CREB Working Paper No. 01-12

Investigating the Proposed Changes to Pakistan's Corporate Bankruptcy Code

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First printing March 2012.

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Preface

The Centre for Research in Economics and Business (CREB) was established in 2007 to conduct policy-oriented research with a rigorous academic perspective on key development issues facing Pakistan. In addition, CREB (i) facilitates and coordinates research by faculty at the Lahore School of Economics, (ii) hosts visiting international scholars undertaking research on Pakistan, and (iii) administers the Lahore School's postgraduate program leading to the MPhil and PhD degrees.

An important goal of CREB is to promote public debate on policy issues through conferences, seminars, and publications. In this connection, CREB organizes the Lahore School's Annual Conference on the Management of the Pakistan Economy, the proceedings of which are published in a special issue of the *Lahore Journal of Economics*.

The CREB Working Paper Series was initiated in 2008 to bring to a wider audience the research being carried out at the Centre. It is hoped that these papers will promote discussion on the subject and contribute to a better understanding of economic and business processes and development issues in Pakistan. Comments and feedback on these papers are welcome.

Acknowledgments

We are grateful to CREB for supporting this research, to Dr Naved Hamid for his overall support, and to Mr Akhtar Hamid for his valuable comments. We also wish to thank Ms Maheen Pracha for her diligent editing. All remaining errors are our own.

Abbreviations

CRA	Corporate Rehabilitation Act
CRB	Corporate Rehabilitation Board
CRC	corporate rehabilitation company
LLC	limited-liability company
SECP	Securities and Exchange Commission of Pakistan
TAC	Technical Assistance Committee
USC	United States Code

Abstract

Over the last few years, firms in Pakistan have failed at an alarming rate, prompting some parties in the business community to call for government intervention, specifically by reforming insolvency law to make, inter alia, bad debt easier to cancel. The Securities and Exchange Commission of Pakistan has responded by proposing an amendment to Pakistan's bankruptcy code, which it calls the draft Corporate Rehabilitation Act (CRA). In this working paper, we evaluate the proposed law from both an economic and a legal perspective. Conceptually, we describe the narrow confines in which economic theory supports bankruptcy, and argue that bankruptcy is poorly conceived as a tool to "rehabilitate" firms. We also argue that rehabilitation policies are, in the first place, an incorrect response to endemic firm closure since they systematically favor loss-making firms, thereby setting up perverse incentives in the economy. Legally, we compare the CRA section by section to Title 11 of the United States Code on which it is based. While observing that the CRA's authors have made a good first attempt at the limited goal of adapting Title 11, we argue that much remains to be done in this regard, given Pakistan's weak institutional and political environment. We conclude that the proposed code deserves a complete review before being signed into law.

JEL classifications: K20, K39, G33, G38.

Keywords: Corporate bankruptcy, corporate rehabilitation, government policy and regulation.

Investigating the Proposed Changes to Pakistan's Corporate Bankruptcy Code

1. Introduction

> There is a widespread dissatisfaction with bankruptcy procedures throughout the world.... We believe the reason for this unsettled state of affairs is that bankruptcy law has developed in a fairly haphazard manner, as a series of attempts to solve perceived immediate problems. There has been relatively little effort to step back and ask what the goals of bankruptcy procedure should be or to consider how one would set up an optimal bankruptcy procedure if one were starting from scratch (Aghion, Hart, & Moore, 1994).

> ... given the growing closures in industrial sector and the increasing non-performing loans (NPLs) in the banking sector, it is considered imperative to enact the CRA at the earliest (Securities and Exchange Commission of Pakistan [SECP], 2009a).

Over the last few years, firms in Pakistan have failed at an alarming rate, leading parts of the business community to call for the government to address this problem. The call for action has focused on insolvency law reform—analysts have pointed out that the current legal system does not allow bad debt to be cancelled or firms to be easily closed down (Jamal, 2008).

In response to this, the SECP proposed an amendment to Pakistan's bankruptcy code in the shape of the draft Corporate Rehabilitation Act (CRA) (SECP, 2009c). The law was authored by Salman Ali Shaikh and Feisal Naqvi, and ratified by the Banking Law Review Commission in 2004 (SECP, 2009a). After much delay, the Ministry of Finance constituted a committee to review and finalize a draft of the CRA in April 2009, under the chairmanship of Salman Ali Shaikh, who had by this time become the chairman of the SECP. Other attendees included a number of

industrialists, while meetings were also held to take on board bankers and lawyers (SECP, 2009b). In November 2009, the draft CRA was handed over to the Ministry of Finance (Chaudhry, 2009). In February 2010, the federal cabinet discussed the draft law, and in June 2011—after approval by the SECP, the State Bank of Pakistan, the Ministry of Law, and others—it came to the Finance Minister for approval for submission to the Cabinet and for parliamentary debate scheduled for September 2011 (Kiani, 2011). This working paper attempts to evaluate the proposed law,[1] both at a conceptual and technical level.

Corporate bankruptcy law exists to resolve the difficulties faced by firms in financial distress. It is the set of legal processes through which insolvent firms resolve their debts. The law needs to be designed so that debtor firms can resolve their problems quickly and effectively. If designed badly, bankruptcy law can give firms' managers incentive to take excessive risks, cause efficient firms to close down, or lead to a flight of investment from the country (White, 2005). Here, we analyze how a country's bankruptcy law can lead to such occurrences and how the code might be reformed to avoid these perverse outcomes.

Having briefly discussed above the background to this proposal for reform and charted the history of its development, Section 2 reviews the economic justifications for bankruptcy laws in general. Bankruptcy is a legal construct, and not every firm that fails needs to enter bankruptcy proceedings. In the law (in stark contrast to its definition in the English language), bankruptcy is a tightly defined term. Section 2 also underlines the specific economic reasoning for the bankruptcy process and the limited effectiveness of bankruptcy.

Section 3 then moves to a specific discussion of the CRA both in its own right and in comparison with other laws, primarily US bankruptcy law—in particular, Title 11 of the United States Code (USC)—on which it is based. The principal architects of the CRA admit that, while drafting the CRA, they have tried to follow closely the American model of bankruptcy law (Shaikh & Naqvi, 2008). Understanding where the proposed Pakistani law deviates from the USC will allow us to highlight the strengths and weaknesses of the CRA relative to a mature and highly evolved set of laws. Moreover, there is a large body of scholarship

[1] Our analysis is based on the latest publicly available draft of the CRA (SECP, 2009d).

analyzing changes to and the current state of US bankruptcy law. If we can identify similarities and differences, we can also determine what criticisms or praise of the USC might apply, in turn, to the CRA. In this section, we attempt to (i) summarize the key features of a very complicated legal document, (ii) explain the linkages between different sections of the Title, and (iii) explore alternative designs through a discussion of how different countries undertake insolvency differently.

Finally, in Section 4, we summarize, make recommendations, and conclude the paper. We argue that the intended goals of the CRA are incorrect and that its implementation is flawed. We conclude that the CRA needs to be reconsidered in detail before further proposals for its implementation are put forward.

2. The Economic Theory of Bankruptcy

Bankruptcy is a particular legal construct that regulates firm behavior in certain situations. The form the law takes during such times needs to be determined by lawmakers. In order for lawmakers to design a bankruptcy code, they must first articulate the case for a bankruptcy code.

This section seeks to provide a theoretical framework through which to test the qualities of the particular bankruptcy laws we will discuss, by outlining some arguments for and against bankruptcy. In addition, we underline the limited application of changes in bankruptcy to economic rehabilitation.

2.1. Bankruptcy as a Legal Construct

According to Baird (1987),

> It is possible—and, indeed, desirable—to imagine a world without bankruptcy law. Bankruptcy law works against a backdrop of other rights. It can be best understood and disputes in bankruptcy can best be understood when this principle is kept in mind.

In common parlance, bankruptcy is identified as the terminal failure of a firm. As a legal concept, however, bankruptcy has a different, more complex meaning. In drafting a bankruptcy code, lawmakers must be acutely aware of the distinction between (i) being a failed firm for economic

or liquidity reasons, and (ii) being a bankrupt one. It is possible for a firm to fail without ever entering bankruptcy proceedings, and equally possible for it to enter bankruptcy despite having a positive net worth.

It is similarly possible for an economy to function without the presence of "bankruptcy" laws. Moreover, developed countries have bankruptcy laws that differ significantly from one another, and there is no prima facie evidence that one is superior to the other. In fact, it has been suggested that fundamental differences across economies—such as access to different types of information—imply that different types of bankruptcy codes suit each particular system (Berkovitch & Israel, 1999). Even the aims of different bankruptcy laws can be very different: some, such as old English laws, heavily favored maximal recovery for creditors; others, such as current American laws, often favor debtors more.

Modern bankruptcy often consists of the following elements:

I. An automatic stay: a restriction levied on creditors and others, restricting recovery efforts against the debtor outside of bankruptcy proceedings.

II. A reprioritization of the debtor's obligations: changes (either major or minor) to the order in which obligations such as debt must be paid.

III. The acceptance of a rehabilitation plan or entry into liquidation: decisions made concerning the firm's future based on its health and on the voluntary restructuring of debt by its creditors.

IV. Discharge: the cancellation of some outstanding debt at the time the firm leaves bankruptcy.

These elements can vary widely in form and other equally important elements may exist, but a useful starting point may be to consider both the purported advantages and disadvantages of a bankruptcy regime that includes these elements.

2.2. The Case for Bankruptcy

2.2.1. Rehabilitation of Viable but Illiquid Firms

The first argument in support of a bankruptcy regime is superficially appealing: imagine the case of a firm that is viable in the future, i.e., has

a positive future stream of expected profit, but has earlier incurred heavy costs and has existing obligations that it cannot honor. From society's (myopic) perspective, costs already incurred are sunk and irrelevant to how resources should be allocated. Therefore, society will not choose a situation in which creditors force the firm to sell its components to recover as much of their assets as possible.[2] Economic efficiency, it would seem, lies in protecting the firm from liquidation or reorganization. From this perspective, a bankruptcy law that forces creditors to maintain the integrated firm is preferable.

This first argument for rehabilitating future-viable but illiquid firms through the renegotiation of debt (or its outright discharge) is an appealing one, and is an implicit component of the CRA authors' writings justifying that law. Unfortunately, the argument is fallacious or, at least, of extremely limited scope, because the case described above ignores the dynamic implications of rehabilitating such a firm to wit that, if managers know that they are likely to have loans written off or renegotiated ex post, they are more likely to make risky or even deliberately loss-making investments ex ante. Rehabilitation can thus engender dependency within the system.

2.2.2. Relieving Overwhelming Debt

The second argument for a bankruptcy regime is that society should have systems in place to relieve overwhelming debt as an end in itself, or because this is needed to encourage debtors to undertake risky but profitable investments that they would not otherwise take, thus facilitating economic growth. In other words, bankruptcy may be useful as a risk-spreading tool (see, for example, Sachs, 2003).

