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SM/01/8
Correction 1

January 23, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Involving the Private Sector in Resolving Financial Crises—Corporate Workouts—Preliminary Considerations**

The following corrections have been made in SM/01/8 (1/9/01):

Page 5, para. 10, lines 5-6: for “system, in part”
read “system, it...crises, in part”

Page 13, footnote 10, last line: for “published...year.”
read “published shortly.”

Corrected pages are attached.

Att: (2)

Other Distribution:
Department Heads

10. The establishment of a coherent workout strategy is a necessary means of involving the private sector in both forestalling and resolving financial crises. In terms of *crisis resolution*, the cost of bank restructuring has generally been borne by the fiscal accounts. Accordingly, to the extent that a corporate restructuring strategy is in place that can maximize the value of the assets of the banking system, it will contribute to easing the fiscal burden of resolving financial system crises, in part by ensuring that other creditors and shareholders share losses. In terms of *forestalling financial crises*, the effective design and implementation of the legal framework that underpins a corporate restructuring framework gives creditors the ability to predict with reasonable certainty how their claims would be treated in the event of a workout, thereby enabling the private sector to assess better the risks that they incur when extending credit. This suggests that assessments of insolvency regimes should form a part of the more general work on the assessment of vulnerabilities.

Operational issues

11. In many cases, reforms to facilitate orderly corporated workouts will be an important element of Fund-supported adjustment programs. Given the World Bank's expertise in this area, and its role in promoting structural reform, the Bank would normally take the leading role in the design and monitoring of corporate workout mechanisms. In many cases, it is expected that the Bank will have a timely lending instrument to support the introduction of the reforms, and provide the necessary monitoring. In some cases, however, if the Bank is not able to address these issues in a timely fashion, assistance in the design of such reforms may have to be sought elsewhere, either within the Fund or from other sources, if corporate restructuring reforms are considered critical to the success of a Fund-supported program. Over time, of course, it would be expected that the Bank would deepen its involvement with this element of the reform agenda, and would assume the leading role as soon as possible. In any event, staff would provide regular updates to enable Directors to assess progress and the consistency of the reforms with the objectives of the program.

III. ESTABLISHING A FRAMEWORK FOR THE RESOLUTION OF CORPORATE SECTOR CRISES

12. Given the impact that a distressed corporate sector can have on the financial system, macroeconomic and balance of payments stability, and economic growth generally, the establishment of a framework for resolving corporate difficulties should be a high priority, particularly for emerging markets.⁵ It is important that the central elements of such a framework be established during a period of relative tranquility, as it is critical that it be in

⁵ In a similar vein, it would be important to address other sources of vulnerability that may contribute to financial crises, including, for example, corporate governance.

place in advance—or immediately after the start—of a crisis, so that it can help to facilitate an orderly and efficient process for working out the financial difficulties of the corporate sector.

A. The Role of an Orderly and Effective Insolvency System

13. As demonstrated recently in the context of a number of Fund-supported programs, ***an orderly and effective insolvency system forms a central component of any framework for resolving corporate sector difficulty***. Both inside and outside the context of a crisis, an effective insolvency system with well-designed rehabilitation and liquidation procedures can maximize the value of corporate sector assets for the benefit of all stakeholders (including, debtors, creditors, and employees) and the economy more generally.

14. Specifically, the relevant parties—including creditors—may be of the view that the assets of the enterprise (including, therefore, the value of creditors' claims) can be most efficiently maximized through the "going concern value" of the company. This will often—but not always—be the case where the inability of the company to service its debt is due to a macroeconomic/balance of payments crisis. In these circumstances, ***rehabilitation proceedings*** provide an effective means of preserving the value of a going concern, as they normally involve: (i) a stay on potentially disruptive creditor litigation during the period in which a restructuring plan is being negotiated; (ii) plan approval provisions that allow a court to approve a restructuring plan and make it binding on minority dissenting creditors; and (iii) provisions that encourage new financing by providing a payment priority to new credits. By facilitating a restructuring that will often involve debt reduction and/or debt-for-equity conversions, an effective rehabilitation procedure helps to ensure that private creditors bear a portion of the burden of the financial crisis, thus limiting the public cost of resolving the crisis. Also, by requiring private creditors to incur the costs of the risks they have assumed, such a system generates greater stability in the financial system. More generally, effective rehabilitation systems help to limit the loss of asset value (and financial losses that may be borne by creditors) associated with excessive delays in workouts.

