation proceeding than the liquidation proceeding. A debtor and creditors can employ such sales schemes used in a reorganisation proceeding in voluntary negotiations for debt rescheduling.

The benefits to both debtors and creditors come from and are the same as the total value of the debtor’s property (the insolvency estate in an insolvency proceeding). The value of a debtor’s property is divided among the debtor and the creditors. Each box in Figure 4 below stands for the value of the debtor’s property in different scenarios. Scenario 2 in Figure 4 represents the case when compulsory execution or liquidation is implemented properly. The total value of the debtor’s property goes to creditors if the value of the debtors’ property is less than total amount of debts, in which case the debtor’s benefit level is nil. In Scenario 3, where a reorganisation proceeding applies, the total value of a debtor’s property increases and the increase (the so-called going concern surplus) is divided among creditors and the debtor pursuant to a reorganisation plan. The benefit to creditors and the debtor can be higher than in Scenario 2. This is the reason for reorganisation proceedings.

However, in Scenario 1, where normal compulsory execution is not available, creditors are forced to negotiate with a debtor at a lower level than in Scenario 2, or resort to other private collection schemes, thus incurring greater expenses than in Scenario 2. In this case the total amount of payment to the creditors decreases and the remaining portion goes to a debtor or a third party. Figure 4 illustrates the importance of compulsory execution. As previously mentioned, the insolvency proceeding is a value maximisation procedure. To maximise the value of a debtor’s property, the magnitude of Scenario 2 should increase. The value of Scenario 3 can then increase in turn. However, if Scenario 1 occurs, the total value available to creditors’ is less than under Scenario 2, and the portion that goes to creditors decreases.

Figure 4: Value of debtor’s property
For ex post efficiency of insolvency mechanisms, only the total value of the debtor’s property should be taken into consideration. After a debtor becomes insolvent, the relative magnitude of firm value or the size of debts has nothing to do with ex post efficiency. If a legal system works properly, the value can be maintained as in Scenario 2 and the total value cannot go down below that of Scenario 2. Compulsory execution is, thus, the cornerstone of the insolvency system.18

c) Incentives and disincentives

A rational person is assumed to make decisions that maximise his or her own benefits. Benefits might be appraised from various aspects including economic, social, political, and emotional perspectives. Each alternative has incentives and disincentives for the person. People naturally weigh those merits and demerits and choose an alternative that can produce the best outcomes. This theory explains why people use one insolvency scheme more frequently than others. If there is a consensus in society that a certain insolvency scheme is more desirable than others, one can build a system that leads people to choose the desirable scheme by providing incentives and disincentives to each scheme. Consequently, the identification of incentives and disincentives for each insolvency scheme is the first step in building an efficient and effective insolvency system.

The biggest incentive is the economic benefit to creditors and debtors. Under a scenario where liquidation value exceeds going concern value, the economic benefit to creditors comes from proceeds realised in a liquidation proceeding. The amount of those proceeds is that realised in a public auction minus procedural expenses and priority claims (usually including some tax and labour claims). The amount of proceeds in public auctions depends on several factors: whether there is any entry barrier to the auction; whether the information on public auctions is easily accessible; whether the decision of the court in charge of public auctions is finalised quickly without spending times in disputes; and whether public auctions are processed expeditiously. One can presume that public auctions are effective if the proceeds are almost the same as the amount available in normal transactions under current
market conditions. In addition to these internal factors regarding public auctions, it is also important that creditors can easily find debtor's properties and put them up for auction. If finding hidden or uncovered properties costs time and money, the total amount of proceeds will be far less than what it should be even if the public auction process is efficient.

Under a scenario where going concern value exceeds liquidation value, a going concern must continue to operate in order to create economic benefits. A corporate reorganisation proceeding is the insolvency scheme to maximise the value of a debtor’s properties as a going concern. Various rules can be employed for maximising going concern value: stay of execution of creditors’ claims; avoidance of fraudulent conveyances or preferences; assumption or rejection of executory contract; and change of creditors’ right. These tools can be used as incentives for a corporate reorganisation proceeding.