Consider a situation in which an honest but unlucky entrepreneur finds herself in extremely difficult circumstances through no fault of her own. While we may we wish to relieve her from her circumstances, it does not mean, however, that debt discharge is the best policy response to these moral objectives. There are several reasons for this.

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[2] Even when future profits are maximized by maintaining an integrated firm, private incentives may be such that individual creditors remove property on which they have a security interest, leaving the firm broken up.

First, regardless of morality or circumstance, relieving a debtor's debt means that riskier investment decisions become more likely, as discussed above. The systematic discharge of debt will not just benefit the honest-but-unlucky entrepreneur discussed above, but also investors making risky investments in the knowledge that they will not have to bear completely the cost of failure. Other ways of dealing with such issues—such as improving corporate governance, tightening legal enforcement, and increasing vigilance on the part of shareholders—could all help mitigate this, but ceteris paribus, the effect remains.

Second, there is a lack of symmetry to this argument. Imagine a world where a businessperson takes a loan and invests in a risky venture. If the industry remains profitable, she earns profits and repays the loan. If the industry starts making losses, she makes losses too and goes bankrupt, thereby not repaying the loan. If we wish to subsidize the unlucky entrepreneur (by writing off her debt) for losses that were arguably out of her control, we should be equally eager to tax the lucky entrepreneur.

Third, if society wishes to rehabilitate its sick firms, the argument must be that this is in the public interest—that is, there are social benefits to rehabilitation over and beyond the debtor's personal pecuniary advantage. We are then essentially saying that debt discharge is a public good. If this is the case, then it is hardly egalitarian for a small number of creditors to have to bear these risk-spreading costs (which they do since they bear the full costs of the debtor's failure). Instead, these costs should be spread, just as they are for other public goods, in the form of taxes.

Finally, investors already enjoy insurance against suffering debilitating, life-changing losses due to investment decisions, in the form of limited liability laws. If a limited-liability company (LLC) cannot meet its obligations, investors and creditors alike will share the losses incurred. However, the superiority of this form of risk spreading is that risk spreads only to those willing to share in the risk (as willing creditors of an LLC).

This second argument then, is only fractionally stronger than the first. It bears underlining that the main economic argument for bankruptcy is not that firms should be propped up or overwhelming debt relieved.

2.2.3. Cheaper Credit

The third argument for bankruptcy laws is that, by restricting unilateral recovery efforts (through the automatic stay), bankruptcy procedures may ultimately recover more of the initial loan for creditors by preserving the value of the firm in bankruptcy. On the other hand, since debt discharge in bankruptcy can lower the ability of creditors to recover loans, bankruptcy may also lower overall recovery. It is an empirical question then, whether creditors recover loans better with a bankruptcy regime or without. Since this argument can work either in favor of, or against, the introduction of bankruptcy laws, it may only be used with some empirical evidence one way or the other.

The fundamental tension between protecting creditor and debtor interests can be seen in a comparison of European experiences. The level of protection (from creditors) given to a firm's assets varies among all European countries, with France offering the highest protection, followed by Germany, and the UK.

France, as is discussed elsewhere in this paper, has one of the most debtor-friendly (or creditor-unfriendly) bankruptcy law regimes relative to other countries, as its top priority has been to preserve employment and the continuation of the firm. Consistent with this inclination, the participation of creditors in the reorganization plan is also minimal, and the decision to reorganize depends to a large extent on the courts' discretion and does not demand a formal voting procedure (Blazy & Chopard, 2004). The friendly nature of France's code toward debtors has serious implications for creditors' recovery rates. On the other hand, as British law is very creditor-friendly, British banks rarely forgive debt so as to credibly commit to being tough in negotiations and avoiding strategic default by firms.

Franks and Davydenko (2008) have studied the impact of a country's insolvency code on banks' recovery rates, using a sample of 2,280 firms across the UK, France, and Germany. Their results clearly show that the median recovery rate in bankruptcy is lowest in France (39 percent) relative to 61 percent in Germany and 82 percent in the UK. Furthermore, the harshness of the insolvency code also affects the level of collateral that banks demand.

If a bankruptcy code is creditor-unfriendly (as in the case of France), creditors are expected to demand more collateral ex ante. Franks and

Davydenko (2008) provide evidence that the above theory holds and that French banks ask for more collateral per dollar of debt, relative to banks in the other countries sampled. The median level of collateral was 41 percent of debt outstanding in Germany, compared to 62 and 104 percent in the UK and France, respectively.

The above variables should influence a firm's level of investment, i.e., higher collateral levels and creditors' low recovery rates should have a negative impact on a firm's investment. The former increases the cost of borrowing and the latter increases the risk of lending. Pindado, Rodrigues, and de la Torre (2008) investigate this relationship and consider how the various procedures of a bankruptcy code can change a firm's level of investment. According to their study, the two most important aspects of a bankruptcy process that influence investment are (i) the allowance to file for reorganization without creditors' consent, and (ii) creditors' inability to control the reorganization process. Pindado et al. find that if a bankruptcy code incorporates both these aspects, investment will be more sensitive to cash flows. The reason for this relationship lies in the argument that creditors bear more risk if either of or both these factors are present in an insolvency code, as they cannot influence the restructuring process and are not in control of their payoffs, post-bankruptcy. In response to this greater risk, creditors will demand higher interest rates and the firm's level of investment will fall.

The differences between various codes discussed in this section are a snapshot of the competing aims and benefits of alternative design features of a given bankruptcy law. The discussion is far from exhaustive, but it serves to underline the argument that any given feature of the law is likely to favor either creditors or debtors in practice. Where the balance is made should be determined through a careful analysis of the economic benefits of favoring one over the other. Favoring debtors can help achieve efficiency as a solution to the immediate problem, i.e., rehabilitating sick firms in the short term, but favoring creditors can help increase the availability of credit in the system, favoring longer-term solutions to the problem of "sick" industries.

The French experience yields another, more specific, lesson for Pakistan. French law, as we have just seen, is very debtor-friendly, protects a firm's assets, and attempts to give firms the best possible chances of survival. The unintended consequence of this is that creditors in France require much greater collateral ex ante than in neighboring countries,

since the former expect little payback of unsecured credit in the case of a bankruptcy filing.

In Pakistan, a different debtor protection mechanism has had similar consequences: Pakistani law allows LLCs. However, since debtor default reached very high levels in the past, creditors have been increasingly prone to contracting around that law by requiring personal guarantees from firms' directors, in effect turning LLCs into personal-liability firms once again. Naturally, this means not only that fewer people are willing to serve on boards—to the detriment of corporate governance—but also that credit becomes more expensive.

This tendency of creditors to insist on personal guarantees has been cited by the CRA's authors as a problem that they wish to rectify using bankruptcy law reforms. There are significant parallels between this move and the debtor-friendly nature of French bankruptcy laws, and similar outcomes are likely: the more the law is made debtor-friendly and emphasizes firm continuation, the more likely that credit will dry up or become expensive. The better the chances of creditors recovering loans ex post, the lower the interest rate, and the greater the availability of credit ex ante. Recovery rates both inside and outside bankruptcy are, therefore, likely to affect investment decisions and growth.

A related argument for bankruptcy is that, by allowing debtors to have their loans discharged in some (loss-making) cases ex post, the system incentivizes creditors to be more diligent in providing loans ex ante, by scrutinizing a firm's health before they provide additional credit, etc. This argument is predicated on the assumptions that creditors can and should monitor a firm's health.

There are two responses to this. First, if creditors are forced to monitor firm health in an environment of lower contract enforcement (as a consequence of bankruptcy discharging loans), they are likely to lend only with collateral or to firms with whom they have long-term relationships.[3] Second, whoever bears the loss in loss-making cases will

[3] This can be convincingly demonstrated using game theory through the classical "agency" or "trust" game, without and with contracts ensuring the investor's payoffs. The investor moves first and decides whether or not to invest; the debtor moves second and decides whether or not to appropriate. Contract enforcement allows the efficient equilibrium of "invest, cooperate" to be reached.

have incentive to make the correct decision beforehand regarding the possibility of entering such a situation. Thus, an equally valid argument might be that bankruptcy should not remove the firm's liability since the latter should scrutinize its own health at the time of taking the loan, and can do this better because it has more information about its local circumstances than the bank.

2.2.4. Collective Bargaining for Recovery

When a firm approaches the point of being unable to repay loans, creditors' unilateral actions to recover outstanding loans can often be worse from society's perspective than collective action. Arguably, the strongest argument for bankruptcy is that it replaces individual bargaining with collective action in such situations.

Consider the following scenario: the absence of bankruptcy laws. A firm has assets worth PKR50 million which it is using to produce output from which it will earn PKR100 million one week later. It has cash in hand totaling PKR10 million, and it has loan repayments due today to eight creditors of PKR10 million each (totaling PKR80 million). From an economist's perspective, such a firm is viable in the future and should be protected because it can create extra wealth of PKR50 million (output minus assets). It is not, in the long term, insolvent in the balance sheet sense. However, it has loans due today that it cannot pay using the available cash, thus it is insolvent in the cash flow sense (see Section 3.1.2 for a more detailed discussion of these terms).

An individual creditor might then reason as follows: If I push to recover my loan today but no one else does, the firm can pay me now and pay the others later. However, if I push to recover my loan today and everyone else does too, the firm will have to sell its assets prematurely to distribute a total of PKR60 million among us. If I do not push to recover today and no one else does either, I will be paid my loan one week later. However, if I do not push to recover today and everyone else does, the firm will still be liquidated, they will all get a portion of what is owed them, and I will be left with nothing.

A creditor reasoning about his or her private payoffs in a noncooperative (with other creditors) world will always push to recover his or her loans. The self-interest of individual creditors is opposed to the interests of the group as a whole. As more and more creditors recover loans

unilaterally, the lower the probability of being paid, and the greater the rush to be paid. This is called "the race to recover," and it is capable of debilitating a healthy but illiquid firm.

Now imagine the same scenario *with* bankruptcy laws in place. As creditors start trying to recover, the firm files for bankruptcy. An automatic stay immediately stops creditors from trying to recover money privately. A reorganization plan is proposed, which redraws the firm's obligations such that it pays each creditor the PKR10 million it owes, but only after one week. The plan is accepted, the firm goes ahead with its original plans, earns PKR100 million in a week's time, and is able to pay each creditor at that time.[4]

Bankruptcy thus changes procedures in such a manner that all those to whom the firm has outstanding obligations can act collectively, and increase the total paid back. Moreover, this logic is not restricted to a healthy but illiquid firm. If a firm is making losses and needs to be liquidated, it often needs to be sold off in parts. If the sale is made gradually or if the firm's components are sold in bundles (for an early discussion on this, see Posner, 1986, Chapter 14), it can recover more money while winding up than it would do otherwise. In such situations, and more generally in all situations where the revenue generated increases if creditors' actions are coordinated, the automatic stay and bankruptcy can be very useful.

