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WORKING GROUP ON CORPORATE GOVERNANCE

"Building Sound Insolvency Systems in the MENA"
Cairo, Egypt, 21 May 2007

Synthesis Note

The OECD, in co-operation with the Hawkamah Institute of Corporate Governance, INSOL International[1] and the World Bank, organized a meeting on *Building Sound Insolvency Systems in the MENA* The meeting was co-hosted by the General Authority for Investment and Free Zones and the Egyptian Institute of Directors in Cairo (Egypt) on 21 May 2007.

The meeting brought together approximately 80 officials, members of the judiciary, private sector practitioners, insolvency experts and academics from Egypt, Jordan, Lebanon, Spain, United Arab Emirates, India, United States and United Kingdom. Representatives of the Centre for International Private Enterprise, the European Union and the US Agency for International Development participated as well.

The purpose of the meeting was to learn about the legal and institutional framework of MENA insolvency systems; introduce international guidance and emerging insolvency issues, which have triggered international debates in recent years; identify areas of interest for a regional dialogue on insolvency in the region.

Some of the important issues discussed at the meeting can be summarised as follows:

- Efforts are needed to build more sophisticated insolvency laws in the MENA region and the institutional capacity required for their implementation. There are important international reference points, such as the World Bank *Principles for Effective Insolvency and Creditor Rights Systems* and the UNCITRAL *Legislative Guide on Insolvency,* which could be of assistance to MENA jurisdictions, interested in strengthening their insolvency systems in line with recognized standards.
- There is no "one size fits all" insolvency model fitting all countries. Insolvency systems will embody different policy choices on risk allocation, and should take into account the strengths and limitations of the institutional infrastructure, the level of economic development and the existing social traditions.
- Insolvency reforms will not get off the ground unless policy makers acknowledge the benefits of sound insolvency systems for the efficient reallocation of resources. In contrast, the absence of a well-functioning insolvency regime may precipitate capital flight, and destroy value in the corporate and financial sector, frustrate creditors and discourage domestic and international investors.
- Notwithstanding the importance of country-specific approaches, there are certain core features of effective insolvency systems. One of them is the need for balancing the interests of debtors and creditors. Given the existing limitations of MENA insolvency systems, there is a case to be made for empowering the creditors. Conversely, in order to encourage entrepreneurial behaviour, there is a need to reduce the stigma of insolvency and make it possible for debtors to restart business on a clean slate after a failure.

[1] INSOL International is the international organization of insolvency practitioners.

- Comprehensive insolvency reforms in the MENA should encompass rescue and restructuring proceedings, which are largely lacking in their current frameworks. Otherwise, MENA economies will continue to bear considerable insolvency related costs.
- Furthermore, formal and informal (out-of-court) mechanisms should complement each other. Effective formal mechanisms have a disciplining effect for debtors and creditors. Well-developed informal mechanisms are needed as courts are unlikely to have adequate capacity to deal with all insolvency cases.
- Court systems in particular are at the heart of the insolvency infrastructure. Their independence and integrity, expertise and quality of service should be improved in order for them to fulfil their role.
- The court systems in the MENA countries would be severely strained if asked to actively conduct complex bankruptcy and re-organisation proceedings. While there is a need for judicial supervision of such proceedings, the burden of courts would be more manageable if the negotiation and settlement rights of creditors and their representatives are further developed.
- To this end, it is important to focus on facilitating the emergence of qualified professionals, who could act as trustees, or advisors to enterprises undergoing re-organisation. A clear set of rules regarding licensing, duties, responsibilities and ethics need to govern the insolvency professionals.

A summary of the discussions in the meeting is provided in the following sections.

