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Insolvency – a second chance?

Why modern insolvency laws seek to promote business rescue

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This article considers some of the broad socio-historical, political and economic factors that have shaped modern insolvency laws leading to the development of the "rescue" culture. It also examines some of the unique features of insolvency law reform in the former socialist bloc and seeks to anticipate some of the issues that may be encountered in the southern and eastern Mediterranean region.

Insolvency laws are under greater scrutiny than ever before as governments and legislators seek to mitigate the effects of the global financial crisis on both businesses and consumers. While some insolvency laws have been comprehensively overhauled, others have introduced new procedures or have been subjected to important amendments, especially with a view to encouraging business rescue. Legislative change has not been confined to the sphere of business insolvency. The expansion of consumer credit in recent years has resulted in reforms to consumer insolvency laws. Some countries, such as Lithuania, have introduced for the first time a consumer insolvency regime to address the problems of personal over-indebtedness. The pace of insolvency law reform has been fast and even, at times, relentless.[1]

International financial institutions have been involved in reform efforts and, in certain cases, have made financial assistance conditional upon insolvency law reform. Ireland and Portugal are countries where the reform of insolvency laws is part of an International Monetary Fund programme of assistance. At the EBRD, insolvency is a focal area of technical assistance and insolvency best practice is encouraged as part of measures to improve the investment climate in the Bank's region of operations. The EBRD region includes a number of European Union (EU) countries. These have benefited from efforts by EU legislators to ensure better coordination of insolvency proceedings among EU Member States through the 2000 European Union Insolvency Regulation (EUIR).[2] The EUIR, which regulates insolvency proceedings of natural or legal persons involving an EU cross-border element, was the product of many years of labour that commenced with the establishment of the Insolvency Working Party in the late 1960s. The EU has sought to

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promote insolvency best practice at Member State level, supporting projects advocating a "fresh start" after insolvency for consumers in the 1990s and from 2000 onwards following the European Councils of Lisbon and Feira, for entrepreneurs and small and medium-sized enterprises. The United Nations Commission on International Trade Law (UNCITRAL) has also sought to encourage greater cooperation and coordination of insolvency proceedings among international states through its 1997 Model Law on Cross-Border Insolvency, which has been adopted by some 20 jurisdictions across the world to date.[3]

Notwithstanding such initiatives, insolvency is an area of law where there is little uniformity of approach even among countries that share a similar common or civil law framework. This reflects the numerous areas of law and human experience that insolvency touches on, from employment and pension matters to property and secured rights. Despite such diversity, one can see across most insolvency jurisdictions in the Western world, a historical shift in policy terms from viewing insolvency as a terminal proceeding for businesses ending in liquidation, to recognising insolvency proceedings as a gateway to potential business rescue. This has been accompanied in many quarters by a reduction in the stigma attached to insolvency, which historically led to debtors being treated as criminals and social outcasts. Effective insolvency laws have come to be recognised as an essential part of an economy that encourages businesses and persons to be entrepreneurial and to take economic risks.

The launch of EBRD's investment activities in the south and eastern Mediterranean (SEMED) region of Egypt, Jordan, Morocco and Tunisia presents new and exciting challenges for the EBRD as an institution, including in the field of insolvency law reform. This article considers some of the broad socio-historical, political and economic factors that have helped shape modern insolvency laws, with particular emphasis on business insolvency. At the same time, it examines some of the unique features of insolvency law reform in transition economies following the dismantlement of the communist system and seeks to anticipate some of the issues that may be encountered in SEMED. The terms "insolvency" and "bankruptcy" are used interchangeably throughout the article.[4]

The development of business insolvency law

Insolvency would not be possible without the existence of credit since insolvency is, by definition, the inability to pay one's debts. The extension of loans and founding of a credit based economy brought with it the risk of default, leading to the introduction of laws and procedures to regulate non-payment.

The Romans formulated insolvency concepts that are familiar today, from assignment of the debtor's property to his creditors *(cessio bonorum)* to liquidation of the debtor's assets *(distratio bonorum)* and compositions with creditors *(dilation)*. Later, the bankruptcy of merchants came to be regulated by medieval European law merchant *(lex mercatoria)*, a substantial part of which was absorbed into English common law. Law merchant emerged from the body of commercial law developed in the merchant cities of northern Italy, where the practice of modern banking was first established.

In Russia, a law of 1497 (the *Sudebnik*) enacted by Ivan III sought to regulate, among other matters, the repayment of commercial loans in instalments for merchants whose goods were lost, through no fault of their own, for instance by being sunk at sea, or burned, or seized by troops.[5] In England, the first modern bankruptcy law was the 1542 Statute of Bankrupts of Henry VIII, which was primarily a debt-collection device for creditors. It directed the sale and distribution of the debtor's assets and codified for the first time in English statute law the *"pari passu"* principle of equal treatment of creditors. The principle of discharge of debts for natural persons was first introduced into English bankruptcy legislation by the 1705 Statute of Anne, which required the debtor to prove his honesty before benefiting from any debt discharge, hence its title *"An Act to Prevent Frauds Frequently Committed by Bankrupts"*.

