Ibero-American Institute for Law and Finance

Working Paper 3/2020

Insolvency Law in Emerging Markets

Aurelio Gurrea-Martínez [1]

[1] Aurelio Gurrea-Martinez is an Assistant Professor of Law and Head of the Singapore Global Restructuring Initiative at Singapore Management University. Email: aureliogm@smu.edu.sg. For helpful comments and discussions, I would like to thank Simin Gao, Andrew Godwin, Akshaya Kamalnath, Michael Murray, Rebecca Parry, Rosa Maria Rojas, Richard Squire, Stacey Steele, Susan Thomas, Sophie Vermeille, Wai Yee Wan, and the participants of various events where I had the opportunity to present a preliminary version of this paper, including a webinar organized by the Mexican Bar Association and a Conference on Global Restructuring of Companies in Financial Distress organized by City University of Hong Kong. For excellent research assistance, I would like to thank Siu Farn Chew, Terry Xu and Samuel Loh. All errors are mine.

Abstract

A well-functioning corporate insolvency system can serve as a valuable tool to promote entrepreneurship, innovation, access to finance and economic growth. Therefore, if having an efficient insolvency framework is essential for any country, it becomes even more important for emerging economies due to their potential for growth and their greater financial needs. This article seeks to analyze the problems and features of insolvency law in emerging markets and suggest a new framework for financially distressed companies in developing economies. It will be argued that, even though, in an ideal scenario, any improvement of the insolvency framework in emerging markets should start by enhancing the judicial system and the sophistication of the insolvency profession, these reforms usually take time. In fact, due to a variety of factors, including lack of resources and political will, they might never occur. For this reason, this article suggests a corporate insolvency framework for emerging economies taking into account the current market and institutional features of these countries, which generally include inefficient courts, unattractive insolvency proceedings, the lack of a sophisticated body of insolvency practitioners, and the prevalence of small firms and large companies with controlling shareholders.

Table of Contents

1 Introduction

Corporate insolvency law can serve as a powerful tool to promote economic growth.[2] *Ex ante*, a well-functioning insolvency framework can facilitate entrepreneurship, innovation and access to finance. *Ex post*, corporate insolvency law can perform several functions, including the reorganization of viable companies in financial distress, the liquidation of non-viable businesses in a fair and efficient manner, and the maximization of the returns to creditors. Therefore, having an efficient insolvency framework is essential for any economy and even more for emerging markets due to their greater financial needs.[3]

Unfortunately, the academic literature has generally paid more attention to the regulation of corporate insolvency in developed countries.[4] Thus, it has largely omitted the debate about the optimal design of insolvency law in jurisdictions that, in addition to requiring a more active policy debate, amount to 85% of the world's population and 59% of the global GDP,[5] since they include some of the world's largest economies such as China, India, Brazil, Russia and Indonesia.