The International Perspective

In 2006, ***the World Bank***, in co-operation with the United Nations Commission on International Trade Law (UNCITRAL), issued a document, setting out a unified *Insolvency and Creditor Rights Standard*. The document integrates the World Bank *Principles for Effective Insolvency and Creditor Rights (ICR) Systems* and the *Recommendations* of the UNCITRAL Legislative Guide on Insolvency. Participants were acquainted with the main lessons from the World Bank experience underlining that many countries have had to struggle with antiquated and inefficient insolvency legislation in the last decades. Initiatives included the development of reorganisation proceedings for distressed enterprises, measures to strengthen enforcement proceedings, and reforms to address ineffective courts and weak regulatory systems. Many countries are acquainted with the World Bank *Principles*, have benefited from the dialogue and technical assistance developed within the World Bank insolvency initiative and have requested to be evaluated in the framework of the Bank's ICR ROSC process[2].

INSOL International provided an overview of its work and achievements in encouraging greater international co-operation and communication among the insolvency profession worldwide. Publications and initiatives in specific areas of common interest and cutting edge issues, such as directors' liabilities and employee entitlements in insolvency, cross-border issues, deposit insurance, etc. were introduced to participants. Most importantly, it was concluded that insolvency proceedings will function effectively only if they are addressed as a system composed of laws, institutions, enforcement and regulatory mechanisms. The effectiveness of the system would depend on the competence and integrity of all involved, from the legislator to the judges and practitioners.

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[2] A country's observance of standards and codes, in twelve different areas, is assessed, at the request of a member country, by the IMF and/or World Bank. The results of these assessments are summarized in a Report on the Observance of Standards and Codes (ROSC). The World Bank evaluates insolvency and creditor rights (ICR) regimes under the ROSC program.

The OECD focused on its experience with the development and implementation of insolvency reforms in Asia and the lessons of relevance to the MENA region. It was stressed that the global consensus on the existing international guidelines on insolvency as a reference for national reform efforts should not prevent countries from focusing on their adaptation to national circumstances. In doing this, policy makers should address important political, social and insolvency specific concerns. The latter include a set of issues, such as rule of law, clear decision on the role of the market and the role of the state in the economy, addressing social concerns and improvement of social safety nets in parallel to insolvency reforms. Probably the most compelling lesson from a decade of Asian insolvency reforms indicates that implementation and institution building are equally important as lawmaking. This is especially important in MENA jurisdictions, in which insolvency frameworks have previously attracted little attention and in which there is an increasing pressure for rapid economic development and job creation.

Hawkamah underlined the link between insolvency, corporate governance and access to capital. Indeed, companies with a good corporate governance record reduce the risks of lenders and are often able to borrow more and on more favourable terms than their competitors with a poor governance record. The complexity and importance of designing sound and effective insolvency systems in the region implies a need for information exchange and a regional dialogue on common challenges and approaches that work. Hawkamah expressed its readiness to support regional co-operation on insolvency together with its partner organisations.

Legal frameworks of insolvency in the MENA region

The discussions in the session revealed that there is a considerable scope for adjustment and modernization of the legal frameworks of insolvency in the MENA region. Egypt and Jordan have undertaken concrete steps in this respect, with the support from United States institutions for both countries. Throughout the discussions, examples and solutions proposed in the US, UK and emerging economies frameworks were referred to. Given the similarities with European commercial law, it would be beneficial to also involve non-US experts in further reform efforts to be put in place in the MENA region.

It appeared that MENA economies bear a considerable insolvency related costs as rescue procedures are either inexistent or underdeveloped. Against the background of examples from the MENA, participants felt that there is an urgent need to address this issue. In light of the important role of courts overall, including in realizing security interest, a first step would be to empower MENA creditors. Better access to information for creditors and greater accountability on debt recovery could constitute important first steps in this respect. Meanwhile, introduction of incentives to companies to restructure, as well as improved enforcement of security contracts could bring about tangible results in the medium term, before launching broad-based reform measures.