Bankruptcy legislation became more extensive with time, the influence of some bankruptcy law models extending geographically with colonisation and empire. The first federal US Bankruptcy Act of 1800 was based on English bankruptcy legislation before a century of reforms, many of which were short-lived, saw the US taking a very different approach towards bankruptcy than England (discussed below). The bankruptcy provisions

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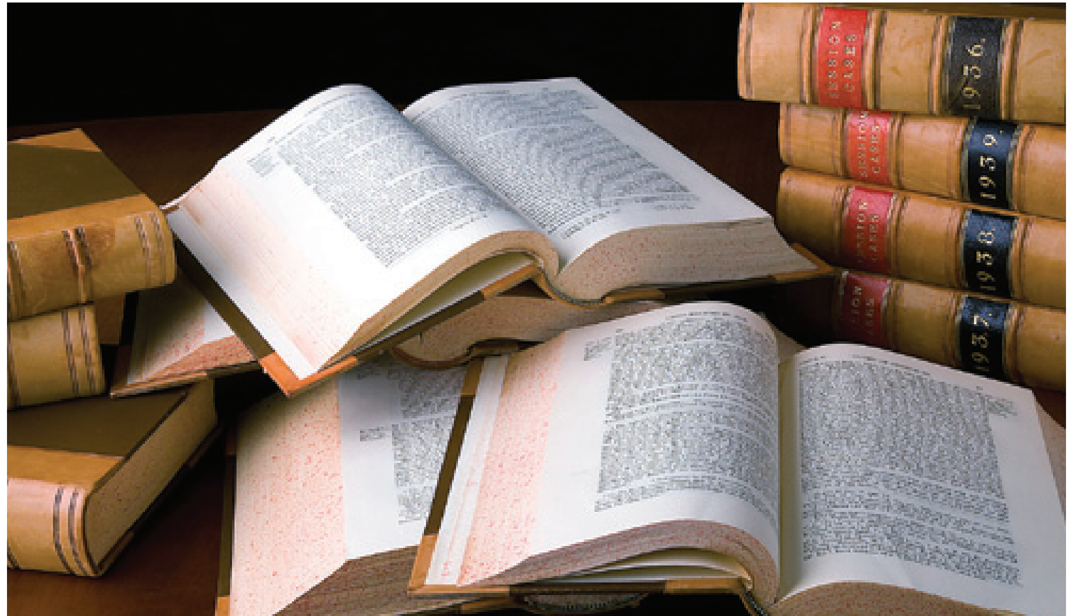

of the French Commercial Codes of 1807 and 1838, first codified in the 1673 Ordonnance de Commerce, formed the basis of many Napoleonic bankruptcy laws around the world, including Morocco, Egypt and Tunisia. In the 19th century, bankruptcy laws were introduced by newly formed European states. The first federal German Bankruptcy Code came into force in 1877, following unification in 1871. Similarly, the Italian Commercial Code of 1869, which contained bankruptcy procedures, came into force soon after the founding of the Italian state in 1861.

Nonetheless, before the birth of the modern company in the mid-19th century onwards, bankruptcy laws were reserved for individuals. Typically, a distinction was drawn between individuals acting in a commercial capacity (merchants) and those acting in a personal capacity (non-merchants). In England, bankruptcy laws were only for merchants, until the enactment of the 1861 Bankruptcy Act extended the availability of bankruptcy laws and bankruptcy debt relief to non-merchants. This development was followed by the 1869 Debtors Act, which abolished imprisonment for debt and the punishment of certain fraudulent debtors.[6] Imprisonment for debt, principally affecting small debtors, had been common in the earlier 19th century. References to "debtors" prisons' pervade the literature of the period, including the work of Thackeray and Dickens; the latter's father was imprisoned in the Marshalsea debtors' prison. Debtors' prisons existed throughout Europe. Cervantes and Molière were among earlier well-known European writers in the 16th and 17th centuries to have been imprisoned for failure to pay their debts.

The notion of "corporate insolvency law", by which a corporate entity goes through insolvency without recourse to its owners or shareholders, is relatively recent. It is founded on the principle of corporate limited liability, a development in company law that limited the liability of shareholders for a company's actions and at the same time marked acceptance of the fact that not all corporate debt would necessarily be repaid. Corporate limited liability for joint stock companies was first introduced in the UK by the 1855 Limited Liability Act,[7] however there were attempts to pierce the corporate veil and restrict the application of limited liability in insolvent liquidation. These were defeated in the landmark case of *Salomon v Salomon*,[8] in which the House of Lords (the then highest court in England) upheld the distinct legal personality of the company from its shareholders, overturning the judgment of the Court of Appeal, which had found the majority shareholder of the company liable for the company's debts in liquidation, on the grounds that the company was a "fiction" and had been created to screen its owner from liability. Developments in English company law in the second half of the 19th century also saw the birth of the "scheme of arrangement", a

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court-sanctioned compromise or arrangement between a company and its creditors, introduced by the Companies Act 1862 and the Joint Stock Companies Arrangement Act 1870.[9] Although infrequently used because of their complexity, schemes of arrangement provide a useful means of dealing with the run-off of the insurance business and are increasingly being used as a debt restructuring tool for both English and, more recently, foreign-incorporated companies with English law-governed debt facilities.[10]

In some jurisdictions, corporate insolvency law has developed out of laws for individual bankruptcy and has evolved to form a distinct body of law. In England bankruptcy laws were initially applied by analogy to the insolvency of corporate entities, prior to the development of a distinct body of corporate insolvency law.[11] Today English insolvency law contains two separate regimes of "bankruptcy" for natural persons and "insolvency" for legal persons or corporate entities.[12] In France and in other Napoleonic jurisdictions, insolvency laws are divided along "merchant" and "non-merchant" lines. Merchants, including corporate entities and individual entrepreneurs, fall under one "business law" insolvency regime, while non-merchants, such as consumers, fall under a separate regime. In any event, the focus on "corporate" insolvency law varies according to the relevant economy. In some countries, a significant number of businesses are operated by individuals or families and may be unincorporated. Even where incorporated, banks may seek personal guarantees from the company's shareholders in respect of corporate loans to mitigate the risk of non-payment. The practice of obtaining personal guarantees appears to be quite common in the SEMED region. Corporate insolvency can thus become entangled with individual or personal insolvency.