Since the proceeds in the liquidation proceeding are to be distributed among creditors and stakeholders, allocation rules create important incentives or disincentives for all interested parties. Prioritising the rules, setting out the normal execution process, is the basic rule in insolvency proceeding as well. The increased value through a corporate reorganisation proceeding should also be allocated among creditors, other stakeholder and, this time, debtors. Special consideration could be given to claims of employees and the government in the distribution rule. The share of the debtor in the increased value of the going concern would be decided through negotiation among creditors and debtors. Whether law or negotiation decides the distribution rules, they cannot satisfy all parties because an incentive to one party is a direct disincentive to another in the distribution process.

Most creditors and other stakeholders view direct economic benefits as the strongest incentive. A debtor or the management of a debtor corporation, however, might view the control of the debtor firm as a stronger incentive than anything else. A debtor usually tries to avoid or delay applying for an insolvency proceeding in order to save his or her control over the firm, which provide him or her with social and economic benefits. Delayed application eliminates the viability of an ailing firm or at least reduces the value of a firm as a going concern. Allowing a debtor to retain control over the firm (at least for a certain period of time) can be an attractive incentive for applying a reorganisation proceeding.

Disincentives to the red choices are criminal punishment and monetary disadvantages for not complying with law and regulation. Illegal activities subject to criminal punishments include hiding or destroying debtors’ property, hindering public auction processes, preferentially providing
economic benefits to some creditors, and fraudulently manipulating judicial
debt collection processes. Monetary disadvantages to uncooperative debtors
include applying higher rates in cases of default and ordering damage
payments caused by illegal activities.

A disincentive to uncooperative parties and an incentive to co-operation
is cram down. The corporate reorganisation proceeding is based on the
approval of a designated majority among interested parties including
creditors and shareholders. The court can approve a reorganisation plan
according to which the rights of creditors and shareholders are to be
modified when the plan acquires the necessary consent of all voting classes.
But a plan might deserve the court’s approval even if there are dissenting
classes. The court might cram down the reorganisation plan over dissenting
classes if it deems the plan reasonable. As such, cram down prevents parties
from using a hold out strategy and encourages them to co-operate in
rebuilding failing companies.

4) Diagnosis and prescription

a) Evaluation

Evaluations of the efficiency of national insolvency systems do not
differ greatly even if made by different researchers at different times. The
2001 OECD report, the 2003 SERI report and the 2005 World Bank
report draw almost the same conclusions. Japan has a reliable and stable
judicial system and insolvency mechanisms. Korea has a reliable judicial
system but its insolvency mechanisms need to be refined and reinforced.
Judicial systems and insolvency procedures are not reliable in China or
Thailand. The situation in Indonesia is serious.

The 2005 World Bank report illustrates its evaluations with figures. The
report selected seven fields, which might have legal constraints and
quantified a few indicators in each field in 145 countries as of 2004. Two
fields (“enforcing contract” and “closing a business”) are related with
insolvency law and practice. In the field of “enforcing contract” the
number of procedures, time and cost were surveyed. The number of
procedures means the number of procedures mandated by law and court
regulation that demand interaction between the parties or between them and
the court (or court officers). As for cost, it includes the official court costs,
attorney’s fees (if the use of attorneys is mandatory or common), and the
costs of an administrative debt recovery procedure. Cost is expressed as a
percentage of the debt value. Time is counted from the moment the plaintiff
files the lawsuit in court until the settlement of payment. So, the “enforcing contract” field includes the concept of compulsory execution at its core.

The field of “closing a business” has three indicators under a hypothetical case.\(^{23}\) In this case, cost means the cost of bankruptcy proceeding based on the questionnaire given to local experts. It includes fees paid to courts, lawyers, accountants and other professionals. Bribes are excluded. Time is the average duration to complete a bankruptcy procedure in a calendar year. Recovery rates show how many cents on the dollar are recovered for claimants. So, the “closing a business” field corresponds exactly to insolvency proceeding.

Table 5: World Bank evaluation

<table>
<thead>
<tr>
<th>Country</th>
<th>Enforcing Contract</th>
<th>Closing a Business</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Procedures</td>
<td>Time (Days)</td>
</tr>
<tr>
<td>China</td>
<td>25</td>
<td>241</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>16</td>
<td>211</td>
</tr>
<tr>
<td>Indonesia</td>
<td>34</td>
<td>570</td>
</tr>
<tr>
<td>Japan</td>
<td>16</td>
<td>60</td>
</tr>
<tr>
<td>Korea</td>
<td>29</td>
<td>75</td>
</tr>
<tr>
<td>Malaysia</td>
<td>31</td>
<td>300</td>
</tr>
<tr>
<td>Thailand</td>
<td>26</td>
<td>390</td>
</tr>
</tbody>
</table>