---

[2] For a general overview about the impact that insolvency law may have on the real economy, see Joseph E Stiglitz, 'Bankruptcy Laws: Basic Economic Principles' in Stijn Claesens, Simeon Djankov and Ashoka Mody (eds), *Resolution of Financial Distress: An International Perspective on the Design of Bankruptcy Laws* (World Bank Publications 2001); Vaughn H Armstrong and Leigh A Riddick, 'Bankruptcy Law Differences Across Countries, Managerial Incentives and Firm Value' (2003) Working Paper <https://ssrn.com/abstract=420560> accessed 17 May 2020; Philippe Aghion, Oliver Hart and John Moore, 'The Economics of Bankruptcy Reform', in Olivier Blanchard, Kenneth Froot and Jeffrey Sachs (eds), *The Transition in Eastern Europe* (vol 2, Chicago University Press 2004) 215–244; Jeremy Berkowitz and Michelle J White, 'Bankruptcy and Small Firms' Access to Credit' (2004) 35 The Rand Journal of Economics 69; Stijn Claessens and Leora F Klapper, 'Bankruptcy around the World: Explanations of its Relative Use' (2005) 7(1) American Law and Economics Review 253; Kenneth Ayotte, 'Bankruptcy and Entrepreneurship: The Value of a Fresh Start' (2007) 23 Journal of Law, Economics and Organization 161; John Armour and Douglas Cumming, 'Bankruptcy Law and Entrepreneurship' (2008) 10 American Law and Economic Review 303; Sergei A Davydenko and Julian R Franks, 'Do Bankruptcy Codes Matter? A Study of Default in France, Germany and the UK' (2008) 53 The Journal of Finance 565; Simeon Djankov, Oliver Hart, Caralee McLiesh and Andrei Shleifer, 'Debt enforcement around the world' (2008) 116(6) Journal of Political Economy 1105; Viral V Acharya, Yakov Amihud and Lubomir Litov, 'Creditor Rights and Corporate Risk-taking' (2009) NBER Working Paper Series 15569 <http://www.nber.org/papers/w15569> accessed 17 May 2020; Viral V Acharya and Krishnamurthy Subramanian, 'Bankruptcy Codes and Innovation' (2009) 22 Review of Financial Studies 4949; John Armour, Antonia P Menezes, Mahesh Uttamchandani and Kristin van Zwieten, 'How do creditor rights matter for debt finance? A review of empirical evidence' in Frederique Dahan (ed), *Research Handbook on Secured Financing of Commercial transactions* (Elgar 2015); Giacomo Rodano, Giacomo, Nicolas Andre Benigno Serrano-Velarde and Emanuele Tarantino, 'Bankruptcy law and bank financing' (2016), 120 Journal of Financial Economics 363; Julian Neira, 'Bankruptcy and Cross-Country Differences in Productivity' (2017) 157 Journal of Economic Behavior and Organization 359.

[3] This article will use the terms emerging markets and emerging economies as synonyms. For an analysis of these concepts, see Section 3.1.

[4] Some notable exception include, for example, Oliver Hart, Rafael La Porta, Florencio Lopez de Silanes, and John More, 'Proposal for a new bankruptcy procedure in emerging markets' in Richard Levich (ed), *Emerging Capital Flows* (Kluwer 1988) 401–419; Stijn Claesens, Simeon Djankov and Ashoka Mody (eds), *Resolution of Financial Distress: An International Perspective on the Design of Bankruptcy Laws* (World Bank Publications 2001); Sonali Abeyratne, *Banking and Debt Recovery in Emerging Markets: The Law Reform Context* (Routledge 2019). Other exceptions include articles focused on specific emerging economies, such as India and China. For instance, see Roman Tomasic and Zinian Zhang, 'China's Enterprise Bankruptcy Law - Implementation of the Corporate Reorganization Provisions' in J Garrick (ed), *Law and Policy for China's Market Socialism* (Routledge 2012) 55-69; Kristin van Zwieten, 'Corporate Rescue in India: The Influence of the Courts' (2015), 15 Journal of Corporate Law Studies 1; Simon Gao and Qianyu Wuang, 'The U.S. Reorganization Regime in the Chinese Mirror: Legal Transplantation and Obstructed Efficiency' (2017) 91 American Bankruptcy Law Journal 139; Rebecca Parry and Yingxiang Long, 'China's enterprise bankruptcy law, building an infrastructure towards a market-based approach' (2020), 20 Journal of Corporate Law Studies 157.

[5] David Muller, 'Emerging Markets – Powerhouse of global growth' (Ashmore Group, May 2018) <http://www.ashmoregroup.com/sites/default/files/article-docs/MC_10%20May18_2.pdf> accessed 17 May 2020.

This article seeks to fill this gap in the academic literature. In order to do so, the article is divided as follows. Section 2 provides an overview of the economic problems that corporate insolvency law seeks to solve, as well as the strategies generally used across jurisdictions to address those problems. Section 3 highlights the legal, economic and institutional features generally existing in emerging markets. Section 4 analyzes the particular features of insolvency law in these economies. Section 5 suggests various policy recommendations to enhance the attractiveness of the insolvency and restructuring framework in emerging markets. Section 6 concludes.