The move towards business rescue and the US model

The history of bankruptcy has been variously described as a move from *"debtor repression to debtor protection"*[13] and a *"redefinition of insolvency from sin to risk, from moral failure to economic failure"*. [14] The treatment of debtors in early bankruptcy laws was severe[15] and bankruptcy was a creditor-driven process. The concept of voluntary bankruptcy initiated by the debtor is a modern invention. Grounds for the change in the treatment of bankruptcy started in the US, which became the leading exponent of a new business rescue culture. Some commentators have traced the roots of this culture back to the US's early history

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as a country of immigrants, eager to start over and with a general optimism about the future and the potential of the US economy.

The main turning point in US attitudes towards business bankruptcy originated in the second half of the 19th century, which witnessed the failure of a high number of US railway companies. Given the strategic importance of the railway industry in the development of the US economy, ways had to be found to mitigate the effects of failure. The solution came first from the judiciary, which developed the common law "equity receivership" as a tool for reorganisation, to safeguard the company's assets and enable an agreement to be reached with its creditors. When Munroe Railroad and Banking Co defaulted on its loans in 1894, the US court ordered the sale of the business as a going concern, since a piecemeal sale of the company's assets would have resulted in financial loss for all parties. In 1898, the US legislator introduced a new and lasting Bankruptcy Act, containing a limited compromise procedure for debts.[16] The 1898 Bankruptcy Act is widely recognised as enshrining the principle of the "fresh start" for businesses in US bankruptcy legislation.[17] Although modified many times, significantly by the 1938 Chandler Act, the Act remained in place until replaced by the 1978 Bankruptcy Code. The Chandler Act strengthened composition procedures under US federal bankruptcy law. It introduced Chapter 11 for small debtors and Chapter 10 for public companies, both of which allowed for bankruptcy "reorganisation" as an alternative to straight liquidation. The Chandler Act thus marked an important milestone in the development of the "fresh start" model for US businesses.

The US had come to see bankruptcy as a necessary part of a society that valued entrepreneurial risk and became known for its liberal acceptance of financial failure. Today it is widely considered one of the leading jurisdictions in terms of debtor protection. The debtor-in-possession model, introduced by the 1978 Bankruptcy Code, in which the existing management of the debtor remains in place during corporate reorganisation proceedings, absent their displacement by a court-appointed trustee for cause (such as fraud), embodies the very essence of the "fresh start", since it expresses faith in the ability of the debtor to continue to manage its financial affairs. The US approach of the "fresh start" in bankruptcy has proved extremely influential in the subsequent development of business rescue legislation in Europe, where the concept has formed parts of efforts to strengthen and revitalise Europe's economy.

European legislative developments in business rescue

In France, the first substantial reform of the 1889 law relating to insolvency appeared in 1955 and this promoted business rescue. It introduced a new system of recovery proceedings known as *règlement judiciaire,* which provided for the re-establishment of the debtor in business, as an alternative to liquidation. Further legislation in France in 1967 enacted a moratorium for businesses that were not yet in a state of cessation of payments and set the framework for present day French insolvency legislation. Following the enactment in 2006 of the *procédure de sauvegarde*,[18] a debtor-focused rescue procedure inspired by Chapter 11 of the US Bankruptcy Code, French insolvency legislation is generally considered among the most rescue-focused in the world.

In England and Wales, a new Insolvency Act was enacted in 1985, bringing into force two new corporate rescue procedures, the "company voluntary arrangement" and "administration"[19]. This followed the recommendations of the 1982 Cork Report, which held that one of the aims of a good modern insolvency law was *"to provide means for the preservation of viable commercial enterprises capable of making a useful contribution to the economic life of the country"*.[20] Nevertheless, the take-up of the new corporate rescue procedures under the new Insolvency Act was perceived by many to be disappointingly low.[21] The appointment of an out-of-court "receiver" to realise any security over the debtor and the debtor's property (including its business) continued to be used by secured creditors, as an alternative to liquidation. Although receivership was recognised as having facilitated the rescue of many businesses, the focus of the new regime had shifted to the broader platform of rescue of the company as a whole.

In 2001 the UK government produced a report called *"Insolvency – A Second Chance".* This argued that companies in financial difficulties should not be allowed to close down

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unnecessarily and honest individuals should be granted a "fresh start", given that *"in a dynamic market economy some risk taking will inevitably end in failure"*. The series of reform proposals contained in the 2001 report formed the basis for the 2002 Enterprise Act, which sought to encourage productivity and entrepreneurship through changes to UK insolvency and competition law. Significantly, the Enterprise Act expanded the "administration" procedure, with the objective of making it the main collective corporate insolvency rescue procedure.[22]

Further efforts to promote corporate recovery took place at the EU level as part of a drive to make the EU market economy more competitive. The 2000 European Council in Lisbon had set the goal for Europe to become by 2010 *"the most competitive and dynamic knowledge-based economy in the world"*. This was followed in June 2000 by the endorsement of the European Charter for Small Enterprises at the Feira European Council, which called for an assessment of national bankruptcy laws in light of good practice. In 2002, the project "Restructuring, Bankruptcy and a Fresh Start" was launched under the Enterprise Directorate-General (DG). This resulted in the publication of a final report of the same name in 2003. The report recognised that legal systems could be a real deterrent to a fresh start in business and cited the US, France, Germany and (since the introduction of the Enterprise Act 2002) the UK as jurisdictions that encouraged reorganisation rather than liquidation of companies. Those setting up a business were mindful of the consequences of bankruptcy proceedings and the disqualification and restrictions imposed on those subject to proceedings. The authors argued that failed entrepreneurs generally learned from their mistakes and were more successful in the future. This meant that they should be provided with the opportunity of a fresh start, particularly given the importance of entrepreneur contributions to GDP and economic development. Like the 2001 UK government report, the 2003 EU Report emphasised the need for a distinction to be drawn in insolvency legislation between circumstances where an individual debtor or directors had committed fraud and where they had acted *bona fide.*