b) Diagnosis

Table 5 shows two important findings. One is that the efficiency of closing a business has a strong correlation with the efficiency of enforcing contracts. Part of Table 5 is shown using graphs in Figure 5. The top bar chart shows the time variable of enforcing a contract and the bottom bar chart graphs the recovery rate of closing a business. Considering the shapes of the graphs, a reverse relationship could be assumed between enforcing a contract and closing a business.
A multivariate linear regression was used to see whether the variables under enforcing contract could explain the variables under closing a business. Independent variables of time and number of procedures (variables under enforcing contract) explained recovery rate variables of closing a business with a statistical significance of (p=0.016).

In this model, the time variable of enforcing contract was a meaningful independent predicting factor with a negative coefficient value for the recovery rate variable of closing a business (p=0.043), but the number of procedures variable did not act as a meaningful predictor.
A model having a time variable of closing a business as a dependent factor, and time and number of procedures variables for enforcing contract as independent variables that is statistically significant could be assumed \((p=0.010)\). In addition, only the time variable of enforcing contract was a meaningful independent predictor with a positive coefficient value of \((p=0.023)\).

On the other hand, linear multivariate regression models explaining variables of enforcing contract as dependent factors could not be inferred from the variables of closing a business as independent factors. From this data, the time factor of enforcing contract could be an independent predictor for the status of closing a business \(i.e.\) recovery rate or time.

Furthermore, the efficiency of enforcing a contract and closing a business has nothing to do with the modernity of the insolvency law. The countries with new insolvency laws (Indonesia and Thailand) are in the lower ranks compared to countries without one (China; Hong Kong, China; Japan; and Korea). Why did new insolvency laws not improve circumstances as much as expected in Indonesia and Thailand? And, why did partial changes make the situation better in Japan and Korea?

A new insolvency law may not improve insolvency practices for the following two reasons. The first reason can be found in the choice of structure of debt settlement mechanisms in Figure 3 and incentive structures. Insolvency law is only one of the options that debtors and creditors can choose. If a red choice is available, the possibility that a debtor or a creditor resorts to it cannot be ruled out. In this situation, even though a well-tailored insolvency law exists, it cannot perform its anticipated function. A poorly conducted compulsory execution does not ensure the proper outcome of a liquidation proceeding, not to mention of a corporate reorganisation proceeding.

Another reason can be found in the infrastructure of insolvency mechanisms. Insolvency mechanisms operate on four infrastructures: political; judicial; financial; and corporate. Political infrastructure means whether politicians understand the function of insolvency rules and allow market rules to prevail without intervention. Judicial infrastructure means whether courts apply law as it is written and render timely decisions. Financial infrastructure means whether creditors are profit oriented and competent in evaluating future risks and trading non-performing loans. Corporate infrastructure means whether the governance of corporations is sound and business activities are legitimate. The stronger and more sound the infrastructure is, the more efficient and effective the insolvency mechanisms are. If the infrastructure is weak and fragile, insolvency mechanisms cannot work properly.
Even without a well-tailored insolvency law, markets can operate efficiently if compulsory execution is implemented properly. Hong Kong, China is a good example. Hong Kong, China has old British style bankruptcy laws that are scattered among statutes and subsidiary legislation. It does not have a reorganisation proceeding. However, Hong Kong, China has one of the most efficient markets in the world. Though Japan does not have a unified insolvency law or a specialised insolvency court, it shows the best performance in enforcing contracts and closing a business. That is the same in Hong Kong, China. On the contrary, Indonesia and Thailand both show poor performance even though they have well-tailored and unified insolvency law and insolvency courts.

Such a phenomenon is not only visible in judicial procedures. Indonesia (the Jakarta Initiative Task Force), Korea (Corporate Restructuring Programme, 1998) and Thailand (CDRAC, 1998) launched structured workouts to save ailing financial institutions and large firms, and pushed for debt restructuring with domestic creditors. Foreign creditors were not bound by structured workouts. Negotiation with foreign creditors was conducted in parallel with structured workouts and dissenting foreign creditors have been demanding full repayment of claims. Japanese financial institutions, however, set up the Industrial Revitalisation Corporation of Japan (IRCJ) for a voluntary restructuring programme. IRCJ successfully completed debt rescheduling with foreign creditors. What made the difference? If creditors know how other creditors act and what they receive in judicial procedures, they tend to be co-operative with a rescheduling that provides more benefits than judicial procedures. Transparency and expediency are, thus, the key factors in determining the creditor-debtor relationship.