There are, however, two caveats to this argument. First, the value of bankruptcy is linked to how harmful the race to recover actually is. Thus, in situations where creditors are able to coordinate with one another—e.g., when the number of creditors is small and there is repeat-interaction with one another over time—the value of this argument diminishes. Second, the race-to-recover argument is not one for bankruptcy, but for coordinated action by creditors ex post, i.e., after a firm nears cash flow insolvency. The natural question then is: why cannot private actors achieve coordination themselves? For example, creditors can insert clauses into their loan contracts ex ante to make negotiations less costly in such situations. Similarly, the situation described here is neatly solved if a large bank or holding company buys out all existing creditors, and then simply waits one week before reaping profits.

[4] This example assumes critically that the costs of bankruptcy proceedings are less than the PKR20 million-advantage gained.

An argument of the economic analysis of contract law is that a contract differs from a perfect or complete contract only to the extent that leaving a gap in the contract is more costly than the expected benefit of writing in a clause. When a gap is left, the state can provide a default rule (in this case, the bankruptcy code), but individuals should have the ability to contract around the default rule.

The law of most countries, including the USC and CRA, does not allow such ex ante private bargaining to contract around the bankruptcy law. In the US, the ability to waive or contract around bankruptcy law is debated. Some courts have read Section 510(a) of Title 11 as suggesting that bankruptcy rights can be waived. This is, however, hotly disputed by others.

There are some limited ways of contracting around at least portions of bankruptcy. In the US, one example of this is writing a loan contract stipulating that the debtor will waive the right of automatic stay in bankruptcy (a stay waiver). Another is for the debtor to agree to a reorganization plan with its creditors before filing bankruptcy, and filing this plan and the bankruptcy petition together (a prepackaged bankruptcy) (Skeel, 2003). On the other hand, Section 541(c) of the US bankruptcy code states that pre-bankruptcy agreements that withhold some property from being considered in bankruptcy become invalid. In balance, it can be said that bankruptcy regimes tend to restrict the scope of private bargaining on this issue. Whether such restrictions should exist, however, is strongly disputed.

The dynamics of the potential race to recover debt unilaterally throw up a strong justification for having a system to coordinate between creditors ex post. In the absence or deficiency of private contracting, bankruptcy laws can play a powerful role in preserving firms' value as they become illiquid.

To summarize, we have discussed four arguments for bankruptcy: (i) rehabilitation, (ii) debt relief, (iii) cheaper credit, and (iv) collective action to recover. In our estimation, number (iv) is a valid justification for enacting bankruptcy laws under some conditions, whereas number (iii) is dependent on empirical evidence. To use the latter as an argument to deviate from the freedom to contract, we believe that the burden of proof lies with those seeking the reforms; until such proof is provided, this cannot be a valid argument in support of a bankruptcy law. We also stated that number (ii) is potentially a good aim, but that

bankruptcy is the wrong process through which to achieve it. Finally, we elaborated on how trying to rehabilitate firms through bankruptcy law reform may be erroneous.

Since the criteria by which one evaluates the proposed laws hinges crucially on what one considers the underlying ends, and because the proposed laws explicitly consider rehabilitation to be their central ends, the next section discusses in detail why bankruptcy is poorly conceived as a way of rehabilitating firms.

2.3. The Case Against Bankruptcy as a Tool for Firm Rehabilitation

2.3.1. Firm Failure is Not Prima Facie Cause for Concern

First, consider that firms should not normally be propped up. Some firms should fail: the concept of efficiency in a market economy hinges on the free entry and exit of firms from markets. A poorly run firm, or one that is well run but situated in a declining industry, should be allowed to go out of business and shut down completely to free up factors of production for other, better uses. The free entry and exit of firms from the market is the disciplining force that makes markets efficient.

The closure of a firm is simply an acknowledgement that there are better uses for the resources hitherto allocated it. These resources do not vanish into thin air, but should find other, more efficient uses. In fact, if the firm that closes was inefficient, shuttering it may eventually lead to growth as the resources freed up are slowly absorbed into alternative uses.

Unfortunately, the idea of shuttering a firm is inimical to most people because it is viewed as failure and loss rather than as an opportunity to improve the allocation of resources. The fallacy, as expressed by the architects of the CRA is that "companies are normally worth more alive than dead" (Shaikh & Naqvi, 2008). The problem with this statement is that it ignores the efficiency with which the firm is working, and the signal that supporting it sends to other firms—to wit, that it is all right to perform poorly since government support can be counted on. A better starting point would be to have said: "Companies viable in the future without outside support are worth more alive than dead." In other words, "sick" companies may actually be worth more dead than alive.

Equally unfortunately, many bankruptcy regimes around the world attempt to rehabilitate "sick" firms and industries rather than limiting themselves to solving the issue of creditors' race to recover. This is more likely a response to lobbying efforts and rent seeking than a result of prudent economic management.

Second, to prop up weak units is, possibly, to reward failed management. Engel (1984) captures the logic best: propping up failing firms is equivalent to "setting economic Darwinism on its head," he says. Facilitating bankrupt firms makes firms more likely to enter bankruptcy in the future too, since the private costs of bankruptcy have been lowered for the firm, and society continues to bear the social costs of bankruptcy, which are unlikely to have changed significantly.

Finally, a bankruptcy regime that is explicitly rehabilitative may be very vulnerable to abuse. It is possible that morally bankrupt individuals will attempt to design firms whose investment decisions are planned to take advantage of the reallocation of obligations through rehabilitation. In other words, a rehabilitation regime may fall prey to firms being set up not to maximize their profits over time, but to maximize the payoffs of a few managers. By drawing abnormally large wages or taking super-priority loans from a sister company, for example, a firm may enrich those who control it, at the expense of creditors, the government, and hence the public. This is a particular concern in Pakistan, where loan default is often linked to political strength (Khwaja & Mian, 2005), creditors are often publicly owned institutions rife with principal-agent problems, and bureaucratic oversight is flimsy.

2.3.2. Residual Claims and Rehabilitation

Using bankruptcy as a tool for rehabilitation means that deciding whether a firm is to be rehabilitated or allowed to fail becomes the business not of those who will have to pay the consequences of the decision, but that of government officials, bureaucrats, and judges, who are not likely to have as much information, expertise, or incentives to make these decisions carefully. The idea that it is the courtroom, not the boardroom, where sound economic decisions are more likely is, at best, heroic.

The state can thus become crucially involved in the economic management of large parts of the economy, and this is replete with problems. The decision to reorganize a firm can already be made by the

market mechanism[5] in the guise of private debt restructuring and hostile takeovers. So too can a firm be wound down in the form of vulture capitalism. When a firm is worth rehabilitating but illiquid, it may be bought by others willing to invest in it. If bankruptcy law is to infringe on the free working of the market, it should at a minimum make clear what the shortcomings of that existing system are.

2.3.3. Bearing the Costs of Rehabilitation

When it is decided that a firm is worth saving and needs to be rehabilitated, costs must be incurred in its rehabilitation. The state cannot prop up firms costlessly. In order to do so, it needs to tax citizens or take debt, both of which are separate strains on the economy and ultimately on the public. Deciding that the state will actively rehabilitate "sick" units requires one to assume that taking money from individuals in the form of taxes—or future taxes in the case of sovereign debt—and reallocating it to such industries is the best use of those taxes (instead of, for example, spending that money on developing infrastructure or paying existing debt). The burden of proof for this should lie with the rehabilitation authority.

A societal disadvantage of rehabilitating firms through the legal system is that the shift of obligations from the firm to citizens is opaque: writing off debt owed to government agencies or giving low priority to taxes and other government claims in bankruptcy are real costs imposed on the citizen, but these costs are less visible in the eyes of the public than, for example, an increase in taxes. This disadvantage, however, is potentially a short-term advantage to politicians (if they are more likely influenced by the rehabilitated firm than by the average voter). As a general rule, however, a clear cost allocation—such as taxing citizens and directly subsidizing firms to be rehabilitated—is preferable to the citizen than an arcane one—such as lowering the repayment priority of taxes in bankruptcy.

2.3.4. Rehabilitation is Already Provided for

One of the justifications for bankruptcy as a rehabilitation tool is that investors carrying heavy debt are buried under and cannot re-undertake

[5] This is not to suggest that the market necessarily works perfectly. There may be problems of information incompleteness or asymmetry, for example, or of agency.

entrepreneurial activity. The law already provides investors the means for a fresh start in the form of the LLC. When an LLC folds, investors are clear of all related debt as soon as the company dissolves and can begin new ventures tabula rasa. The "fresh start" justification is, therefore, irrelevant to corporate bankruptcies and applies only in the case of personal bankruptcies, which are neither the subject of the proposed reforms nor of this paper.

Limited liability, like bankruptcy, is in part a means of insulating debtors from the consequences of their actions. This carries tremendous risk for creditors, and they may sometimes provide credit only if debtors agree to sign personal liability clauses—in effect, avoiding the limited-liability structure—which is often the case in Pakistan. That creditors will avoid limited-liability laws—in the form of the precondition that a firm's directors incur personal liability—simply means that they consider loans to LLCs to be risky enough. This does not stop LLCs from coming into being but does mean that, in many cases, they must finance themselves by means other than taking loans from banks. Having signed such documents, failed entrepreneurs should not be allowed to cry foul ex post.

The prevalence of the personal liability clause in the provision of loans is indicative of creditors' unwillingness to provide loans in situations where individuals can avoid their obligations in some cases. Bankruptcy laws emplaced as a response to the personal liability clause simply forces creditors into a situation they are not willing to enter voluntarily—this cannot be a proposed law's underlying objective.

2.3.5. The Threshold Question[6]

Giving firms tax breaks and other advantages in bankruptcy implies that one believes bankrupt firms to be worth this subsidy more than firms that are equally weak financially, but not legally bankrupt. The structure of any bankruptcy law must account for this implication and attempt to avoid it as far as possible. Firms within and without bankruptcy should be treated the same way to the extent possible. Rehabilitation goals should not imply, for example, that creditors be denied interest on loans during bankruptcy or that taxes be automatically written off. Generally, a firm should not be at an advantage by virtue of having entered

[6] The use of this term follows Baird (1987).

bankruptcy. Bankruptcy does not create rights, and it offends common sense to think otherwise.

In the US, the nonbankruptcy world serves as a reference point during proceedings. The Butner principle (*Butner v. United States*, 1979) states that bankruptcy law changes nonbankruptcy law only where the purposes of bankruptcy require it to; and that, in other cases, it leaves the law as it finds it. Not only is this an evaluation criterion in itself, it also forces us to make explicit what the purposes of the bankruptcy law are to begin with. Bankruptcy law should only deviate from nonbankruptcy law to the extent that the latter fails to protect firms that are worth protecting or allows firms that should not continue to do so.

2.3.6. Competing Methods of Rehabilitation

For all the reasons outlined above, bankruptcy is hardly the ideal vehicle of rehabilitation. However, that firms in Pakistan are failing at alarming rates is indisputable. Instead of overhauling insolvency laws, the state's energies could be better used to ensure that human and physical capital is protected, and that access to justice is improved.