2 Economic problems and legal strategies in corporate insolvency law

2.1 The role of corporate insolvency law in the real economy

From an economic perspective, an efficient corporate insolvency framework should perform two primary functions.[6] On the one hand, it should provide a variety of tools to minimize the destruction of value associated with a situation of financial distress.[7] On the other hand, it should facilitate the efficient allocation of resources in the economy.[8]

Corporate insolvency can minimize the destruction of value in several ways. First, when debtors are unable to pay their debts, creditors become entitled to enforce their claims and ultimately seize the debtor's assets. Therefore, their individual enforcement actions may end up destroying the going concern value of economically viable companies.[9] For this reason, insolvency law responds by imposing a moratorium or automatic stay that will stop creditors from enforcing their claims while forcing them to work in a more coordinated manner.[10] Thus, the use of a moratorium can not only preserve value, but it can also promote a more efficient strategy by the creditors.

Second, the existence of a situation of insolvency may incentivize key employees to abandon the firm. Similarly, suppliers and lenders might decide to terminate their business relations with the debtor if they know that they might face the risk of having their claims going unpaid. Therefore, as these circumstances can also destroy value, insolvency law helps minimize these costs by providing various regulatory responses. Among others, insolvency law generally allows post-petition claimants to obtain a priority for their new claims, usually in the form of administrative expenses.[11] Likewise, other solutions to deal with these problems may include the restriction of *ipso facto* clauses and the availability of debtor-in-possession (DIP) financing.[12]

[6] For the purpose of this article, the terms 'insolvency law' and 'bankruptcy law', as well as 'insolvency proceedings' and 'bankruptcy procedures', will be used as synonyms. Likewise, while some references will be made to the treatment of individuals in bankruptcy, this article will focus on *corporate* insolvency.

[7] According to some studies, the costs of financial distress represent 10% to 20% of the market value of the firm. See Gregor Andrade and Steven N Kaplan, 'How Costly Is Financial (Not Economic) Distress? Evidence From Highly Leveraged Transactions That Became Distressed' (1998) 53 Journal of Finance 1443. In liquidations, however, these costs can be even higher. See Julian Granks and Oren Sussman, 'Financial Distress and Bank Restructuring of Small to Medium Size UK Companies' (2005) 9 Review of Finance 65, reporting that, at least in the context of small and medium size companies in the United Kingdom, insolvency liquidations subtract 20% to 40% of the company's proceeds.

[8] Michelle J White, 'The Corporate Bankruptcy Decision' (1989) 3(2) Journal of Economic Perspectives 129.

[9] Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press 1986) 16–17.

[10] In the absence of this moratorium, creditors would be incentivized to start a 'race to collect' that may end up destroying the going concern value potentially existing in the insolvent firm, in addition to increasing collection costs for the creditors. See Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press 1986) 16–17.

[11] This regulatory response is a distinctive feature of insolvency law. In the absence of a majority rule, any agreement between the debtor and the creditors would require unanimity. Therefore, it would hamper the possibility of conducting a successful debt restructuring. See Jose Maria Garrido, *Out-of-Court Debt Restructuring* (World Bank Studies 2012) 12.

[12] These solutions exist, for example, in the United States and Singapore. In fact, given the importance of the second one (that is, the availability of DIP financing), which allow insolvent firms to have access to new

Third, debtors facing financial trouble may have incentives to engage in a series of opportunistic behavior that can destroy or divert value away at the expense of the creditors. This opportunistic behavior may include the transfer of assets to related parties, borrowing money in an irresponsible manner and investing in risky projects in a last attempt to rescue the firm.[13] In order to solve these problems, insolvency law provides several mechanisms including avoidance actions[14] and, in some jurisdictions, special duties and liabilities for directors of financially distressed firms.[15] Likewise, once the debtor is subject to the bankruptcy procedure, most jurisdictions around the world also require the appointment of an insolvency practitioner to manage or supervise the debtor. By doing so, the risk of engaging in opportunistic behaviors will be notably reduced. Therefore, insolvency law can provide once again a valuable response to preserve or restore value.