The second half of the 20th century thus saw the introduction of more "rescue focused" legislation in western Europe. This reflected widespread recognition of the economic benefits of corporate rescue, as compared with piecemeal liquidation. Nevertheless the philosophy behind the reforms differed quite markedly across jurisdictions. In continental jurisdictions such as France, the motivation for corporate rescue was not so much

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the encouragement of entrepreneurial risk, as in the US, but the preservation of business and continuity of employment. Preservation of employment is one of the stated goals of French insolvency law. The UK was more mindful of the interests of creditors in insolvency proceedings, the subsidiary (second) purpose of the administration procedure, after rescue of the company, being the achievement of *"a better result for the company's creditors as a whole than would be likely if the company were wound up"*.[23] Other factors continue to reveal a different philosophical insolvency mindset, such as the presence in certain jurisdictions of liabilities for creditors that recklessly extend credit or the imposition of criminal rather than civil sanctions on directors who continue to trade while the company is insolvent.

In some cases, the introduction of business rescue legislation has been driven by economic protectionism and the government's desire to protect a specific industry or strategically important company. In Ireland, for example, the examinership rescue procedure (described above) was introduced in 1990 at a time when the Goodman Group of companies, of strategic importance to the Irish beef industry, seemed to be in a state of imminent collapse.[24] Similarly, in Italy, the collapse of dairy producer Parmalat in late 2003 prompted the Italian government to introduce the "Marzano Law", a special insolvency law to deal with the insolvencies of large companies having 500 or more employees.[25] It was later amended and used to deal with the insolvency of another important company and employer, Alitalia.[26]

Nevertheless, only a small number of jurisdictions in Europe have to date adopted the US debtor-in-possession model for corporate recovery proceedings. Depending on the jurisdiction, the court or the insolvency office holder will, to a greater or lesser extent, dominate the proceedings. In France, existing management are allowed to stay in place during the *procédure de sauvegarde* and *règlement judiciaire* proceedings, although the proceedings are closely overseen by the court and generally require the appointment of an office holder *(administrateur judiciaire)* to assist the company's management with the preparation of a reorganisation plan. In the Irish rescue procedure of "examinership", existing management stays in place but an examiner (usually an accountant) is appointed to guide the company through a restructuring for a limited period of 70 days, extendable to 100 days. In most jurisdictions, for example, in England and Wales and in Germany, the appointment of an insolvency office holder on the commencement of insolvency proceedings has the effect of displacing existing management powers in favour of the insolvency office holder.

Insolvency reform trends in central and eastern Europe

In the region where the EBRD has operated since 1991, the political and economic landscape in the 1990s was completely different. Communism as an ideology had dictated social and economic policy until 1989. In many of the state-planned economies of central and eastern Europe (CEE), profits from successful companies could be redistributed to meet the losses of unsuccessful companies. As the government controlled the banking sector, loan default by a failing enterprise could be forgiven and a new loan extended. Nevertheless, there were differences among the countries' economies: some remained agrarian, while other countries, such as Poland, had moved towards a centralised, industrial economy. The absence (albeit in different degrees throughout the region) of a market economy and competition during communism meant that insolvency laws, to the extent these existed, had remained for the most part dormant, such as Poland's 1934 bankruptcy law. There were of course exceptions to the rule. In Hungary, two decrees were introduced in 1978, regulating the liquidation of cooperatives and economic associations and state-owned enterprises. A further 1986 Act set out details regarding liquidation proceedings and provided for the restoration of solvency, as well as the winding-up, of enterprises. Of the more limited variety of exceptions, in Russia during the new economic policy, insolvency provisions were included in the 1922 Civil Code to regulate an insufficiency of assets.

In the aftermath of communism, Western economists saw a new role for insolvency laws in assisting the restructuring of the economy and the allocation of assets from the state to the private sector, in addition to their traditional role as a safety net for financial failure in a new market economy. Many state-owned enterprises were technically insolvent. The adoption of insolvency laws depended on the privatisation strategy adopted by the relevant country. By

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1992, most CEE countries had embarked on a strategy of privatisation. Some countries, such as the Czech Republic, gave priority to privatisation and delayed the introduction of insolvency laws. Others, such as Hungary, brought in insolvency legislation to assist with the implementation of economic restructuring. In 1992 Hungary implemented a new bankruptcy law. This contained a narrow liquidity test for insolvency and included penal sanctions for managers who failed to file within 90 days of illiquidity, prompting widespread bankruptcy filings. In Poland, liquidation procedures were widely used as part of the privatisation process.

Some countries, such as the Czech Republic, were able to revive earlier bankruptcy laws. The Czech Republic's 1991 Bankruptcy Law was based on the 1915 Austro-Hungarian Bankruptcy Act, which contained limited composition (debt compromise) procedures. Poland relied on its 1934 Law on Bankruptcy, only replacing it with its existing Law on Bankruptcy and Rehabilitation in 2003. Russia, by contrast, drafted its 1992 Federal Bankruptcy Law without reference to any specific precedent. The transition to a free market economy with the phenomenon of bankruptcy was a cultural and economic shock. There were fears of widespread, uncontrolled bankruptcies and the large scale unemployment this could trigger. In countries such as Romania, governments sought to protect larger businesses from bankruptcy by making them exempt from bankruptcy legislation. The lack of proper infrastructure was a further major issue. There were no insolvency specialists among judges and other professionals. Debtors and creditors were themselves unfamiliar with insolvency procedures. Many people associated bankruptcy with criminality and did not believe that bankruptcy proceedings could lead to anything beneficial.

