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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.