It is evident to any casual observer that (i) the average size of a firm in Pakistan is very small even when technical efficiency requires larger size, (ii) firms tend to be family-owned rather than corporations, and (iii) access to capital is very limited. A key reason for this is the absence of real property rights. There is no central record for land titling, and land disputes are endemic. Property can be gifted orally without change in title, fictitious ownership is rife, and access to the legal system is heavily skewed toward those with economic or political power (corruption in the judiciary is alleged at all levels). Tackling these problems head on would be a more effective, but significantly more difficult, undertaking.

2.4. Restricting the Use of Insolvency

The aim of this section of the paper has been to clarify the economic justifications for bankruptcy, and to demonstrate that justifying bankruptcy law reform as a means of rehabilitating firms is bristling with technical flaws. While this does not mean that bankruptcy reform is not an end in its own right, it is necessary to undertake the remaining analysis while keeping in mind the theory discussed here.

3. Analyzing the Salient Features of the CRA

We have argued that rehabilitation provides a very weak justification for bankruptcy. Since the CRA is designed precisely for this purpose, our fundamental criticism of the proposed law goes beyond the structure and details of the document. However, despite our reservations, it is important also to analyze the legal details of the proposed document and their implications. This section, therefore, summarizes and analyzes the main features of the proposed CRA, and compares them with other codes. This serves two purposes: (i) it can be read as a summary or guide to the main elements of the CRA, and (ii) it allows a stepwise analysis of different components of the act and their merits or demerits.

We focus more on the USC as a comparator because the CRA is derived largely, albeit with heavy modification, from Title 11 ("Bankruptcy") (1978) of the Code.[7] However, we also compare the CRA and the US law on which it is based to laws from Europe. Bankruptcy laws vary across countries because different states have different goals for these laws. One country may favor debtors, another creditors. A third country may favor firms' workers over either, etc. The law can also differ because various interested parties have different lobbying power in different countries, and the law enacted is likely to respond to such differences. A reading of these differences helps understand the fundamental tension between (i) facilitating debtors in crisis, and (ii) safeguarding creditors and incentivizing credit markets.

Our section-by-section study of the CRA is not, however, an exhaustive analysis by any means. Moreover, comparing the letter of the law is not equivalent to comparing two different laws. Differences of interpretation and application of laws can mean that the law in practice may be very different even when two countries' formal laws are similarly worded.

[7] The changes limit the scope of the law (removing bankruptcies for municipalities and individuals, for example); make substantial changes to the relation of different chapters (requiring liquidation to occur after rehabilitation has been attempted); remove US specific clauses; and attempt to shorten and simplify the process of bankruptcy. These changes drastically reduce the length of the CRA (50 pages) compared to the US bankruptcy code, which is more than 500 pages long and introduce features absent in the latter. However, the vast majority of clauses are copied directly from US law.

The first thing to note about the proposed bankruptcy law is its name: the "Corporate Rehabilitation Act;" its basic aim is thus to "rehabilitate" corporations. The preamble states:

> It is necessary to provide for the rehabilitation, reorganization and restructuring of distressed corporate entities—so as to encourage economic growth and development (SECP, 2009c).

This aim is substantially different from that of the US bankruptcy law from which the CRA is derived. As discussed in the previous section, bankruptcy is ill conceived as a rehabilitation tool. It is one thing to restrict the new law to the corporate sector, but a good bankruptcy code does not rehabilitate firms at any cost, as the authors undoubtedly recognize.[8] A critical component of the CRA is that failed rehabilitation leads to liquidation. Therefore, we believe that a better title for the proposed law would be "Corporate Bankruptcy Act." In the law, semantics matter, and it is misleading—perhaps even to lawmakers—to mention rehabilitation alone in the title and preamble.

3.1. Case Administration

3.1.1. The Bankruptcy Forum

A major departure of the CRA from US bankruptcy law is the matter of where bankruptcy cases are heard. The US has separate bankruptcy courts—with specialized bankruptcy judges—specifically designed to consider cases in one place. These courts have national jurisdiction, i.e., if one party files a case in a court in one part of the country, the other party must respond in that court even if it does not have links to that region. Bankruptcy courts operate under the federal district courts—i.e., the district courts have original jurisdiction over the cases, which they turn over to bankruptcy courts as a matter of routine, but not always—and usually function without juries (Baird, 2001, p. 24).

[8] Our reviewer suggested that the CRA state its aim as being to "relieve the economy of the burden of distressed corporate entities through their rehabilitation and reorganization or liquidation." We agree.

In Pakistan, the CRA proposes that the high courts hear bankruptcy cases without the benefit of specialized judges and follow the usual procedures of a high court case. This, perhaps, acknowledges resource constraints: it would require significant judicial reform to introduce specialized courts. However, it also means that the Pakistani context requires that the USC's Title 11 be adapted—which the CRA attempts to do—to compensate for the lack of specialization and other differences. Even so, we believe that a case can and should be made for specialized bankruptcy courts due to the complexity involved, and that the argument of resource constraints is not enough to undermine this case. At the very least, specialized judges must sit on the bankruptcy benches during such proceedings.[9]

3.1.2. Case Initiation

A case starts under the CRA when a petition is filed seeking an order of relief—i.e., a court order that the debtor is insolvent—first with the office of the relevant official administrator—appointed for a five-year term by the federal government with the approval of the high court's chief justice—and then with the court.

Cases can be both voluntary and involuntary. A voluntary case begins with a debtor firm passing a special resolution declaring insolvency, and then filing a petition seeking an order of relief against itself. Unless the court dismisses the case as an abuse of judicial process, the filing of such a petition is considered conclusive proof that the debtor is insolvent and entitled to relief, and relief is passed on the first day of hearing.

An involuntary case starts when one or more entities that hold unpaid claims—or right to payment, whether or not it is disputed and subject to some exceptions—totaling at least PKR50 million, which value can be updated by notification in the Official Gazette, file a petition seeking relief. The company is then issued a show cause notice asking why the order should not be passed, and containing a hearing date within two weeks of this time. The company's reply must be filed with the court and provided to all entities having filed the petition, at least two days prior to the hearing. Relief can only be ordered after this hearing, until which the company can continue to function as if no proceedings were underway.

[9] We thank Akhtar Hamid for raising this point.

The CRA differs from the USC in that the former is available to a much smaller cohort than the latter. This is obvious from its name: "Corporate Rehabilitation Act." Immediately then, individuals—who are the subject of a large part of the USC—and municipalities—also discussed in some detail in the Code—are barred from filing for bankruptcy under the CRA.

It is unclear why the CRA places a restriction on individuals: there are good arguments for allowing private bankruptcy, which may be useful as a reassurance mechanism for would-be entrepreneurs. It is even more puzzling why the proposed law does not include municipalities (which includes public works bodies and local governments in the US). Pakistan has endemic debt problems in these areas, the current circular debt crisis being only the latest issue of this type.

However, the rationale for providing bankruptcy provisions for these other entities and, therefore, the proper legal mechanism, are significantly different. By pointing to the restricted application of the CRA, we are not suggesting that it be made more inclusive without adaptation and vigorous debate in the legal, academic, and political communities. The restriction, consequently, may be prudent for now, but needs further review.

Our main criticism of the CRA's restricted focus, however, is not that it leaves out individuals and municipalities, but that it sets the bar too high for involuntary filing against corporations. Section 13 of the proposed law states that corporations may apply for voluntary bankruptcy without stating a threshold of loans outstanding, but that involuntary bankruptcies can only happen against those corporations that have outstanding loans of PKR50 million or more against those who initiate the case. The comparable figure for the US is only USD10,000—less than PKR0.9 million at exchange rates at the time of writing. Only the largest and most indebted corporations will be subject to involuntary bankruptcies according to this law.

Perhaps the reason for this restriction is to keep the high courts from being flooded with bankruptcy cases, but this is not a good enough explanation. What the high threshold for triggering involuntary bankruptcies does, effectively, is discriminate between larger and smaller firms. Because recovery efforts against smaller firms become limited, the cost of procuring capital may also be higher for these firms than for larger ones. This does not augur well, either for efficiency or distribution.

Different countries take very different approaches to how firms enter, and are treated in, bankruptcy. The CRA and the US Title from which it is derived are in stark contrast to much of Europe on this matter, and it is not clear which is the better approach. With a new bankruptcy code, Pakistan would have no need to follow the US design, and while it might still choose to do so, a review of US versus European design is worthwhile. Below, we outline these differences in the hope that there will be serious debate on the relative merits of each design before the CRA is officially adopted as law.

First, we compare the circumstances under which bankruptcy is initiated in each of these countries. Most countries have provisions both for voluntary and involuntary bankruptcy. Firms carry out voluntary filings to get court protection from creditors racing to recover loans, which can be useful when a firm has cash-flow problems but is viable in the longer term. Creditors carry out involuntary filings to force repayment.

Title 11 of the USC makes voluntary filing of bankruptcy by managers relatively easier than involuntary filing by creditors. Contrary to the common perception, it is not necessary in the US that a firm be "insolvent"[10] before it files for bankruptcy (Engel, 1984). By not requiring insolvency before a voluntary bankruptcy is filed, the US provides bankruptcy cover not only to debtors facing creditors who are actively racing to recover, but also to those who are nearing insolvency. In contrast, Germany has made voluntary access to bankruptcy relatively more difficult. The German code allows a firm to enter bankruptcy only if the expected value of its remaining assets is less than a threshold value of different type of costs (Blazy, Petey, & Weill, 2009). The CRA is closer to the German model in this respect, since voluntary filings can only be made if the firm is insolvent. This is unsatisfactory because there are important circumstances in which a firm nearing insolvency may wish to file for bankruptcy before it is insolvent on the books.

[10] The meaning of "insolvency" is similar across countries and a representative definition would be that it is the "inability to pay off debts" (Wang, 2006). Insolvency can be of two types: (i) cash-flow insolvency, or illiquidity, is the inability to pay off debts as they become due; and (ii) balance-sheet insolvency, which is the inability to pay off total debt after liquidating total assets. A firm can be cash-flow insolvent without being balance-sheet insolvent, and vice versa.

In the US, involuntary bankruptcy proceedings are harder to start, in two ways: (i) three or more creditors are required to start an involuntary petition together, and (ii) it is the creditors' legal duty to prove that the debtor firm is unable to pay their claims. The creditors' collective action problem and their lack of information regarding the firm's condition make it less likely that they will push the latter into bankruptcy. In fact, under Title 11, only 2–3 percent of Chapter 11 ("Reorganization") filings and 1 percent of Chapter 7 ("Liquidation") filings were involuntary during the period 1980–82 (White, 1996). In Europe, on the other hand, if an outside party does initiate bankruptcy proceedings, then it is up to the firm's managers to convince the court that the firm need not be bankrupt (White, 1996). Thus, the burden of proof of a firm's solvency shifts from its creditors to the debtor firm.