On the other hand, an efficient corporate insolvency framework should facilitate the efficient allocation of resources in the economy. This function is achieved by putting the debtor's assets to their best use.[16] Therefore, if a company is not economically viable, and therefore it is worth more dead than alive, the efficient allocation of assets will consist of liquidating the company and reallocating those assets towards more productive activities.[17] If a company has a viable business but the creditors do not trust the shareholders/managers, an efficient corporate insolvency framework should promote the preservation of these businesses, for instance, through a going concern sale. Finally, if a company is economically viable, and therefore the assets are worth more if they are kept together under the current management team, corporate insolvency law should provide the right tools to facilitate the reorganization of these companies by letting them emerge from bankruptcy with a new financial structure more suitable to the company's generation of cash-flows.

---

sources of debt finance that might not be available otherwise, some authors have argued that bankruptcy law serves as a 'liquidity provider' for viable but financially distressed firms. See Kenneth Ayotte and David Skeel A. Jr., 'Bankruptcy Law as a Liquidity Provider' (2013) 80 University of Chicago Law Review 1557.

[13] John Armour, Gerard Hartig and Hideki Kanda, 'Transactions with Creditors' in John Armour, Luca Enriques et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press 2017) 111.

[14] Aurelio Gurrea-Martinez, 'The Avoidance of Pre-Bankruptcy Transactions: An Economic and Comparative Approach' (2018) 93(3) Chicago-Kent Law Review 711.

[15] Justin Wood, 'Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany and Japan' (2007) 26(1) Penn State International Law Review 139; Philip R Wood, Principles of International Insolvency (3rd edn, 2019), chs 30-34; Christopher Symes and Beth Nosworthy, 'The Components of Corporate Governance for Financially Distressed Firms' (2020) 35 Australian Journal of Corporate Law 98; Aurelio Gurrea-Martinez, Towards an Optimal Model of Directors' Duties in the Zone of Insolvency: An Economic and Comparative Approach, Singapore Management University School of Law Research Paper No. 22/2020 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3717631> accessed 21 February 2021.

[16] Michelle J White, 'The Corporate Bankruptcy Decision' (1989) 3(2) Journal of Economic Perspectives 129; John Armour, 'The law and economics of corporate insolvency' (2001) ESRC Centre for Business Research University of Cambridge, Working Paper 197, <https://www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp197.pdf> accessed 4 August 2020.

[17] For an analysis of the concept of viability, and why non-viable (or economically distressed) firms should be liquidated and viable companies (or economically efficient firms) just facing a problem of financial distress should be reorganized, see Michelle J White, 'The Corporate Bankruptcy Decision' (1989) 3(2) Journal of Economic Perspectives 129; Michelle J White, 'Does Chapter 11 Save Economically Inefficient Firms?' (1994) 72 Washington University Law Quarterly 1319; Douglas G Baird, 'The Hidden Virtues of Chapter 11: An Overview of the Law and Economics of Financially Distressed Firms' (1997) Chicago Working Paper in Law & Economics No 43, 9-10; John Armour, 'The law and economics of corporate insolvency' (2001) ESRC Centre for Business Research University of Cambridge, Working Paper 197, <https://www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp197.pdf> accessed 4 August 2020; Alan Schwartz, A 'Normative Theory of Corporate Bankruptcy' (2005) 91 Virginia Law Review 1199, 1200-1201.

A financial reorganization is achieved through a variety of mechanisms provided by an insolvency system. First, bankruptcy law provides an adequate forum for negotiations. On the one hand, an insolvency proceeding usually requires the involvement of independent and reliable third parties (e.g., bankruptcy court) that can create trust. On the other hand, debtors subject to an insolvency proceeding are generally required to provide information to the creditors. Therefore, the combination of trust and lower asymmetries of information between debtors and creditors is expected to favor negotiations. Second, insolvency law provides several tools that can help facilitate a financial restructuring. These tools include the possibility for a majority (or qualified majority) of creditors to impose a decision on dissenting minority creditors[18] and, in some jurisdictions such as Singapore and the United States, even the possibility that a reorganization plan can be imposed on dissenting *classes* of creditors.[19] By providing these tools, insolvency law avoids holdout problems, encourages *ex ante* bargaining, reduces negotiation costs, and facilitates the reorganization of viable but financially distressed businesses.[20]