A recent review of the ***Egyptian*** experience led to the establishment of a National Law Commission, with the mandate to assess commercial statutes, regulations and legal acts, against a set of criteria, such as predictability, coherence, equity and compliance with international guidelines. A special section of the Commission looks into the insolvency legislation with the objective to formulate specific recommendations. A set of problem areas have already been identified. The low rates of debt recovery and the weak underlying mechanisms have led to an antagonism between creditors and debtors. Not surprisingly, a "punitive culture toward debtors" has emerged, stigmatizing them as criminals and resulting in the suspension of some of their civil rights. Such an attitude has been fuelled as well by the emergence of so called "debt millionaires", following weak credit policies and "related lending" by banks. The concept of reorganization exists under the current legislation but is reportedly applied in only 1-2 per cent of the cases, thus preventing viable enterprises from the possibility to survive in situations of distress. A serious technical impediment to the framework enabling a greater number of enterprises to restructure in a

timely fashion is the bankruptcy test or "cessation of payments" which, if proved before the court, triggers bankruptcy.

The presentation on ***Lebanon*** exhibited numerous similarities with the Egyptian framework, especially with respect to the bankruptcy test, and the existence of outdated provisions on reconciliation. Lengthy insolvency proceedings and delays in judges' decisions represent additional obstacles to the cases (300 decisions on average) filed every year. Additional concerns were expressed with respect to the court discussions and final decisions, which are made available only to those who attend the hearings. The lack of transparency is, moreover, coupled with the impossibility to appeal final decisions. Under such circumstances, it was argued that priority should be attached to the amendment of the reconciliation chapters of the existing legislation, including through the development of out-of-court provisions, which would ideally benefit from the input of the banking sector.

In the case of ***Jordan***, a public-private sector initiative is currently aiming to assess the existing insolvency legislation and propose amendments, including the potential unification of all existing provisions in a single law. The priority of claims, which is at the disadvantage of secured creditors, has been one of the most difficult and controversial issues under discussion. In most developed systems, secured creditors have priority over all other claimants, including court costs, the trustee remuneration and holders of other administrative claims. This approach ensures predictable proceedings for secured creditors and is a prerequisite for both, greater access to capital for companies and lending opportunities of banks.

At a more general level, the Jordanian company law provides only a framework for liquidation and as in the case of Lebanon and Egypt, the need for developing a framework for rescue and restructuring proceedings has been acknowledged by all parties involved in the assessment of the insolvency legislation. The Companies Control Department of the Ministry of Industry and Trade attempts to play a pro-active role in promoting corporate restructuring. It has developed a mediation procedure, bringing creditors and debtors together for reconciliation. Experience has not been very satisfactory until now, because of the banks' reticence to co-operate and provide companies with an opportunity to restructure. Most often companies end up in court for liquidation, a process which can take between 3-16 years.

The **UK** and **US** legal frameworks generated a lot of questions. Rescuing business, a central objectif common for the development of both systems and a burning issue for MENA countries, was one of the reasons behind the numerous questions in the general discussions. Both the UK and US frameworks recognize that it is usually preferable for all stakeholders, including creditors, to restructure an insolvent company into a viable business. The frameworks designed to deal with corporate rescue in both countries attempt to address concerns of equity, effectiveness and speed, enabling greater numbers of companies to survive when they get into financial difficulties. When it is not possible to save a business, the procedures in place aim at getting the best possible treatment of secured and unsecured creditors.

The different solutions offered by these countries – the UK relying more on professional autonomy and discretion and the US retaining greater confidence in debtor management – showed the importance of crafting national approaches to insolvency reforms with due regard to national circumstances. The US Chapter 11 of the Bankruptcy Code, providing a framework for court supervised restructuring, is comprehensive and relies on a well functioning judicial system. It enables early protection by allowing companies to file voluntarily for Chapter 11 proceeding, without having to show that they are insolvent and by preventing secured and unsecured creditors (thanks to the "automatic stay") from enforcing their claims. "Debtor in possession" powers permit incumbent managers to continue running the company and their "super – priority" enables them to borrow funds during the restructuring.