If a state has a sound compulsory execution system, it can go further to improve insolvency mechanisms by adopting new rules on insolvency proceedings. Amendments in Japan and Korea are examples of success. The Asian insolvency reform over the last decade has focused on introducing and adopting new insolvency rules and insolvency courts. Such efforts were successful in countries where compulsory execution was implemented properly. It is advisable for countries to adjust their approaches to their needs, and their economic and social environment. In addition, the order of implementing policy measures is important.

c) Prescription

The reason for the poor performance of insolvency laws in countries (even though they carried out insolvency law reforms) is that they overlooked the fact that the compulsory execution system is the basis of an
effective and efficient insolvency system. In many jurisdictions where the principles of rule of law are not fully respected, the importance of a sound compulsory execution system is not fully recognised either. Many lawyers do not appreciate the negative effects of inefficient compulsory execution on business activities among others financial transactions. As explained in the previous section, debtors and creditors have no incentives to choose judicial insolvency mechanisms (including liquidation and reorganisation proceedings) in a situation where compulsory execution is not properly conducted. Judicial insolvency proceedings, where the level of repayment is unsatisfactory, may even be preferred.

Another factor that discourages judicial insolvency proceedings is government initiated rescue programmes. If the government has a programme to sustain ailing firms for any reason, debtors and creditors expect the government to do something. Government initiated rescue programmes give the wrong message to ailing firms (that they do not have to be cautious about liabilities) and create a vicious cycle (as with poor compulsory execution).

This kind of vicious cycle should be broken by enhancing the performance of compulsory execution or by treating ailing companies according to market principles. As long as a vicious cycle exists, efficient insolvency systems cannot be expected. No one makes a choice that produces less profitable results and more difficulties.

When the economic crisis hit the Asian countries, most blamed outdated insolvency laws. So efforts focused on amending or enacting new insolvency laws that reflected good foreign practices. In some countries, however, the outcome of legislative reform fell far short of expectations because of structural weaknesses in the insolvency system. There were insufficient reasons for interested parties to resort to judicial insolvency proceedings. Insolvency reformers saw the superficial defects of insolvency legislation but missed hidden structural weakness.

The hierarchy of insolvency mechanism shown in Figure 1 can be used as the order of learning. Compulsory execution is first and corporate reorganisation last. Without an understanding of compulsory execution, it is very hard to learn corporate reorganisation. Furthermore, new concepts of insolvency proceedings are more difficult to adopt than those of compulsory execution.

Introducing new rules is also a process of learning for those affected by the rules, including judges, lawyers and businesspeople. In order to learn effectively and utilise what is learned, there should be enough reason for learning and adequate levels of learning. Adopting updated new insolvency
rules without considering learning can result in a dead law that exists only in the books and not in the court.

Therefore, in some jurisdictions where sound compulsory execution cannot be expected, the efforts of insolvency law reform should focus on building an effective compulsory execution system first. What should be done to build a sound compulsory execution system? The answer is discourse. It should be repeatedly discussed why rule of law is important in the market economy, why a sound and efficient judiciary system supports economic development, and why ensuring creditors’ rights enhances the efficiency of the economy in general. Research, education and training can make changes. Like technology in science and engineering, advanced rules and mechanisms in legal issues can be imported from advanced countries.

International fora for the exchange of information and ideas like the OECD Forum for Asian Insolvency Reform (FAIR), the technical assistance of the ADB and regional networking on insolvency issues have played an important role in providing advanced theories and practices. Their activities have been a valuable source of information. Sharing information and experiences are the most effective way to acquire knowledge. International co-operation should continue for the welfare of the world, but it should expand its scope of interests to compulsory execution and the infrastructure of insolvency mechanisms.

For there to be material progress in insolvency reform there should be a process of internalisation of new concepts in the domestic sphere as well. Knowing a concept is one thing and making it one’s own is another. Concepts that may be fully understood by a few elite, may not find their way into legislation because legislators may be unfamiliar with new concepts. Even if legislation succeeds, it is difficult to implement unfamiliar rules because the people who apply them may only be generalist lawyers. The internalisation process should involve more lawyers, policy makers and businesspersons, and strive to develop a consensus among them. International co-operation on insolvency reform needs to help internalisation of insolvency rules and theories by enlarging the participants of international fora and networks.