Unsurprisingly, the transition to a market economy led to a high volume of insolvency law reforms across CEE countries from the 1990s onwards, the focus of which has been on business insolvency. Russia replaced its 1992 law with a new law in 1998 and then again in 2002 with its present law. Hungary, by comparison, retains its Act XLIX of 1991 on Bankruptcy Proceedings, Liquidation Proceedings and Voluntary Dissolution, but has amended this over 30 times. The Czech Republic introduced a new Act on insolvency in 2006. A fresh impetus for insolvency law reform in the CEE came with the advent of the global financial crisis, which reached the region in 2008. Easy, foreign-financed credit suddenly became unavailable and export markets collapsed, causing the region's economy to enter into a deep recession. This resulted in legislators in a number of countries, including Latvia, Romania, Serbia, Moldova, Russia and Hungary, taking decisive action to improve their insolvency law regime.[27]

Social and religious attitudes to insolvency and debt

Despite the recent high volume of insolvency law reforms in the CEE and throughout the world, in most countries the stigma of financial failure persists in some form today. Individuals in particular face the risk of social stigma. The inability to meet one's financial obligations has been interpreted at various times by many groups in society as a breach of trust and lack of financial self-restraint. Stigma is relevant since it can impede the proper functioning of rescue mechanisms within insolvency laws and reduce the opportunities for a "fresh start". Although much reduced, residual traces of social stigma related to bankruptcy can be seen in the UK and even in the US, despite its generous debt forgiveness regimes for businesses and consumers.[28] Nonetheless, attitudes are likely to vary according to the community and the sector within that community.

The 2002 UK Government Report on Insolvency observed that the financial and business communities generally did not attach as much stigma towards business failure as consumers and the general community. Acceptance of the separate identity of corporate entities, independent from their owners, has likely helped to reduce the stigma of insolvency for companies. Nevertheless in the business community, the failed entrepreneurs of an insolvent business may have difficulty obtaining loans for new ventures and directors connected with an insolvent company may not easily find further management positions. This is particularly the case where there has been misconduct. In the UK, directors that are found guilty of misconduct in office, by, for example, continuing to trade to the detriment of creditors at a time when the company was insolvent, may face disqualification under the Company Directors Disqualification Act 1986. In some societies, the stigma of financial failure is particularly severe. A recent study on

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Japan concluded that the stigma attached to suicide was lower than for bankruptcy.[29] There are inevitably exceptions to the rule. It is reported that in India in the past and to a lesser extent today, some families have perceived it desirable to marry into another family that has experienced bankruptcy or insolvency, since this is evidence of the vibrant, entrepreneurial nature of the family.

The stigma of financial failure has been around throughout history and was particularly severe in ancient times, when it was accompanied by severe punishments for the unfortunate debtor. The Greeks allowed the amputation of the debtor's limbs and his sale into slavery. Under early Roman law, the debtor's body could be cut up and distributed amongst his creditors, before the *Lex Poetelia* in 326 BC prohibited death and slavery and the Romans developed procedures that were directed at the debtor's assets, rather than his person. Religion has often been a key component of social attitudes and beliefs. Major religions have viewed default on debt payment as seriously wrong but have enjoined creditors to treat the debtor with mercy. Psalm 37:21 of the Old Testament reads, *"The wicked borroweth, and payeth not again: but the righteous showeth mercy, and giveth"*. In Chapter 5 of the Qur'an, debtors are enjoined to respect their promises in the verse *"Oh, ye who believe! Fulfil obligations"*, and creditors are asked to be patient and generous with creditors: *"if the debtor is in difficulty, grant him time 'til it is easy for him to repay. But if ye remit in by way of charity, that is best for you if ye only knew"* (Verse 2.280). Common to both Christianity and Judaism is the Jubilee year, a special year of remission of sins and pardons, where every 50th year *"ye shall return every man unto his possession, and ye shall return every man unto his family"* (Leviticus 25:10). This concept inspired the "Jubilee debt campaign", an initiative launched in 2000 between local and regional groups and national organisations to cancel the unserviceable sovereign debts of poorer countries.

In the medieval church, the stigma attached to non-payment of debt was accompanied by a corresponding stigma directed at creditors lending with interest (usury). The Catholic Church banned the charging of interest by clerics from AD 314 and laymen in 1179, leaving socially marginalised groups to carry out the role of lending with interest. As part of the English Reformation and the break with the Catholic Church, King Henry VIII repealed the usury laws in 1546. While lending with interest is no longer prohibited by the Catholic Church, lending at prohibitively high rates of interest continues to be forbidden under Canon Law. Vestiges of the

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restriction on usury remain in the legislation of certain countries today, such as the caps on charging higher rates of interest or the prohibition on charging interest on rolled-up interest (such as seen in payment in kind instruments).

In countries that follow Islamic (*Shari'a*) law, the prohibition on earning interest (*riba*) on loans continues to be enforced. This is to be distinguished from the principle of allowing an increase in price to reflect usage of a particular asset over time, which is permitted under *Shari'a* law. A number of *Shari'a* law principles interact with insolvency law and may affect insolvencies, particularly in the context of a reorganisation or restructuring of Islamic financing structures, where financiers wish for these to remain *Shari'a* law compliant. The prohibition on riba will, for example, prevent the deferral of a payment obligation additional fees or interest.[30] Interestingly, although bankruptcy may result legally in a forgiveness of debts and only partial payment of creditors, the debtor will remain under a religious obligation to repay any difference to his creditors later in his life if he should come into money.