The UK alternatives, such as the company voluntary arrangements and the administration illustrate a shift towards what is often referred to as a "rescue culture". Voluntary arrangements rely on an agreement between the directors of an insolvent company and its creditors, allowing the company to repay all or some of its debts from future earnings. Although the court does not play an active role in this process, the agreement signed by all parties needs to be filed in court. Administration does not require petitioning the court either, as administrators can be appointed by creditors, debtors or their directors. The court can, however, be involved by creditors. The role of the administrator is to act in the interests of all creditors, to attempt to rescue the company as a going concern or if this is impossible, to maximize the recovery for all creditors.

The UK is also famous for its "London Approach", derived from guidelines issued by the Bank of England. This is a flexible voluntary arrangement for financial institutions with objective of rescuing companies facing difficulties. Based on the availability of sufficient information, under this approach banks are encouraged to take a supportive attitude to their debtors in order to maximize value for creditors and avoid unnecessary liquidations. In this respect, a reference to the **Indian** experience with out-of-court proceedings underlined the critical role of co-operation among banks. A Secretariat, including representatives of all banks, supports informal reorganizations, which are based on voluntary creditor-debtor agreements, negotiated within specified deadlines. Unlike formal mechanisms, informal restructuring has been successful and especially so in steel, fertilizers and other sectors of the Indian economy.

One of the main risks of informal proceedings is the lack of co-operation among creditors, which could lead to a failure of a restructuring plan. Some countries have decided to provide additional incentives for creditors to co-operate and not to petition for bankruptcy, by making security rights avoidable. This can be done under the so called "pre-packaged" or "expedited" proceedings, which allow the approval of rehabilitation plans without unanimous endorsement by creditors. The **Argentinian** example was referred to, as it allows any work-out with a majority of creditors signing the restructuring plan, to petition the court to open a short proceeding. Under such circumstances, other creditors have the right to challenge the plan only for fraud. Once approved by the court, the plan binds all creditors, including those who did not sign it. If the plan fails, the company goes to liquidation but secured claims created under the plan are no longer avoidable. Such plans reduce the risk of hold-outs and provide incentives to creditors to join the work-out.

Participants discussed the similarities with the **conciliation** proceedings, existing under the Egyptian and Lebanese laws and asked about options for making them more effective. In this respect, it was noted that the recent amendments to the French framework for conciliation go in the direction of Chapter 11 by providing incumbent management with a greater role. The new rules allow the chief executive officer to initiate a procedure before as well as after cessation of payments. They also make possible the infusion of "fresh money" intended to support the restructuring and reinforce the anticipation of financial difficulties by introducing a new procedure for stay, triggered by the debtor.

It was also noted that **insolvency of financial institutions** poses specific problems for regulators, however, this has not led to the emergence of a general agreement on the need for a separate insolvency framework. Thus, in Germany, France and the UK, insolvency of financial institutions is governed by the law addressing general insolvency, while in the US, there is a separate law, as well as a set of institutions dealing with financial institution insolvency. In either case, it was noted that the key difference in handling distress in the financial sector is the role that the regulator (supervisor) is required to play.

Institutional frameworks of insolvency in the MENA region

Insolvency laws are dependent on the institutional capacity required for their implementation. The discussions of the institutional frameworks of insolvency in the MENA region focused on Egypt, Jordan and the UAE, with references made to the experience of US, UK and Asian jurisdictions.

In ***Jordan***, there are no specialised courts, nor specialised judges for insolvency cases. The performance for judges is subject to general standards for performance evaluation irrespective of the nature of the cases that they had been responsible for. The Ministry of Justice and the Judicial counsel organise specialised courses, some of which focus on insolvency, but there is no systematic effort in this respect. It is also observed that there is no *strictu sensu* insolvency profession, composed of lawyers, accountants and other experts, focusing predominantly on liquidation and re-organisation. Moreover, the role of insolvency professionals is limited with lawyers involved in the proceedings to the extent that they represent the parties, object or appeal on their behalf, while other experts are required to provide asset valuations or audits. The current legislation provides greater powers to liquidators who are in charge of keeping the records pertaining to the liquidation proceeding, verifying creditor claims, and ensuring the execution of court decisions.