If a corporate insolvency regime manages to minimize the destruction of value while putting the debtor's assets to their best use, it can play a major role in the promotion of economic growth. *Ex post,* it can contribute to the real economy in several ways. First, corporate insolvency law can save viable but financially distressed companies. Therefore, it can preserve jobs, business relationships with third parties (e.g., suppliers), and the generation of wealth for society. Second, by liquidating non-competitive firms, insolvency law will serve as a valuable mechanism to reallocate resources towards more productive activities. Third, the ability of insolvency law to preserve value will allow creditors to maximise their recoveries. And if so, their financial position will not be significantly undermined by the situation of insolvency of their debtors. Therefore, the maximisation of the returns to creditors will reduce the risk of having a 'domino effect' in corporate insolvencies (especially among small and non-diversified creditors more exposed to the debtor's default) while preserving the stability of the financial system if these creditors are financial institutions.

Ex ante, however, the role of corporate insolvency law can be even more relevant for society. That will depend on how debtors and creditors are treated in insolvency proceedings. From the perspective of debtors, if companies (or their shareholders/managers) know that, in the event of insolvency, a variety of tools will help them preserve value and fix their financial problems, they will have incentives to pursue more investment projects, hire people, borrow money and take risks. Therefore, corporate insolvency law can be a powerful tool to promote entrepreneurship, innovation, job creation, access to finance and economic growth. However, in order to achieve these goals, corporate insolvency law should not punish honest and diligent directors just because their companies became insolvent. Otherwise, they might be discouraged from taking risks or serving on corporate boards. Besides, in a system with a very harsh liability regime for corporate directors, the initiation of insolvency proceedings might take

[18] This 'majority (or qualified) majority rule' replacing the unanimity rule generally existing outside of bankruptcy is a general feature of insolvency law. See *supra* note 11.

[19] The possibility of imposing a plan on dissenting classes of creditors, usually known as 'cramdown' or 'cross-class cramdown', is generally subject to certain conditions and is a solution existing in various jurisdictions around the world, including the United States and Singapore. Likewise, it has also been implemented in the European Directive on Preventive Restructuring Frameworks. For an analysis of the rationale and requirements of the cramdown provisions in the United States, the European Union and Singapore, see Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law 829, 838-841.

[20] Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law 829.

place at a later stage.[21] Therefore, an unattractive insolvency regime for debtors or corporate directors can be harmful for the promotion of entrepreneurship, innovation, and access to finance, as well as for the successful rehabilitation of economically viable companies, the quick liquidation of non-competitive businesses, and the maximisation of returns to creditors.

From the perspective of creditors, corporate insolvency law can even become a more powerful mechanism to promote economic growth. Indeed, since insolvency law helps preserve value, creditors will be able to maximise their returns. As a result, from an *ex ante* perspective, they will have more incentives to lend money at a lower cost. Hence, an efficient insolvency system capable of preserving value and allocating resources efficiently will facilitate firms' access to debt finance.[22] Thus, companies will be in a better position to obtain the financial resources needed to pursue investment projects that can ultimately generate jobs, wealth and social welfare.

2.2 International divergences in economic problems and legal strategies

While the economic problems addressed by corporate insolvency law are generally found in any financially distressed firm, the *intensity* of these problems may differ across firms and countries. Factors affecting the economic problems that insolvency law seeks to solve, and therefore the optimal regulatory strategy to address those problems, include corporate ownership structures, debt structures, level of financial development, firm size, sophistication of the insolvency profession, and attractiveness of the insolvency framework.

First, in jurisdictions where companies usually have dispersed ownership shareholders,[23] the risk of opportunism of shareholders *vis-à-vis* creditors will probably be lower. In these companies, the directors are usually more independent from the shareholders due to the existence of many dispersed and rationally apathetic minority investors unable to closely monitor and influence the managers. Therefore, in companies with dispersed ownership structures, managers should have fewer incentives to engage in these types of opportunistic behavior of shareholders *vis-à-vis* creditors that may occur in the zone of insolvency. As a result, the appointment of an insolvency practitioner to manage or oversee the debtor's operation, or the imposition of special duties requiring corporate directors to file for bankruptcy, are legal strategies that might not be needed in these jurisdictions.[24]

---

[21] Douglas G Baird, 'The initiation problem in bankruptcy' (1991) 11 International Review of Law and Economics 223; Barry E Adler, Vedran Capkun and Lawrence A Weiss, 'Bankruptcy Initiation In The New Era of Chapter 11' (2006) American Law and Economics Association Annual Meeting 53, < https://law.bepress.com/cgi/viewcontent.cgi?article=1655&context=alea> accessed 4 August 2020.