Shari'a law is part of the legal framework of Islamic countries, although its application and interpretation varies from country to country. In Jordan, the Constitution specifically grants the *Shari'a* courts exclusive jurisdiction over matters affecting the personal status or family code of Muslims. In Morocco, *Shari'a* law is at the origin of the family code. Recently, the extent to which *Shari'a* law will be recognised as the principal source of law by the new constitutions of Egypt and Tunisia has been a matter of dispute between different national groups. Egypt's former Mubarak-era constitution had recognised *Shari'a* law as the main source of legislation, unlike Tunisia, which was a predominantly secular regime. The prevalence of *Shari'a* law in the future may affect the financing structures adopted in SEMED and, by extension, the insolvency and restructuring framework.

Southern and eastern Mediterranean

Given the variety of approaches to insolvency law found in national legal systems, it is perhaps to be expected that differences also exist within the EBRD's new region of operations. One common theme that can be identified among all of the SEMED countries, however, is the influence of French law upon insolvency legislation. In Morocco and Tunisia, such influence has continued into modern times, hence the inclusion in the Moroccan and Tunisian commercial codes of the French law business rescue procedures of amicable settlement *(règlement amiable)*[31], aimed at promoting a settlement between a debtor and its creditors prior to insolvency and judicial reorganisation *(redressement judiciare),* which involves the preparation of a reorganisation plan during the course of insolvency proceedings.

By contrast, Egypt and Jordan, while influenced by the French (Napoleonic) model, have not (yet) incorporated business rescue procedures into their insolvency legislation. Instead their insolvency legislation contains more limited debt composition procedures. A study of Insolvency Systems in the Middle East and North Africa (MENA) presented by Hawkamah/World Bank/OECD/INSOL International in 2009, which included Egypt and Jordan but not Morocco and Tunisia, suggested that the region's laws were the *"least developed in the world"* with regard to reorganisation of companies in financial distress. In the insolvency laws of certain SEMED countries, including Egypt and Tunisia, there remains an overt emphasis on penal sanctions in connection with insolvency, which may encourage the social stigma of insolvency. The Tunisian Commercial Code provides that failure of a merchant to file for insolvency, within one month of a state of insolvency or suspension of payments, will result in criminal liability.[32] In Egypt, a debtor who in bad faith fails to list all of his creditors in his filing for bankruptcy may be subject to a prison sentence for a minimum period of six months,[33] whereas under the Tunisian Commercial Code it is a criminal offence for a creditor to have agreed, with the debtor or a third party, certain rewards for voting in the bankruptcy proceedings.[34] The insolvency legislation of Egypt and Jordan, as well as Tunisia, is under review at present. It is hoped that reforms will result in the introduction of more business-friendly rescue procedures aimed at promoting the survival of viable businesses, while lessening in certain cases the punitive emphasis of the insolvency laws.

The existence of laws that provide for business rescue is only the starting point. There may be deficiencies in how the laws are administered or within the actual detail of the legislation. The EBRD's analysis to date suggests that obstacles to a proper functioning of insolvency law may also exist within the SEMED region, particularly

Insolvency laws have been in a state of flux and there are indications that greater change lies ahead

as regards business rescue. One of LTT's key findings from meetings with stakeholders in Tunis in June 2012 was that adoption of the French law *règlement judiciaire* procedure in the 1995 Reorganisation Law[35] appears to have resulted in overly long insolvency proceedings in Tunisia. The strict time periods (up to a maximum of six months) prescribed by the 1995 Reorganisation Law for the preparation of a reorganisation plan of the debtor's business are not respected in practice. Parties cited reorganisation cases as taking on average three to seven years to complete. Within the 1995 Reorganisation Law itself, there are issues with the lack of effective compromise procedures to force a reduction in the overall principal amount of the debt on a dissenting minority of creditors, which have resulted in reliance on a lengthy, and possibly ineffective, deferral or rescheduling of debts. Tunisia is in the process of considering reforms to its insolvency laws, which may seek to address such issues.

Further reforms are likely to be needed in Tunisia and other SEMED countries to improve the overall system of qualification and regulation of insolvency office holders, which play a central role in the management of the estate of the debtor and, often in business rescue proceedings, in the preparation of a reorganisation plan. The EBRD has focused many of its past insolvency-related technical assistance projects on strengthening the profession of insolvency office holders in countries, such as Serbia and Russia and was behind the development of a set of insolvency office holder principles which provide recommendations of some of the issues that should be addressed by legislators in relation to the profession within an insolvency law regime.[36] Such work was run in parallel with commenting on proposals to reform Serbian and Russian insolvency laws. As the EBRD expands its operations into SEMED, the EBRD will work to apply its insolvency-related expertise gained in the CEE to new technical assistance projects for insolvency law reform and capacity building in the SEMED region.

Conclusion

There have been significant advances in recent times to facilitate access to business rescue across a number of jurisdictions in the EBRD's region of operations. These developments have taken place against a wider backdrop of evolution in the nature of insolvency laws since their inception. Many jurisdictions have moved towards a de-criminalisation of many aspects of insolvency and have sought, as part of this process, to differentiate between dishonest or irresponsible debtors and honest debtors, reserving the majority of penalties and sanctions for the former. Efforts have been made by national legislators to reduce the stigma historically attached to business failure through a re-labelling exercise, following the lead of the US, which replaced references to "bankrupts" by the more neutral term "debtors" in its 1978 Bankruptcy Code. The existence of business rescue proceedings has helped facilitate a change in public perception. In the UK, the Association of Recovery Professionals, R3, has sought to demonstrate the positive contribution of its members (insolvency office holders and other professionals) and the insolvency sector to the wider economy.[37]