The discussion of **Egypt** focused on the process of the revision of the existing institutional framework of insolvency, falling under the responsibility of the National Law Commission. The Commission comprises representatives of all stakeholders from the public and private sector, to carry out consultations and prepare a report with recommendations by the end of June. The Commission participates in training programmes for judges, including through co-operative initiatives and the organisation of visits abroad. There is a broad agreement among the members of the Commission on the need for greater knowledge and continuous learning opportunities for the judiciary.

In the **UAE**, the implementation of the law is very closely linked to the judicial capacity, as insolvency cases are highly dependent on courts as well. Bankruptcy cases are a rare occurrence ranging from one-two cases per judge per year at most. It is noteworthy that only twelve cases were filed in Dubai courts in 2006. Bankruptcy cases are often protracted and thus not seen as an efficient means for creditors to seek recovery. Moreover, creditors face various procedural impediments to the enforcement of their rights and especially with regard to realising collateral. Conversely, companies are discouraged by the proceedings, as they lack protection allowing them to restructure on a going-concern basis. Insolvency professionals are licensed following multiple sets of criteria, which may benefit from streamlining.

Significant changes have taken place within **Bahrain's** judicial system in recent years. As per a presentation submitted for this meeting, the independence of the judiciary was introduced in 2002 by virtue of the Amiri Decree, which also provides a framework for the appointment, mandate, promotion, and impeachment of judges. The Decree establishes the High Judicial Council supervising the court system. As in the UAE, the number of insolvency cases per year is low, which would indicate that the number of judges and experts in the country specialising in insolvency issues is negligible. However, discussions are currently underway on the establishment of financial courts, specific measures aiming to improve the functioning of the court system, as well as greater access to alternative dispute settlement mechanisms, which may have a positive impact on the institutional framework for insolvency cases as well.

The **US** and **UK** presentations underlined the importance of the institutional framework of insolvency in order to address distress in an orderly fashion. They pointed in particular to factors such as the number and competence of judges, their accessibility and their capacity to provide solutions in the short term, before the involvement of creditors and other experts (or in support of their initiatives), as critical in terms of

effectiveness. The UK Insolvency Service (Department of Trade and Industry) and the US Office of Trustees (Department of Justice) encompass the regulation of private sector insolvency administrators and the oversight of insolvencies administered by the latter. Private sector bodies for accountants and lawyers can also regulate and monitor the insolvency profession, as well as provide training to their membership. Importantly, **INSOL international** stated their readiness to continue implementing training programmes and exchange experiences with interested organisations, building on their long-standing experience, supported by their members, and especially by the so called Group of 36 firms.

The general discussions focused *inter alia* on what was referred to as "early warning systems" for insolvency. Company reporting and disclosure practices, active credit management, as well as monitoring by professionals constitute important elements enabling timely restructuring ahead of major failures. In this respect, it is key to address as well a broader set of issues, such as corporate governance, financial discipline imposed on corporations and enforced within the financial sector itself, including through mechanisms preventing fraud and wrong-doing.

Future work

Throughout the discussions, participants expressed their interest in establishing a regional dialogue, as a mere comparison of the MENA region with Europe or US is of limited value. It was felt that there are considerable opportunities for assistance, mutual support and learning with other countries from the region, which could add value in making MENA insolvency laws more efficient and more deliverable.

Participants stressed that it is imperative to engage policy makers if a regional insolvency initiative is to emerge as a follow-up to this event. In addition, all future endeavours should attempt to integrate the work completed by international organisations. Initial stock-taking should serve as the basis for structuring future work on insolvency in the region, to ensure that conclusions and recommendations would work in the prevailing MENA environment.