The consequence of harder—and, as will be discussed in the next section, less favorable—voluntary access is that, across many European countries, managers of insolvent firms are penalized if they delay filing for bankruptcy. In France, once a firm realizes that it is in financial distress, it must file for bankruptcy within 15 days (White, 1996) while in Germany, this time period is three weeks. Failure to file within the stipulated time can lead to criminal or civil lawsuits against the firm's managers (Tilley, 2005).

According to White (1996), the rationale for this penalty is that, if a firm is in financial distress, it should take outside help by initiating bankruptcy proceedings as quickly as possible rather than delaying filing and worsening its condition. However, since managers lose control of the firm in bankruptcy, they must be pushed to file at the correct time. On the contrary, Title 11 has no penalty and policy toward a delay in filing for bankruptcy, because it tends to treat managers leniently during bankruptcy[11] and hopes that this clemency will encourage them to file early when the firm is in financial distress (White, 1996).

Pakistani designers should be cognizant of two factors:

(i) Our historic weakness in punishing "default by design," i.e., where a loan is seen as a way of siphoning off resources with no intention of returning it, which suggests that voluntary initiation—as is US practice and proposed by the CRA—may not be favorable.

[11] Under Chapter 11 of the Title, the managers are likely to remain in control of the firm, and the law also grants the firm an automatic stay over creditors' claims (White, 1989).

(ii) Our institutional weakness and the problems that will arise if managers are (a) punished for late initiation, and (b) replaced by other officials upon initiation, as would happen if European practices were adopted.

This issue merits careful consideration and debate before a decision is taken.

3.1.3. Mediation

The US usually supports out-of-court settlements, but there is no court-sponsored mediation in that country. Unlike in the US, the CRA states that, when a bankruptcy case is initiated, the parties must immediately enter negotiations overseen by an official mediator. For both voluntary and involuntary cases, once relief is ordered the case is referred to mediation in accordance with (SECP-determined) regulations. The debtor-in-possession—or the administrator,[12] if one is appointed—provides a notice of the order of relief. This notice contains the date and place where the official administrator or administrator will hold a creditors' meeting, specify the name of the appointed mediator, and give the date and place of the first meeting with the mediator.

This mediator is appointed, trained, certified, and regulated by the SECP-regulated Corporate Rehabilitation Board (CRB), and conforms to SECP-mandated regulations and procedures of mediation. He or she is paid by the party that initiated proceedings, according to rates prescribed by SECP-determined regulations. The mediator tries to help all interested parties agree to a plan of rehabilitation that meets the CRA's requirements. If mediation is successful, the case can be quickly resolved, but if an agreement is not reached, the mediator files a report summarizing relevant facts and claims along with features of the proposed rehabilitation plan, and listing why some parties have refused to accept the plan.

Puzzlingly, the CRA does not provide any details about how the court will use the mediator's report. Does it have any legal value, or is it just a guide for the judges? The answer to this may determine whether the mediator helps decrease legal costs and resolution time, or becomes simply another

[12] An administrator is an official appointed by the court to look after the interests of creditors and other shareholders, or because the debtor's affairs are being mismanaged by managers, and who is authorized by the Corporate Rehabilitation Board.

costly hoop to be jumped through without any productive bearing on the dispute resolution. The reviewer points out that mediation is increasingly used as a burden-reducing aid for judges in various laws. If a party that had either refused mediation or rejected a proposed agreement loses the case, the judge may penalize it. If mediation is to be used in the CRA, it may be valuable to attach such consequences to it.

Since compulsory mediation is not a feature of the US—or, to our knowledge, of any other code—its success or failure, and consequences for other parts of the code, will become clear only once it is adopted. Close monitoring and the willingness to adapt or discard the feature are necessary for this reason. In particular, an issue that will require very close scrutiny is the fact that the mediator is paid by the initiating party. Will this make it easier for the initiating party to bribe the mediator? Might the responding party be suspicious of the mediator for this reason?

3.1.4. Dismissal or Conversion of a Case

The court may dismiss CRA cases that would abuse the judicial process. The filing entity pays all costs and a fine of up to PKR10 million, and all proceedings, charges, or transfers avoided are reinstated. However, future cases are not affected by this dismissal.

Under the CRA, a case is converted to winding up if (i) the debtor-in-possession makes an application with advance approval by a special resolution of the company; (ii) the debtor has filed a petition fraudulently; (iii) no rehabilitation plan is timely filed or confirmed by the court; or (iv) the court revokes a fraudulently confirmed rehabilitation plan. It may also be converted to winding up if (i) the estate suffers continuing losses, or rehabilitation is unlikely; or (ii) there is delay by the debtor that is prejudicial to creditors. Only the debtor, the creditors' committee, the administrator appointed in the case, or the official administrator can make an application for conversion.

When the case is converted, a liquidator is appointed. The winding up is deemed to have begun at the same time as the case started. All winding-up proceedings are carried out according to the provisions of the Companies Ordinance. The single exception is that a financial institution may initiate or continue with proceedings under the Financial Institutions (Recovery of Finances) Ordinance 2001, without seeking the court's permission under Section 316 of the Ordinance.

In the US, reorganization and liquidation are separate chapters of Title 11. Managers are free to enter either, and the court retains the power to convert a case from one type to another. In Pakistan, the CRA focuses more heavily on rehabilitation through reorganization by sending all firms automatically into the equivalent of Chapter 11 of the Title, and then sending them into winding up only if an interested party—which may be the debtor firm itself—makes an application to this effect.

There are other differences as well. First, forcing a company to liquidate (involuntary winding up) is significantly harder under the CRA than under Title 11 (instead of filing a Chapter 7 proceeding directly, Pakistani creditors have to file a CRA case and then request conversion into winding up). Second—and this is admittedly a rare and unlikely scenario—while US courts retain broad powers to convert a case from reorganization into liquidation and vice versa, their Pakistani counterparts cannot take a case filed through the winding-up procedures of the Companies Ordinance and convert it into CRA reorganization. The implications of these differences need to be considered more carefully before the proposed law is enacted.

Moreover, the actual law that governs winding up is not part of the CRA, since winding up is still handled by the existing law of the Companies Ordinance. An important question is how the CRA is to interact with the Companies Ordinance.[13] Will all windings up have to pass through the CRA into the winding-up section of the Ordinance, or will liquidations occur principally through the latter? It is our understanding that the CRA is meant for rehabilitations alone, with conversion into liquidation (using the Ordinance) as a backstop or default.

It is true that most firms in the US file for Chapter 11 reorganization and are converted into liquidation where necessary, and few file directly for Chapter 7. However, the absence of Chapter 7 undermines the coherence of the CRA as the principal law dealing with bankruptcy. More seriously, Chapter 7 (in the US) and Section 305 of the Companies Ordinance (in Pakistan) influence threat values (or alternative options) during negotiations on a reorganization plan. It is conceivable that their differences will cast a shadow that means that Title 11 and CRA, even if identical in letter, may be used very differently in both countries. Since

[13] This issue was brought to our attention by Akhtar Hamid.

the backdrop of liquidation is fundamentally important to reorganization, we would recommend that the CRA be modified to include liquidation, rather than leaving it in another ordinance.

3.1.5. The Administrator's Role

If no administrator is appointed, the debtor-in-possession continues to control the property and takes on both the rights and duties of the administrator. However, the debtor-in-possession receives no compensation (as provided to other administrators under Section 32 of the CRA). On the application of an interested party, the court may restrict these rights and duties. However, under some circumstances, an administrator is appointed as a steward of the estate and to facilitate the cooperation of the debtor company in the case.

The administrator's roles include, inter alia, (i) running the debtor's business, (ii) performing the duties assigned to him or her under the Act, (iii) evaluating and reporting on the affairs of the debtor's business, and (iv) filing a plan under the Act or recommending that the debtor's firm be wound up. Administrators may hire professionals to assist them in their tasks. Meanwhile, the debtor and his or her directors and employees must cooperate with the administrator, if one is appointed. They must surrender the estate to the administrator and appearing at hearings where necessary. The appointment of an administrator ceases, with some exceptions, the powers of the debtor company's directors and other officers.

An administrator will always be appointed in (i) involuntary cases, (ii) in voluntary cases when the management mismanages the debtor's interests, or (iii) when appointing such an administrator is in the interests of shareholders. Administrators must be certified by the (SECP-controlled) CRB, and must have a minimum of 10 years' relevant experience. On confirmation of a rehabilitation plan, or conversion of the case into winding-up proceedings, the administrator's appointment is automatically terminated. If the administrator resigns or dies during the case, a replacement must be appointed within three working days. Administrators may be replaced or their appointment terminated on the request of either an interested party or the official administrator (in which case their services are terminated from all cases on which they are serving, unless the court orders otherwise). Vacancy in the administrator's post does not affect the course of the case.

This is an appropriate place to discuss who controls the firm during bankruptcy. How a country chooses to design this is of fundamental importance to the propensity with which firms voluntarily enter bankruptcy. When a firm enters bankruptcy it must still be managed day to day until such time that it is fully reorganized or liquidated.

Control of the firm during bankruptcy is an important issue for two reasons:

(i) If left unchecked, managers who remain in control of a firm may undertake activity that runs counter to the outcome desired by the legal process—they may try to hide important information, or favor one group of creditors over others unlawfully. On the other hand, these managers might still be better administrators than any that the legal system allocates (who may even be interested in perpetuating the time the firm stays in bankruptcy if their remuneration is structured in certain ways).

(ii) Allowing managers to retain control can be an important incentive to induce them to willingly enter bankruptcy at the right time. In a system where control is taken away, managers must be incentivized to initiate bankruptcy through the threat of punishment (as discussed in the example of Germany in Section 3.1.2).

In Europe, after a firm files for bankruptcy,[14] the court appoints an outside official to take over from the existing managers. He or she then decides whether the firm should be liquidated or reorganized (White, 1996). For instance, in the UK, the firm's board of directors needs to step down during the liquidation process, while the liquidator manages the firm during bankruptcy proceedings.[15] In Germany and France, too,

[14] This does not imply that creditors cannot trigger bankruptcies in Europe. In all the European countries under consideration, creditors have the power to trigger bankruptcy and involuntary bankruptcies are pervasive across Europe (Brouwer, 2006).

[15] Prior to 2003, a creditor in the UK with a floating charge would appoint a receiver who would assume control of the firm and represent only the floating-charge creditor. However, the receivership model led to conflict among various classes of creditor as creditors would quickly seize their assets, resulting in the closure of the firm even when it could have continued as a going-concern (Franks, Nyborg, & Torous, 1996). Therefore, a new act of Parliament was passed in 2002 that disallowed the floating creditor from appointing the receiver (Blazy et al., 2009). Instead, British law now requires that a court-appointed administrator take over the firm and prepare a reorganization plan. The administrator model tries to overcome the deficiency of receivership and allows a firm to continue as a going-concern (White, 1996).

an administrator takes control of the firm and recommends a future course of action—reorganization or liquidation—to the court (Blazy et al., 2009; Franks, Nyborg, & Torous, 1996).