China and Korea are good examples in terms of internalisation. Instead of drafting a new insolvency law by a few elite with the assistance of foreign experts, these countries have prepared draft bills over years and have listened to the opinions of domestic and foreign experts. Though it has taken several years, more lawyers and policy makers became aware of insolvency rules during this process.
5) Future tasks

Over the last decade, many East Asian countries endeavoured to reform their insolvency systems. These efforts focused on enacting advanced insolvency laws, and produced positive results but not to the extent wished. The areas where insolvency law reforms did not produce expected outcomes can be reduced by strengthening the weaknesses of insolvency systems. A six step policy plan is suggested that should help build effective and efficient insolvency mechanisms in East Asian countries. The ordering of the steps is a function of the duration of the individual projects; the first step represents the shortest project and the last step the longest.

1st Step: Let no one avoid compulsory execution

Problems lie first and foremost in compulsory execution and not insolvency law. If compulsory execution can be bypassed, the whole debt settlement structure becomes fragile and the outcome of debt collection activities (including insolvency proceeding) will be decided at a lower level than anticipated when loans are rendered. There should be strict sanctions and monetary penalties for illegal or uncooperative activities in compulsory execution. Compulsory execution is the foundation of the entire insolvency structure.

2nd Step: Make compulsory execution produce more distribution in less time

The recovery ratio is the most important incentive in debt collection activities. The recovery ratio in compulsory execution is the starting point of all other schemes including liquidation and reorganisation proceedings. Debtors’ properties should be easily found out for realisation. Information on public sales at court should be subject to timely notice, and procedures for compulsory execution should be completed rapidly.

3rd Step: Provide incentives to creditors and debtors to apply for liquidation or reorganisation proceedings

If compulsory execution is conducted properly, incentives are a main driver of the application of insolvency schemes. Tools for maximising going concern value could be used. Debtors’ concerns should be considered. Retention of control over the firm and other benefits, including retirement programmes could be considered.
4th Step: Upgrade insolvency laws on a standing basis or with participation of more people

Insolvency law is the product of history to solve a conflicted debtor-creditor relationship. It is impossible to enact a complete set of insolvency laws at one time. There will be provisions that need to be revised and supplemented. Changes in the market create new problems. Amending insolvency law should not just be a one-off event. It should be an ongoing process that results in more people getting interested in insolvency law. Lawyers are not familiar with insolvency law in some jurisdictions. The best way to learn insolvency law is to participate in interpreting and amending insolvency laws. Questions and answers, discussion and proposals are means for spreading ideas and internalising rules. The more people participate, the more citizens can gain a deeper understanding of insolvency law.

5th Step: Reinforce the infrastructure of insolvency mechanisms

Insolvency mechanisms cannot be separated from related social systems. Political, judicial, financial and corporate infrastructure are the foundation of insolvency mechanisms. The operation of insolvency schemes cannot exceed the lowest level of these infrastructure elements. Since these elements relate to many fields in society and the economy, they can have synergistic effects.

6th Step: Ensure the principle of rule of law in the market

An insolvency proceeding is resorted to in a situation where the rights of one party collide with the obligations of another. If each party wants to solve the conflict by law, insolvency law will take charge of the situation. If not, there is no room for the legal intervention. If the law is fully respected and abided by in the market, every party in the market (including debtors, creditors and regulators) naturally assumes that the law will resolve the conflict. The rule of law applies not only to political issues but also to economic issues. The rule of law in a market economy must be constantly emphasised.

1 1800-1804, 1841-1843, 1867-1878, 1898.
OECD Centre for Co-operation with the Economies in Transition (1994), Corporate Bankruptcy and Reorganisation Procedures in OECD and Central and Eastern European Countries.


OECD (2001), Insolvency Systems in Asia. This publication contains six country reports.


Footnote 6.

Strengthening Economic Legal Infrastructure Co-ordination Group (2003), Study on Debt Collection Litigation/Arbitration in APEC Economies.