Insolvency laws have been in a state of flux and there are indications that greater change lies ahead. In December 2012, the European Commission published a proposal for a Regulation of the European Parliament and Council to amend the European Union Insolvency Regulation to address a range of practical problems in the Regulation.[38] Of particular concern was the lack of existing coverage and coordination of national practices in promoting the rescue of enterprises in difficulty. In a statement about the proposed amendment, the EU Justice Commissioner, Viviane Reding, commented, *"Our current insolvency rules need updating to make it easier for viable businesses in financial difficulties to keep afloat rather than liquidating. 1.7 million jobs are lost to insolvencies every year – we want to give honest companies and the people they employ a second chance."*

An effective insolvency regime has come to be valued by many as a key component of a free market economy that values entrepreneurship and competition. At the same time, it has been recognised as providing an important toolkit for dealing with the present global financial crisis, which has affected so many businesses and sectors of the economy. Nevertheless, even where insolvency laws legislate for business rescue, a careful balancing exercise will still need to take place between the interests of all of the various parties, the debtor, its creditors, its members or shareholders, with a view to the broader interests of society and the economy as a whole.

Views

Insolvency – a second chance?

A development perspective

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As a provider of technical assistance on issues relating to insolvency and non-performing loans (NPL)/debt resolution to countries around the world, the World Bank Group has had an opportunity, together with other donors such as the EBRD and the IMF, to witness an increased awareness among policy-makers of the importance of sound insolvency systems. As Catherine's paper notes, the financial crisis precipitated an urgent response, in some countries, to a rise in NPLs. A more common phenomenon, however, has been a contraction of credit and an overall retrenchment by financial institutions, even in countries where NPLs did not rise significantly during the height of the crisis. This reluctance to lend is the result, in part, of an overall debt enforcement and insolvency environment that creates an environment of uncertainty and unpredictability for lenders.

As countries have experienced the crisis in vastly different ways, so too have they differed in their approach to insolvency reforms. At the same time however, trends, particularly within regions, can be observed in the approaches being taken. In the eastern Europe and central Asia (EECA) region, for example, Catherine's paper notes the pervasiveness of reform during the immediate "transition" period following the fall of the Berlin Wall. Many countries in this region can be said to have enacted their "first wave" of insolvency reforms, although with differing levels of success. In these countries we see a move to address some of the more difficult and intractable implementation challenges related to insolvency reform, such as the regulation of insolvency practitioners and the establishment of frameworks to resolve insolvency cases outside of formal court proceedings. Many of the weaknesses in the application of the law that give rise to these reforms were highlighted in the EBRD's 2004 Legal Indicator Study of EECA insolvency systems (http://www.ebrd.com/pages/sector/legal/insolvency/legal_indicator.shtml).

In the Middle East and North Africa (MENA), by contrast, the "Arab spring" has prompted a renewed focus on, among other things, creating an enabling environment that supports the growth of the private sector – with a hope that the private sector will contribute significantly to job creation in the region. To that end, countries are embarking on a range of "first wave" reforms, including in the field of insolvency. These typically involve either the introduction or the significant refinement of forms of business rescue. Drawing on international experience consistent with their domestic legal traditions, many countries in MENA are opting to develop local versions of the French insolvency process, including through the use of the *mandataire ad hoc* to provide third-party assistance to debtors and creditors trying to seek negotiated solutions, albeit under the umbrella of a formal court proceeding.

A practitioner's view

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European insolvency law has gone through a remarkable transformation over the past decade. Until recently, in contra-distinction to the US market, restructuring of finance obligations took place through the negotiation of restructuring agreements between the debtors and the various financial creditors (predominantly financial institutions). The alternative to reaching a consensual solution was bankruptcy and a severe loss of enterprise value for everyone. The principles against which the restructuring would take place are known as the INSOL Principles, which still form the basis of international best practice (see http://www.ifecom.cjf.gob.mx/PDF%5Carticulo%5C4.pdf). These principles evolved in turn from the London Rules or the London Approach, based on best practice promoted by the Bank of England in the London market in which English law debt was originated for the world of international finance.

These principles have nevertheless come under strain with the growing complexity of debt obligations (including circumstances where a debtor has a mix of obligations in relation to widely held capital market instruments as well as bank debt) and the development of the secondary debt market where purchasers of the debt may be prepared to act contrary to the principles. In response to this, European jurisdictions, to some extent led by the London market with its use of schemes of arrangement, have been developing moratorium and composition procedures to facilitate restructurings where creditors who hold out must be bound in or crammed down. Additionally, the London market has developed the use of "pre-pack" administrations to break the deadlock between shareholders, company and creditors by means of a quick sale of operating companies or the debtor's business to an entity controlled or financed by those creditors "in the money".

The restructuring of Eurotunnel through the *procédure de sauvegarde* in France probably marked the first serious restructuring in Western continental Europe to be facilitated by the European Union Insolvency Regulation. We are seeing an increasing use of English schemes of arrangement for non-English companies, pre-packs and local composition procedures as the market becomes ever more sophisticated. These ideas have started to be exported to countries in the Gulf as well. All of this is a far cry from where we were not too long ago.

Notes

[1] Insolvency law reforms have been introduced over the past few years in countries such as Albania (2008, 2009), Bulgaria (2006, 2010), France (2008, 2010), Germany (2012), Hungary (2009), Italy (2010, 2012), Kazakhstan (2012), Latvia (2008, 2010), Lithuania (2010, 2012), Moldova (2012), Portugal (2012), Romania (2010), Russia (2008, 2009), Serbia (2009, 2011), Spain (2009, 2011) and Ukraine (2012).

[2] Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings. Note that it does not apply to Denmark. On 12 December 2012, the European Commission published a proposal for reform of the EUIR.

[3] Australia 2008, Canada 2005, Colombia 2006, Eritrea 1998, Greece 2010, Japan 2000, Mauritius 2009, Mexico 2000, Montenegro 2002, New Zealand 2006, Poland 2003, Republic of Korea 2006, Romania 2002, Serbia 2004, Slovenia 2007, South Africa 2000, Uganda 2011, British Virgin Islands 2003, Great Britain 2006, and the United States of America 2005.