Blazy et al. (2009) found that, in both France and Germany, liquidation was the common course of action recommended by the administrator to the court. Of 264 cases of French bankruptcy filings, they found that 95 percent ended up in liquidation, whereas all 126 German firms in their sample were liquidated. The corresponding percentage in the UK was 85 percent. These results suggest that, in Europe, liquidation is more pervasive than reorganization. This is not surprising, perhaps, when we consider that firms do not enter bankruptcy as easily in these countries.

In France, the outside official appointed is a representative of the state rather of the creditors, and protects the debtor firm from creditors' claims (White, 1996). In fact, French bankruptcy law considers "safeguarding the business" and "protection of employment" as its primary objectives; creditors' claims are stayed for a period of 20 months (Blazy et al., 2009; White, 1996).

In a voluntary bankruptcy in the US, the firm's incumbent managers—rather than outside officials—can often choose to liquidate or reorganize since it is their choice to file under Chapter 7 or Chapter 11. Moreover, unlike in European countries, Title 11 usually allows the existing management to remain in control—as debtor-in-possession—while the firm is being reorganized under Chapter 11.

Managers' control is strengthened further by virtue of the exclusivity period: within the first four months of bankruptcy, the firm's managers even have the sole right to propose a reorganization plan while the creditors choose whether or not to accept it. The plan is accepted through a voting procedure; in case of nonacceptance, the court intervenes and decides according to the information presented by both sides (White, 2005). Thus, incumbent managers in America usually play a far larger role in bankruptcy than their European counterparts, and this, along with other factors, makes reorganization an attractive option in the US (Brouwer, 2006). A related consequence is that liquidation is more pervasive in Europe than in the US and cases of reorganization are more common in the latter than the former.

However, this is not to say that managers retain full control in the US. In all involuntary cases, and in voluntary cases where the court finds that creditors' or other shareholders' interests are not being fully protected, an outside official (the administrator) may be appointed. Liquidations are also managed by officials. Moreover, the court can order, and other parties can request the court to order, the conversion of a case filed by the management under one chapter into another.[16] Still, compared to the European countries, the US is far more likely to have incumbent managers retaining control of the firm during bankruptcy, with important consequences for how the firm is managed both prior to and during bankruptcy. In Pakistan, the CRA's designers have removed exclusivity to help speed up the process of bankruptcy (see Section 3.3). The negative consequences of this on firms' propensity to file voluntarily have not, to the best of our knowledge, been actively discussed.

3.1.6. The Creditors' Committee

The CRA envisions the official administrator appointing a creditors' committee, and also possibly appointing a shareholders' committee. Both committees must have adequate representation, and to ensure this, the court may order the official administrator to appoint such additional members as it feels necessary. The committee may (i) consult the administrator or debtor-in-possession about the case, (ii) review the debtor's relevant dealings and other matters relevant to the case or to formulating a plan, and (iii) participate in formulating a plan and advise those it represents regarding such a plan. It may also request the appointment of an administrator. Subsection 34 of the Act states that the stakeholders represented by the committee pay for it, but neither 34 nor 35 states whether the committee may hire experts to assist in its work.

3.1.7. Adequate Protection and the Automatic Stay

Once a firm enters bankruptcy, its creditors are usually restrained from pursuing individual recovery actions against the insolvent debtor. Both American and European bankruptcy regimes accord different levels of protection to the debtor firm's assets. In the US, most creditor claims are stayed automatically so that creditors stop competing for a firm's assets and reducing its going-concern value (Hart, 2000). While this automatic

[16] For example, creditors may request conversion from reorganization to liquidation even if managers have filed under Chapter 11.

stay is the norm, a creditor may be able to have the stay removed if he or she can demonstrate to the court the urgent need to do so.

As mentioned above, the debtor is protected from creditor claims in France. In the UK, only the administrator model offers the debtor an automatic stay on creditors' claims (White, 1996), whereas in Germany there is a fixed three-month automatic stay against all claims (Franks et al., 1996). Consequently, the level of protection given to a firm's assets varies across Europe, with France clearly offering the highest protection, followed by Germany and the UK.

In Pakistan, the CRA provides adequate protection to any entity's interest in property through cash payments, automatic stays, replacement charges, or other methods to the extent of the decrease in value of that entity's interest in the property. The one exception is that the entity concerned is not entitled to compensation as administrative expenses. The Technical Assistance Committee (TAC) determines whether protection is adequate.

The order of relief in this case is a stay against the commencement or continuation of relevant cases, the enforcement of judgments already obtained under nonbankruptcy law, and any acts to recover charges against property of the estate, etc. The automatic stay is thus meant to stop creditors from recovering from the debtor outside bankruptcy proceedings, once begun. The automatic stay is lifted if more than 180 days have passed since the court received the TAC's report on the plan submitted to it. It seems, therefore, that the CRA affords greater protection to debtors through the automatic stay than in Germany or the UK, and which may or may not be greater than that provided in the US.

3.1.8. Continuing Business

The CRA administrator may freely enter transactions, including selling or leasing property in the ordinary course of business, but requires a notice or hearing if such a transaction is outside the ordinary course of business. Such actions must not violate relief already granted. Any insolvency clauses in existing contracts or other legal documents will be null. Actions taken in good faith in these regards, even if reversed on appeal, will be upheld.

The administrator may obtain unsecured credit in the ordinary course of business as an administrative expense, while unsecured credit beyond the ordinary course of business can be obtained after notice and a

hearing. If credit cannot be obtained by either of these methods, the court may allow, after notice and a hearing, credit with priority over all administrative expenses or a charge on property. If even this method fails to obtain credit for the business, the court may provide a superior or equal charge on condition that the original holder of the charge is provided adequate protection. The administrator must prove that the said adequate protection is provided. As before, if actions taken in these regards are taken in good faith, a reversal on appeal of authorization will not be retrospectively valid.

At the time the case starts, the firm may have some contracts where obligations are outstanding on both sides. These are called executory contracts, and both they and unexpired leases can be accepted or rejected by the bankrupt firm in certain circumstances. Until the contract is assumed or rejected, the debtor must meet all obligations. All parties must be provided notice of the rejection before it can take place. A party prejudiced by such rejection may file a claim for damages. Default on an executory contract or unexpired lease that is accepted is treated as default on a loan outstanding immediately prior to the date on which the petition was filed. Finally, once a case starts, parties other than the debtor may not change such contracts or leases based on insolvency clauses.

This section of the CRA, which draws heavily on the US Title, is an important feature of any bankruptcy law: the ability to continue business during bankruptcy is provided in the hope that the firm continues to seek and grasp opportunities to profit.

3.2. Creditors, Debtors, and the Estate

3.2.1. Statement of Affairs

A statement of affairs of the debtor—assets, liabilities, outstanding loans, pending suits, etc.—is to be filed with the court and official administrator within 21 days of the order of relief, and appropriately communicated to parties in interest. Failure to file the statement is grave—the debtor-in-possession or administrator may be removed and either replaced by a new administrator. False statements of affairs can lead to imprisonment and fines.

3.2.2. Claims of Interest

Once the statement of affairs has been filed, creditors can file proofs of claims of interest within 21 days, and these will be deemed allowed unless objected to in a further 14 days. This section differs significantly from Section 502(b) of the US's Title 11: instead of details on how much of the claim the court may allow, the CRA leaves it to the official administrator to determine the amount of the claim if an objection is made (if the amount determined by the administrator is objected to, the court makes its own determination). This is an immense discretion granted to these officials, and could lead to many an arbitrary, unconsidered, or dishonest determination being made.

3.2.3. Administrative Expenses

Administrative expenses are allowed from time to time during proceedings, including the costs of preserving the business, loans taken to run the business (under Section 40), wages and salaries, payment for goods supplied for the ordinary running of business, payment for agricultural produce supplied as raw material, and compensation to bankruptcy administrators. These administrative claims have priority over all other claims.

A minor revision we would recommend is that all raw material, and not just agricultural produce, be incorporated into Section 44(a)(iii) of the CRA. Section 44, which outlines the allowed administrative expenses, is far more concise than the corresponding section under Title 11 (Section 503). In particular, an important subsection left out is 503(b)(3), which deals with giving creditors and others the right incentives during the bankruptcy. For example, it allows creditors to be paid for expenses incurred in recovering property concealed by the debtor. In a country like Pakistan, where it is very likely that debtors will attempt to avoid the legal process, such incentives are greatly needed.

3.2.4. Claims of the Government

A major difference between Chapter 3 of the CRA and the equivalent text in Title 11 (Chapter 5, "Creditors, the Debtor, and the Estate") is that the former gives government claims the same (low) priority as unsecured claims. This is true for some types of taxes in the US, but certain classifications of taxes also get included in the (high) administrative expense bracket. This is an important difference and, we believe, a grave mistake.

A bankrupt firm usually has more obligations than it can meet, and outstanding losses have to be borne by all those with existing claims—classes of claims are therefore prioritized or ordered. While senior claimants can voluntarily share in the losses of junior claims—and sometimes do so to win support for their preferred rehabilitation plan—the legal order of different types of claims plays an important role in determining both the likely payment and any bargaining that might occur between different claimants.

This has implications both for private claimants and the government. Private claimants are affected in the following way: the priorities established actively influence not just the distribution of what is liquidated, but also incentives to do business with the firm both before and during bankruptcy. As an example of this importance, consider the following: working capital can be easily obtained in the US, since new loans can be borrowed during Chapter 11 reorganization, which take priority over existing claims (Franks et al., 1996). The tradeoff is that a firm just about to enter bankruptcy may have a hard time obtaining loans since creditors might anticipate future working capital to take priority in repayment over their loan (thus lowering its expected payoff). The order in which loans must be paid changes economic incentives to liquidate or continue (White, 2005).

Another example of priorities' importance concerns the costs of insolvency proceedings. These, including the wages and prices of administrators, officials, and courts, etc., must take priority over many other types of loans, the idea being that, if officials are not likely to be remunerated, they may do a worse job of completing proceedings with high levels of interest and effort. The table below shows loan priority, and how it varies between the US and selected European countries.

Table: Comparative Loan Priorities

Country	Top priority		Lowest priority	
US	Secured creditors	Costs of insolvency proceedings	Labor creditors	Others
UK	Dead securities	Costs of insolvency proceedings	Labor creditors	Floating security
France	Labor creditors	Costs of insolvency proceedings	Secured creditors	Unsecured creditors
Germany	Secured creditors	Common creditors		

Source: Wang (2006).

In the US, some types of government obligations are given low priority, and others higher. In the CRA, Section 46 proposes that all claims of the government and government-owned agencies or utility service providers—"revenues, taxes, cesses, rates and amounts"—shall be considered unsecured credit, i.e., be given lowest priority of repayment. This goes far beyond anything in the USC.

The CRA's authors seem to have envisioned this clause as a way to breathe life into sick industries. However, this is perhaps one of the most shockingly flawed clauses of the proposed law for at least three reasons. First, Pakistan's ability to underwrite the "rehabilitation" of sick industries is nonexistent. It is financially irresponsible to dole out money to private companies when government debt is stratospheric. Specifically, in designing what is effectively widespread loan write-off into the CRA, the authors were responsible for convincingly demonstrating that the money expended in this could not be allocated more productively. To the best of our knowledge, this has not been done—and in our view, automatically making government credit unsecured in bankruptcy is indefensible.