15. Where, because of the financial condition of the company, creditors are of the view that the enterprise is no longer viable, ***liquidation proceedings*** provide an effective means of maximizing the liquidation value of the company's assets through provisions that (i) prevent premature dismemberment through a "grab race" by individual creditors, (ii) provide for the appointment of an independent administrator whose duty is to maximize liquidation value (for example, through the avoidance of fraudulent and preferential transactions), and (iii) provide for equal treatment of similarly situated creditors.

16. Orderly and effective insolvency procedures can also achieve broader economic objectives that go beyond value maximization. For example, by establishing a mechanism that enables creditors to enforce their rights against a debtor, and establishing liquidation distribution priorities that recognize the payment seniority established in preinsolvency contracts, an effective liquidation procedure can create predictability and confidence in the credit system, to the benefit of borrowers (including through greater availability and lower

government-owned AMU owns a large amount of nonperforming loans) being pursued at the price of dismantling, or otherwise impeding the restructuring of, viable companies.

45. Apart from taking into consideration the above issues when designing Fund-supported programs, the question arises as to whether there are additional steps that the Fund and other international organizations could take to foster improvement in this important area. At this early stage of discussion, it is worth noting the following points.

46. First, given the direct impact that a system for the enforcement of creditor rights has on the financial sector, consideration could be given to including a review of these in Article IV discussions in those circumstances where the financial system in question demonstrates considerable vulnerabilities. In that regard, it should be noted that creditor rights, corporate restructuring, and loan recovery are already elements of the Financial Sector Assessment Program (FSAP), which the Fund carries out jointly with the World Bank.

47. Second, assessments could be conducted of the adequacy of a member's corporate restructuring system in the context of a ROSC. In this regard, it would be noted that considerable work is being undertaken in a number of fora to develop best practices and generally accepted principles in this area. With respect to the out-of-court framework, the leadership of the International Federation of Insolvency Practitioners (INSOL)—whose lenders' group includes many large international lenders—has completed work on a set of principles that are intended to guide multicreditor workouts.⁹ Countries could use these principles, which are attached as Appendix I, as a starting point in establishing ex ante a framework that debtors and creditors in their own jurisdictions would be expected to follow in the event that a crisis results in systemic difficulties within the corporate sector.

48. Regarding the legal framework that provides the necessary underpinnings for an effective out-of-court framework, significant work has been done, or is being done, by the Bank and the Fund on identifying the critical features of an effective domestic insolvency system.¹⁰ Building on this work, an insolvency working group established by UNCITRAL (United Nations Commission on International Trade Law) has recommended that UNCITRAL prepare a legislative guide that would provide guidance as to the design of a domestic insolvency law that would be applicable to both developed and developing countries. UNCITRAL has already completed work on a model law on cross-border insolvency. The Financial Stability Forum has identified insolvency principles as one of the 12 key standards to which countries are encouraged to accord a high priority. At such time as

⁹ Upon invitation, the Fund staff has attended the working group sessions of INSOL as observers.

¹⁰ With respect to the Fund, see *Orderly and Effective Insolvency Procedures: Key Issues*. The Bank's publication, entitled "Principles and Guidelines for Effective Insolvency Systems," is scheduled to be published shortly.

sufficient progress is considered to have been made in developing standards in this area, an assessment of insolvency systems against these standards by the Fund and the Bank could become part of the ROSC exercise.¹¹

¹¹Separately, the Group of 30 is leading a private sector initiative that seeks to establish methods for the better dissemination of information about legal vulnerabilities in country-specific corporate restructuring frameworks, including methods that would encourage private investors to take insolvency and other “legal risks” into consideration when making investment decisions.