[4] "Insolvency" derives from the words "in" (not) and the Latin "solventem" (paying). "Bankruptcy" is thought to have its origins in the Italian "*banca rotta*" or Latin "*banca rupta*" (literally: broken bench) and the symbolic practice in medieval Italy of breaking the bench of a bankrupt merchant or money lender.

[5] See Article 55 *(Concerning Loans)* of the Sudebnik 1497, translated by H. W. Dewey at: http://www.departments.bucknell.edu/russian/const/sudebnik.html

[6] The practice of debtors' prisons in the US ended earlier in 1833.

[7] The 1844 Joint Stock Companies Act was the first general Act of Parliament to allow for the incorporation of a company as a distinct legal entity, although it provided for unlimited liability for the company's members.

[8] *Salomon v Salomon* [1897] AC 22.

[9] Schemes of arrangement between a company and its members were introduced at a later date by section 120 of the UK Companies (Consolidation) Act 1908.

[10] Foreign companies to have used English law scheme of arrangements include Seat Pagine Gialle (Italian), Rodenstock and Primacom (German), La Seda and Metrovacesa (Spanish), British Vita and Wind Hellas (Luxembourg) and Vivacom (Bulgarian).

[11] In England and Wales the 1844 Winding Up Act was the first Act of Parliament to make corporate entities subject to bankruptcy legislation.

[12] Personal bankruptcy and corporate insolvency were unified for the first time in one legislative Act in 1986.

[13] Principles of International Insolvency, Philip Wood, 2nd Edition, 2007, Sweet & Maxwell.

[14] Bankruptcy in the Age of American Independence, Bruce H Mann, 2009, Harvard University Press.

[15] In England and Wales, the death penalty for so-called "fraudulent bankruptcy", where the debtor failed to turn over all assets and books, submit to examination and otherwise cooperate fully with the bankruptcy commissioners, was abolished and converted to imprisonment or hard labour in 1820.

[16] The practice of equity receiverships continued to operate up until the 1930s. An amendment to the Bankruptcy Law in 1933 provided a similar level of protection for consumers who had been affected by the Great Depression.

[17] In fact, the move towards a more rescue-orientated culture in the US had begun earlier with the introduction of the 1841 Bankruptcy Act, which was repealed within 18 months as it proved too debtor-friendly. Prior to the inauguration of the 1898 Bankruptcy Act, there had not been a federal bankruptcy law in place for 20 years.

[18] Law No. 2005-845 of 26 July 2005, which came into force on 1 January 2006.

[19] Unlike the US, which witnessed rapid bankruptcy reform in the 20th century, the legislative picture in England and Wales remained relatively stable. The 1914 Bankruptcy Act remained in force, with minor amendments, until 1985. On the date it entered into force, the 1985 Insolvency Act was replaced by the 1986 Insolvency Act, which consolidated the Insolvency Act 1985 with the principal insolvency provisions of the Companies Act 1985.

[20] See paragraph 198(j) of the 1982 Report of the Review Committee chaired by Sir Kenneth Cork. According to the Cork Report, fresh impetus for insolvency law reform in England and Wales came with membership of the European Economic Community in 1973.

[21] See the 2001 UK government report "Insolvency – A Second Chance" at paragraph 2.1.

[22] One of the ways this was achieved was by prohibiting the use of"administrative receivership" by secured creditors, involving the appointment of a receiver to the whole or substantially the whole of the debtor's business. This prohibition was subject to certain limited exceptions contained at sections 2B to 72GA of the Insolvency Act 1986. Secured creditors who might otherwise have been able to appoint an "administrative receiver" were given the option of appointing their choice of administrator out-of-court.

[23] Insolvency Act 1986, Schedule B1, paragraph 3(1).

[24] The Companies (Amendment) Act of 1990, which introduced Irish examinership, was substantially amended by the Companies (Amendment) (No. 2) Act 1999.

[25] Law Decree No. 347 of 23 December 2003.

[26] The amendment of the Marzano Law was enacted by Law Decree No. 134 of 28 August 2008, converted into Law No. 166 of 27 October 2008.

[27] Report by the European Banking Coordination Initiative Working Group on NPLs in central, eastern and south eastern Europe, March 2012.

[28] Note that access to the debt forgiveness regime for consumers under the US Bankruptcy Code has been restricted by a series of amendments introduced by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

[29] Mark West, *"Dying to Get out of Debt: Consumer Insolvency Law and Suicide in Japan"*, University of Michigan Law School (2003).

[30] Religion may even have an impact on the willingness of debtors to respect their financial obligations. See, for example, the study by Baele et al., "*Of Religion and Redemption: Evidence from Default on Islamic Loans*"(2012).

[31] *Règlement amiable* in France was replaced by the new procedure of conciliation in 2005.

[32] Article 448 of Book IV on Composition Procedures and Insolvency of the 1959 Commercial Code.

[33] Article 769 of Chapter V of the Code of Commerce number 17 of 1999.

[34] Article 577 of Book IV on Composition Procedures and Insolvency of the 1959 Commercial Code.

[35] Tunisian Law no. 95-34 of 17 April 1995 (as amended).

[36] http://www.ebrd.com/downloads/legal/insolvency/ioh_principles.pdf

[37] See for example, *"The Value of the Insolvency Industry: A study into the economic significance of the insolvency, recovery and turnaround profession"*, July 2008 on R3's web site: http://www.r3.org.uk/media/documents/publications/professional

[38] http://ec.europa.eu/justice/civil/files/insolvency-regulation_en.pdf

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