Second, compared to a healthy rival that pays for electricity, gas, etc., a failing firm is actually rewarded by this plan for failing, by having its government obligations written off. Coupled with the fact that Pakistan has a large public sector, this means that a corporation can shed large swathes of its obligations by a trip through bankruptcy. The CRA, in other words, provides the worst firms a prize for coming last.

Third, having such a clause in the proposed law actually incentivizes businesses to run up large debts against the government, and then enter bankruptcy to have them written off. Since corporations are run by private parties that directly benefit from these write-offs, and given that the government is run by officials who do not directly benefit by resisting the write-offs, it is likely that abuse of the system will be largely unchecked and that the state's boards and commissions will not have the combined institutional capacity to check potential fraud and abuse.

3.2.5. Property of the Estate

The CRA's authors have done largely well in adapting Section 541 of the USC to Pakistan's needs by correctly pruning that section of US-specific subsections, while leaving intact major features. The resultant Section 47

defines what is included in the property of the estate, and states, in effect, that creditors cannot insert a clause specific to the danger, filing, or proceeding of insolvency.

The CRA requires the property of the estate to be turned over to the administrator, subject to some restrictions. It also gives circumstances in which transfers made to creditors can be reversed. These rules exist to make sure that creditors do not try to recover their loans outside bankruptcy while bankruptcy proceedings are ongoing. These sections are also selected from equivalent US laws. Additionally, the CRA preserves setoff clauses—that allow mutual debt to be settled against itself—and a clause on the abandonment of property. It leaves out many clauses of the USC, such as the ones dealing with fraud and post-petition transactions.

3.3. A Reorganization Plan

3.3.1. Submission

In a voluntary case, the debtor files a reorganization plan with the petition for an order of relief, and may amend it within 120 days of the order of relief having been granted, with a further 60-day extension possible. In an involuntary case, the administrator must file a plan within 120 days of the order of relief. Any party may file a plan within the 120-day period after the order of relief is granted. This is significantly different from the USC, which gives an exclusivity period within which only the debtor-in-possession can file a plan. Details of how competing plans are voted on and what order they are considered in, etc., are left unexplained in the CRA.

In the US, debtors-in-possession have the exclusive right to propose reorganization plans during the first 120 days of bankruptcy, and have another 60 days in which to secure acceptance. This exclusive privilege of proposing a rehabilitation plan can be extended for up to 18 months. When exclusivity ends, the alternative plan proposed can often be liquidation. Lifting exclusivity has the effect of ending the automatic stay.

In Pakistan, the CRA's authors wish to emphasize speedy justice and have thus shortened all the timelines given in the USC. In the interest of saving time, they have also cancelled the exclusivity period from the USC, so that anyone can now propose a plan for the firm from the first

day of bankruptcy. One consequence of this is that Pakistani managers will be relatively unlikely to want to file voluntarily, since the privilege of exclusivity is an important incentive for encouraging manager filing in the US. This does not seem to have been addressed.

3.3.2. Contents

A plan specifies classes of interests and how they will be treated. There may be no differential treatment of claims within a class, adequate means must be provided for the plan's implementation, and the consequences of default under the plan must be listed. The plan can impair or leave unimpaired classes of claims, and modify the rights of holders of secured claims. It can also assume or reject executory contracts. If a plan is modified after a claim holder's decision regarding it, the original decision will be taken as current unless the claim holder changes it.

A weakness of the CRA, however, is that it leaves out the important clarification that modifications to a plan must meet the same criteria as the plan originally submitted. This clarification exists in the USC as 1127(a), and its absence here could complicate cases or make them prone to abuse.

3.3.3. Confirmation and Implementation

The confirmation of a plan in the CRA is substantively less restrictive than the equivalent section of the USC (1129). Courts will confirm only one plan; if there is more than one eligible plan, they will confirm the one that creditors and shareholders prefer. Plans can be rejected if the principal purpose is tax avoidance. The USC holds that each claim holder must accept the plan or be provided at least the current liquidation value of his or her claim. The CRA requires that the class of interest, but not necessarily the individual, accept the plan. In general, this change is likely to favor debtors over creditors.

The CRA holds that charges pass through bankruptcy untouched. It also states that, if a class of unsecured claims is not paid fully, no junior claims will be paid. This is a very important clause preserving the notion of classes of interest. While the CRA's authors have done well to preserve these important sections from the USC, the latter prioritizes certain types of claims: administrative and legal expenses, the costs of preserving the

estate of the distressed firm, certain wages and salaries, and many types of taxes. None of these priorities are preserved in the CRA.

Once confirmed, a plan binds the debtor, creditor, or shareholder, and entities issuing securities or buying property under the plan. Except where the plan provides differently, claims on property and debt will be discharged, and the rights and interests of shareholders terminated. The debtor or a designated entity must then implement the plan.

A confirmed plan may be revoked if it was procured by fraud, and efforts will be made to protect entities that acquired rights in good faith reliance on the order of confirmation. However, an important clause of the USC (Section 1144) that has not transferred to the CRA's equivalent section (Section 60) and which could cause abuse by omission, holds that revoking a plan automatically revokes the debt discharge of the debtor.

3.4. Supporting Institutions

3.4.1. The CRB

The CRB's major function is to regulate and certify the mediators, administrators, and accountants needed to implement the CRA's laws. It is also meant to encourage scholarship and periodically review the country's insolvency laws. The board comprises no more than six members, including a chairperson. The members are expected to be experts in a field related to insolvency, such as law, economics, or accountancy. They serve three-year terms and may hold two terms. The board may also employ consultants and other workers as necessary. The SECP appoints members and the chairperson, approves bylaws, determines how accounts are to be held, and receives audit reports.

3.4.2. Corporate Rehabilitation Companies (CRCs)

CRCs are companies that acquire nonperforming loans (NPLs) from financial institutions to restructure and resolve them, and which revive or liquidate distressed firms. CRCs are not allowed to engage in speculative transactions, aid other companies in exploiting insolvency laws, or circumvent the fair valuation of NPLs. CRCs are also not allowed to conduct business, except at arm's length.

The SECP licenses and approves the incorporation of CRCs, and regulates them. It may also require a CRC to provide it relevant business information, and order inquiries and special audits on the basis of which it can issue specific directives to the CRC.

3.4.3. The TAC

The TAC is a 15-member committee, members of which are appointed by the SECP for three-year terms. It determines whether plans submitted before the court are fair and equitable, or the modifications needed to these ends; the liability of secured creditors; and whether claims are justified based on "generally accepted accounting principles." The chairperson is empowered to decide members' access to cases, and is appointed by the SECP.

3.4.4. Miscellaneous

The SECP can make regulations and rules that are necessary to carry out the CRA, for which it must elicit public opinion in the Official Gazette. It also has the power to issue relevant directives and guidelines.

In the US, a trustee oversees bankruptcy cases (this role being very similar to that of an official administrator under the CRA). This is necessary because bankruptcy cases are prone to abuse, and the trustee is tasked with ensuring that this does not happen. He or she must protect the interests of small, dispersed creditors facing a suit against a large, monolithic debtor. These interests need safeguarding due to the collective action problems that creditors might face: a small creditor is likely to have only a small effect on proceedings in a large bankruptcy suit, and the benefits of this may not be worthwhile compared to the possible loss from losing the case. The US trustee acts to secure small creditors' interests.

Under Title 11, Section 1104, the trustee may also appoint examiners whose job it is to verify that the debtor does not prefer one creditor over another unfairly. In bankruptcy, loans must be paid according to rank or class. A higher-class loan must be paid before a lower-class loan, and creditors in the same class must be paid or treated equally. When obligations are great and the debtor cannot pay everyone, he or she may have outside interests to pay one creditor more than another of the same class. For example, the debtor-in-possession will prefer a creditor with

political influence or one who secretly agrees to pay the debtor a portion of what he or she recovers, over one who does not offer these advantages (this is called "fraudulent conveyance"). It is the trustee's job to ensure that such illegal discrimination does not happen.

Pakistan needs far stiffer oversight to ensure that bankruptcy is not abused. With weak political institutions and a less robust capital market, we face a larger likelihood of attempted fraud in bankruptcy. First, fraudulent conveyance is likely a larger threat in Pakistan because businesses assiduously cultivate political favor and it is relatively easy to make secret monetary transfers in the absence of the auditing and income recording standards in place in the US. Second, Pakistan needs to protect not just small creditors facing collective action—or free-rider—problems, but also large creditors with significant principal-agent problems. If the creditor is a large financial institution on whose behalf an individual banker is sanctioned to pursue loan recovery, this agent may not have the correct incentives to pursue the case with vigor, especially if the bank is publicly owned.

3.4.5. Going beyond Title 11

US bankruptcy law is much more than Title 11 of the USC. For one, states often enact their own laws that apply in bankruptcy cases, so that the bankruptcy law applied in a representative case may differ from Title 11. The reformers behind the CRA would do well to study these additional state-level laws and why they were needed to supplement Title 11.

More importantly, US courts routinely interpret the law in ways that are significantly different from or even opposite to what is written in Title 11. For example, the Title mentions the need for "notice and a hearing" in certain circumstances "as appropriate in the particular circumstances." This seems somewhat vague and open to interpretation, but is not. The US has a highly developed legal system that has witnessed the evolution of a body of learning that disciplines who needs to be notified and in what manner. This body of knowledge is encapsulated not in a text but in the precedence established by past cases. Before implementing the CRA, it is necessary for Pakistani reformers to study the US bankruptcy laws over and beyond what is contained in Title 11.

Another example of the confusion that can arise from reading the USC literally is the matter of the broad grant of power to the bankruptcy

judge (mentioned in Section 105 of the USC), which states that the court may "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title." This clause is copied neatly into the CRA and extended to the powers of the CRB and SECP for the purposes of the Act (see, for example, Sections 86 and 87 of the CRA). However, consider the following comment on Section 105 of the USC (comments in parentheses are ours):

> The power that a judge enjoys (under this clause) must derive ultimately from some other provision of the bankruptcy code. Lawyers who advance an argument (likely requesting some advantage) that relies solely on (the clause on judges' discretionary powers) should expect to lose. As Richard Posner puts it, "The fact that a proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be (as cited in Baird, 2001, p. 7).[17]

In designing a new legal text, the reformers should incorporate as far as possible any clarifications and corrections of the text on which it is based. Failure to do so—as is the case in the CRA's current guise—is likely to cause confusion and the occasional miscarriage of justice.