[22] John Armour, Antonia P Menezes, Mahesh Uttamchandani and Kristin van Zwieten, 'How do creditor rights matter for debt finance? A review of empirical evidence' in Frederique Dahan (ed), *Research Handbook on Secured Financing of Commercial transactions* (Elgar 2015).

[23] Except for the United States, the United Kingdom and, to a lesser extent, Japan and Australia, most countries around the world often have companies with controlling shareholders. See Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer and Robert Vishny, 'Law and Finance' (1998) 106 Journal of Political Economy 1113; Rafael La Porta, Florencio Lopez de Silines and Robert Vishny, 'Corporate Ownership Around the World' (1999) 54 Journal of Finance 471; Adriana de la Cruz, Alejandra Medina and Yun Tang, 'Owners of the World's Listed Companies' (2019) OECD Capital Market Series <http://www.oecd.org/corporate/ca/Owners-of-the-Worlds-Listed-Companies.pdf> accessed 17 May 2020; Gur Aminadev and Elias Papaioannou, 'Corporate Control around the World' (2020) 75(3) Journal of Finance 1191.

[24] It should be noted, however, that while the duty to file for bankruptcy does not indeed exist in any of the countries traditionally identified with dispersed ownership structures (that is, the United Kingdom, the United States, Australia and Japan), the debtor in possession as a formal governance model of insolvency proceeding only exists in the United States. In the United Kingdom, however, it has been said that there is a *de facto* debtor in possession in viable companies run by reliable managers seeking to reorganize the firm. However, this procedure is conducted out-of-court in the form of a 'workout', following the so-called 'London

By contrast, in countries where companies usually have controlling shareholders, as it happens in most jurisdictions around the world,[25] the interest of the directors will be more aligned with the interest of the shareholders, not only because the former will be closely monitored by the controlling shareholders but also because the shareholders are often the directors themselves. Therefore, there will be a higher risk of opportunism by shareholders *vis-à-vis* creditors. As a result, a duty to file for bankruptcy, or the imposition of an insolvency practitioner to manage or monitor the debtor's activities, might be more justified in jurisdictions with concentrated ownership structures.[26]

Second, in countries where companies generally have dispersed debt structures (as it often occurs in the context of public companies, especially in jurisdictions with developed capital markets such as the United Kingdom and the United States), creditors face greater collective action problems.[27] Likewise, the existence of more creditors can increase the holdout problems that bankruptcy law seeks to solve.[28] Therefore, the imposition of a moratorium or automatic stay, as a legal strategy seeking to stop creditors from enforcing their claims while forcing them to cooperate in a more coordinated manner, may be more needed in these countries. By contrast, in jurisdictions where companies usually have concentrated debt structures, as it happens more often in countries with bank-based financial systems, and also in emerging economies without a developed financial system, creditors can easily coordinate their actions and the risk of facing holdout problems will be reduced. Therefore, a financial restructuring, usually through a workout, can take place even without the formal imposition of a statutory moratorium.[29] Similarly, the imposition of other regulatory strategies such as the creation of a committee of unsecured creditors or the imposition of a court-appointed trustee will also make more sense in countries with dispersed, unsophisticated creditors.[30] In countries where companies have concentrated debt structures, however, these legal strategies might not be needed, especially if the creditors are sophisticated lenders.