The Corporate Reorganisation Act was amended in 2005 again pursuant to amendments to the Commercial Code (Company Act).
Since 2004, the number of insolvency cases has exceeded 10 000 per year because of consumer bankruptcy. Discussions on the establishment of an insolvency court have been restarted recently.


The importance of compulsory execution can be found in ex ante efficiency too. The division of value between a debtor, creditors and other stakeholders determines ex ante efficiency. See Nam, Il Chong and Soogeun Oh (2001), p. 23. If compulsory execution is properly implemented, the value in Scenario 2 goes to creditors only. The division of value in Scenario 3 is beyond the scope of this paper.

Footnote 6. It does not cover China and Japan.


Starting a business, hiring and firing workers, registering property, getting credit, protecting investors, enforcing contract and closing a business.

To make the case comparable across countries, 10 assumptions are employed: 1) The debt value equals 200% of the country’s income per capita. 2) The plaintiff has a 100% right. 3) The case presents a lawful transaction between businesses residing in the country’s most populous city. 4) The bank refuses payment for lack of funds in the borrower’s account. 5) The plaintiff attempts to recover the debt by filing a lawsuit or going through an administrative process. 6) The debtor attempts to delay service of process but it is finally accomplished. 7) The debtor opposes the complaint. 8) The judge decides every motion for the plaintiff. 9) The plaintiff attempts to introduce documentary evidence and to call one witness. 10) The judgment is in favour of the plaintiff. 2005 Doing Business, p. 86.

1) The business is in default on its loan and the default will continue. 2) The creditor bank has security interests on the debtor’s properties including floating charge. 3) Debtor’s options are a reorganisation proceeding, a liquidation proceeding, and sales of business in or out of the court. 2005 Doing Business, p. 87.

For statistical analysis, a “p value” of less than 0.05 was considered to be significant. The Pearson method was used to evaluate the correlation between the two variables. The recovery rate variable of closing a business was strongly inversely correlated with the time variable of closing a business (r=−0.879, p=0.009).
A1. ANOVA of model with recovery rate of closing a business as dependent variable:

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>5 000.906</td>
<td>2</td>
<td>2 500.453</td>
<td>13.594</td>
<td>.016</td>
</tr>
<tr>
<td>Residual</td>
<td>735.771</td>
<td>4</td>
<td>183.943</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>5 736.677</td>
<td>6</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Predictors: (Constant), time of enforcing contract, number of procedures of enforcing contract.
Dependent variable: recovery rate of closing a business.

A2. Coefficients of model with recovery rate of closing a bank as dependent variable:

<table>
<thead>
<tr>
<th>Unstandardised Coefficients</th>
<th>Standardised Coefficients</th>
<th>Sig.</th>
</tr>
</thead>
</table>
Model | B | Std. Beta |
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>(Constant)</td>
<td>124.774</td>
</tr>
</tbody>
</table>

**Independent variables of enforcing contract**

| | Number of procedures | -1.590 | 1.004 | -.361 | -1.583 | .189 |
| | Time | -.115 | .039 | -.666 | -2.924 | .043 |

Note: Dependent variable: recovery rate of closing a business.

B1. ANOVA of model with time of closing a bank as dependent variable:

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>17.189</td>
<td>2</td>
<td>8.595</td>
<td>18.017</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>1.908</td>
<td>4</td>
<td>.477</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>19.097</td>
<td>6</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Predictors: (Constant), Time of Enforcing Contract, Number of procedures of Enforcing Contract. Dependent Variable: Time of Closing a Business.

B2. Coefficients of model with time of closing a bank as dependent variable:

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardised Coefficients</th>
<th>Standardised Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>(Constant)</td>
<td>-1.599</td>
<td>1.083</td>
<td>-1.476</td>
</tr>
<tr>
<td>Independent Time</td>
<td>7.166E-03</td>
<td>.002</td>
<td>.718</td>
<td>3.567</td>
</tr>
</tbody>
</table>
Note: Dependent Variable: Time of Closing a Business.

29. The Companies Ordinance, the Companies (Winding-Up) Rules, the Bankruptcy Ordinance and the Bankruptcy Rules.

30. These structured workouts were closer to government-managed financial rescue programmes rather than voluntary bargaining processes. It was also often the case that the structured workouts replaced judicial insolvency proceedings. The government, rather than the court, determined the boundary of exit mechanisms. See Nam, Il Chong and Soogeun Oh (2001), p. 62.