This is not to suggest that such changes have not been successfully attempted elsewhere. For example, a difference between the wording of the US bankruptcy law and actual practice in America is in the role of the trustee in choosing a creditors' committee. Theoretically, the trustee must chose the seven largest creditors by claim. This is not practically the case, since the trustee typically tries to find representative creditors from each class. Section 1102(b) discusses who may be included—i.e., the seven largest claimants—but is left out of the CRA's corresponding Section 34, which may represent an improvement in brevity. Similarly Sections 36 and 37 of the CRA on adequate protection and the automatic stay, respectively, have been very intelligently lifted from Sections 361 and 362 of the USC: the important points have been preserved and the irrelevant ones left out.

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[17] Baird cites Judge Posner's remarks ln re Chicago, Milwaukee, St. Paul & Pacific Railroad, 791 F.2d 524 (7th Cir. 1986).

Our criticism here is not that the US law has been badly adapted—although we have pointed out mistakes in adaptation throughout this section, particularly in Section 3.5. The criticism is that Title 11 relies on very well developed legal and executive institutions, and that such reliance does not befit the much weaker—and, in some cases, absent—institutions with whom the CRA must work. It would be more appropriate to place more restrictions on the working of the official administrator for example, than the equivalent restrictions on the US trustee. Ultimately, the effect of the CRA if it is adopted will be from how it interacts with the country's cultural, economic, and political conditions; and how it is interpreted and used by Pakistani judges, the various institutions supporting it, and by lawyers.

3.4.6. Power to the SECP

As noted earlier, the SECP plays a massive role in shaping how bankruptcy cases will be dealt with under the CRA. At the very least, it makes the regulations, accredits and licenses mediators and administrators, appoints the members and chairpersons of the CRB and TAC, and licenses CRCs. The federal government appoints the official administrator.

In a country with weak institutions, this is too much power concentrated in the SECP chairperson's office. Historically, the SECP has been seen as far less autonomous than the State Bank of Pakistan, whose governor resigned just nine months into his tenure, citing differences with the government (Lodhi, 2011); and which is currently defending the legality of its loan write-off circular 29 of 2002 in the Supreme Court ("SC hears SBP's Circular 29 case," 2011). It is unlikely that the SECP will be seen as autonomous and impartial in the context of such conditions. If these fears are correct, bankruptcy procedures could be hijacked either by placing political pressure on the SECP chairperson, or installing a pliable person in this position who could then use his or her legal powers to manipulate the process to ensure loan write-off for the politically favored. In the present political context, it would be far more prudent to disperse powers of appointment and regulations far as possible.

3.5. What Gets Lost in Translation?

As we have shown, the CRA is a heavily modified version of the corresponding US text. While some sections, like those discussed above, have been adapted successfully, others have given rise to errors. The

purpose of this section is to point out some of these mistakes so that they may be corrected if deemed necessary, and to provide evidence that the CRA needs to be reconsidered at all levels before it is formally adopted as law.

3.5.1. Indexing Monetary Values

In the US, any monetary values discussed are indexed and regularly reviewed, and this review is part of the law (Section 104 of Title 11). Unfortunately, in Pakistan, specific monetary values are sometimes discussed with no suggestion of review as inflation or other factors make them obsolete. This is a simple error of omission that needs to be corrected.

3.5.2. The Contents of a Rehabilitation Plan

The CRA has not been properly simplified. For example, Section 53(2)(e) of the Act is adapted from Subsection 1123(b)(5) of Title 11, which reads:

> Subject to subsection (a) of this section, a plan may… (5) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, *or of holders of unsecured claims*, or leave unaffected the rights of holders of any class of claims… [emphasis ours]

The CRA's authors may have wished to remove the exception for the debtor's principal residence, since their aim has been to adapt Title 11, which is a document for both corporate and consumer bankruptcies to their purposes. However, in doing so, their version, Section 53(2)(e), reads:

> Subject to subsection (1) [a plan may—]… (e) modify the rights of holders of secured claims or leave unaffected the rights of holders of any class of claims; and…

The phrase "or of holders of unsecured claims" appears to have been left out by mistake and not intentionally, because the ability to modify the rights of unsecured claims is a critical part of a rehabilitation plan, and it is unthinkable that the law should allow the rights of holders of secured claims to be modified, but not those of unsecured claims.

3.5.3. Other Omissions

Similar to the cases mentioned above, there are other parts of the US law that have been transferred wholesale to the CRA, but with subsections left out, seemingly without reason. These cases include Section 54(b), which is based on the US law's Subsection 1124(2), but which leaves out Subsections 1124(2)(c) and (d) without apparent reason. Likewise, the US law's Subsection 362(c) states that the automatic stay continues till the property is no longer property of the estate, which clause is not present in the CRA.

Title 11 also includes Subsection 521(j), which states that if taxes are not properly filed, the taxing authority can, after 90 days, request that the case be converted into liquidation or dismissed. A second omission is Subsection 521(a)(2), which requires details regarding the debtor's plans with respect to secured credit; and a third, Subsection 502(g)(1), is that claims arising from the rejection of executory contracts be treated like claims arising before proceedings started.

These omissions and ostensible mistakes are consequential for two reasons. First, others have not carefully reviewed the CRA. It is perfectly natural for the authors to make mistakes in a large undertaking such as this, but others need to flag such errors. That such mistakes exist suggests that oversight has not been as careful as desired. Second, the drastic truncation of a very large legal code implies that the various sections preserved may not fit together in the new document as intended in the original. It is necessary that the CRA be discussed as a document in its own right; and each decision to lift or leave specific US law clauses, documented.[18]

3.6. Conclusion

It is not surprising that, in adapting a 500-page document from another country, mistakes have occurred. The CRA's authors have made a good first attempt at the limited goal of truncating and adapting Title 11 to focus on corporations, emphasize rehabilitation, and hasten decisions. However, there remain major conceptual flaws—such as using bankruptcy for firm rehabilitation. As we have also argued, the original

[18] We would like to thank the reviewer, Akhtar Hamid, for raising this point.

source has not been sufficiently adapted to Pakistan's weak institutional and political environment—consider the sparse constraints to the powers of a single office, the SECP—while the CRA itself is wont to adopt US bankruptcy design in letter in the absence of correspondingly strong support bodies and institutions. For a subject this critical to the health of the economy, the CRA is an incomplete and flawed document that needs to be heavily reviewed and revised at both the conceptual and implementation levels.

For a project of its scope, the CRA requires far wider buy-in by various stakeholders than it currently has. The SECP could take the lead in this by holding seminars and disseminating the work, not just in press releases to newspapers, but across various forums such as university events, etc. Legal and economic experts—national, regional, and international—could be brought in to advise on the project. The idea of the CRB periodically reviewing both insolvency regimes and Pakistani law is one that is best pursued before the proposed Act is signed into law, and—as envisioned by the CRA's authors—it should certainly continue later.

4. Evaluation, Recommendations, and Conclusions

The draft CRA was proposed in response to the endemic failure of large firms in Pakistan in recent years, and to the debt that has become a constant feature of the country's economic landscape. This draft law is meant to replace certain existing sections of the Companies Ordinance and is based on the bankruptcy laws laid down in Title 11 of the USC.

In considering this draft law, our first fundamental criticism is that it poorly conceives of bankruptcy as a tool to "rehabilitate" firms. The authors' oft-repeated mantra that "companies are worth more alive than dead" is fallacious. In fact, bankrupt firms are often worth more dead than alive. Systematically rewarding proven failures does not, from an economic perspective, justify bankruptcy. Moreover, such a conceptualization does not take into account the costs of propping up such failures. Even if one accepts for a moment the notion that companies are worth more alive than dead, the cost to the economic and legal system of keeping them alive will likely outstrip the supposed value preserved. This conceptualization also ignores the question of why a small group of creditors, rather than the general taxpayer, should pay for the alleged public goal of firm rehabilitation. For reasons

discussed earlier, it is also unlikely that a bankruptcy regime will allow credit to become cheaper.

The idea of bankruptcy allowing firms that are viable but illiquid momentary respite from creditors is one argument for bankruptcy, but it is a very limited one. The other main economic argument for bankruptcy—that it allows collective bargaining by creditors and stops them from racing to recover and causing dynamic inefficiency in recovery—may be plausible in some cases, albeit with caveats. Ironically, this justification is as important in liquidation—usually half of a bankruptcy regime but absent in the CRA—as it is in reorganization. To belabor the point, the theory does not strongly support bankruptcy as a method of rehabilitation; attempting to improve the health of firms through such means—while possibly successful in the short term—means that the state systematically favors loss-making, failing firms, and this sets up perverse incentives in the economy.

A complete redesign from scratch rather than tinkering on the margins is, therefore, necessary for the CRA to prove an economic success. This serious, existential criticism notwithstanding, the CRA's design and implementation are promising but currently flawed—in places dangerously so.

The CRA is meant only for corporations with large amounts of debt (PKR50 million or more of unpaid claims); solvent firms cannot file. Delayed filing is not penalized; the manager usually retains control, and a relatively long automatic stay of six months is provided. In contrast to these debtor-friendly design elements, managers do not enjoy an exclusivity period in submitting a reorganization plan. In balance though, the CRA seems distinctly debtor-friendly.

There are flaws in the current draft that are relatively easy to fix: mediation, which is compulsory, is currently toothless; winding up, which is an extremely important element of a bankruptcy law is, regrettably, left to the 1984 Companies Ordinance.

The lack of a mature legal and technical environment is finessed: bankruptcy courts and specialized judges are deemed dispensable, and crucial areas of autonomy are left for executives (administrators, official administrators, mediators, and personnel of the CRB, CRC, TAC, and SECP). The SECP in particular is endowed with far more power than is

prudent in one office. This means that, in practice, the Pakistani experience with the CRA will be far removed from the US experience it so eagerly wishes to emulate.

These flaws are magnified because of a gravely dangerous design decision: all government claims are made unsecure in bankruptcy, which in a country with a relatively large public sector opens the door to cases of enormous misuse.

That the CRA is flawed is not for want of effort or legal expertise on the part of the authors. Some sections, such as that on firm operations during reorganization proceedings, on automatic stays, charges passing untouched through bankruptcy, and details of the property of the estate, etc., have been adroitly adapted. However, the conceptual flaws and omissions in the discussion of a reorganization plan and nonindexation of monetary values, etc., betrays the project's lack of broad-based ownership, its impressive outreach efforts notwithstanding.

Given that a bankruptcy law is still desired, even a perfect adaptation of the law from another country would be flawed since case precedence, supporting institutions, and underlying circumstances cannot be grafted over. Yet the CRA is far from being such an adaptation and is, in its current guise, no more than a first attempt to set up the scaffolding over which a proper, indigenous law can be constructed.

Ultimately, the question that arises is whether bankruptcy law reform should be high on Pakistan's list of priorities. The government should be moving to rehabilitate the country, not necessarily firms with PKR50 million or more in unpaid debt. The big issues of security—protection of life, property, and contract, perhaps in that order—coupled with the provision of selected large-scale public goods such as electricity, water, oil and gas infrastructure, and public transport require the state's energy and resources far more than a bankruptcy act rebranded as rehabilitative. We hope that the energies of the state and its regulatory bodies are channeled, not into reforming failed firms, but into providing the most facilitative environment possible for businesses of all sizes to flourish.

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