Third, in countries with developed financial systems, viable but financially distressed debtors should not find many difficulties having access to new finance. Therefore, the inability of financially distressed debtors to pursue value-creating projects, generally known as 'underinvestment problems', will be notably reduced in these countries.[31]

Approach'. See John Armour and Simon Deakin, 'Norms in Private Insolvency: The "London Approach" to the Resolution of Financial Distress' (2001) 1 Journal of Corporate Law Studies 21. Therefore, the divergences in the governance model for insolvency proceedings between the United Kingdom and the United States might not be that significant in practice. See John Armour, Brian R Cheffins and David A Skeel Jr, 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2003) 55 Vanderbilt Law Review 1699.

[25] See *supra* note 23.

[26] Aurelio Gurrea-Martinez, Towards an Optimal Model of Directors' Duties in the Zone of Insolvency: An Economic and Comparative Approach, Singapore Management University School of Law Research Paper No. 22/2020 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3717631> accessed 21 February 2021.

[27] John Armour, Gerard Hertig and Hideki Kanda, 'Transactions with Creditors' in John Armour, Luca Enriques et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press 2017) 140–141.

[28] Anthony J Casey, 'Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy' (2020) Columbia Law Review (Forthcoming) <https://ssrn.com/abstract=3353871> accessed 17 May 2020.

[29] John Armour, Gerard Hertig and Hideki Kanda, 'Transactions with Creditors' in John Armour, Luca Enriques et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press 2017) 140–141. Showing that debt restructurings can easily be achieved in companies with simple capital structures, see Stuart C Gilson, Kose John and Larry HP Lang, "'Troubled Debt Restructurings: An Empirical Study of Reorganization of Firms in Default' (1990) 27 Journal of Financial Economics 315; Edward R Morrison, 'Bargaining around Bankruptcy: Small Business Distress and State Law' (2009) 38 Journal of Legal Studies 255.

[30] This solution, for example, exists in the United States. See section 1102(a)(1) of the United States Bankruptcy Code.

[31] See Stewart C Myers and Nicholas S Mailuf, 'Corporate Financing and Investment Decisions: When Firms have Information the Investors Do Not Have' (1984) 13 Journal of Financial Economics 187. By contrast, the

However, in countries without developed financial systems, the underinvestment problems generally existing in a situation of financial distress will be exacerbated. As a result, the use of priority (or even super-priority) for post-petition financing and similar strategies to address these problems can be more desirable in these latter jurisdictions.

Fourth, in countries where most companies are micro and small firms ("MSMEs"), the insolvency system should provide specific solutions for these companies.[32] Otherwise, subjecting MSMEs to regular insolvency proceedings can be particularly costly,[33] undermining the ability of insolvency law to preserve value and reallocate the debtor's assets in an efficient manner.

Fifth, in countries with sophisticated insolvency professionals, the mandatory appointment of an insolvency practitioner to replace or, if so, supervise the debtor's management team can add value to the procedure. However, when these practitioners do not have a high level of credibility and expertise, the appointment of an insolvency practitioner may generate a cost that might not be justified. Therefore, the imposition of a debtor in possession governance model of insolvency proceedings, and more generally reducing the intervention of insolvency practitioners in a bankruptcy procedure, may make more sense in countries without sophisticated insolvency practitioners.

Sixth, in countries with unattractive insolvency frameworks, the initiation of insolvency proceedings can end up doing more harm than good.[34] For this reason, the use of the formal insolvency proceedings should be minimized in these countries. This can be achieved, for example, by not imposing a duty to file for bankruptcy,[35] favoring out-of-court restructurings and the adoption of pre-insolvency frameworks,[36] and relying more on contractual and market mechanisms.[37]

---

concept of 'overinvestment' refers to those situations in which projects with a negative net present value are being financed. See Richard A Brealey, Steward C Myers and Franklin Allen, *Principles of Corporate Finance* (10th edn, McGraw-Hill Irwin 2011) 291.

[32] See The World Bank, 'Saving Entrepreneurs, Saving Enterprises: Proposals on the Treatment of MSME Insolvency' (2018), <http://documents1.worldbank.org/curated/en/989581537265261393/pdf/Saving-Entrepreneurs-Saving-Enterprises-Proposals-on-the-Treatment-of-MSME-Insolvency.pdf> accessed 4 August 2020.

[33] Edward R Morrison and Andrea C Saavedra, 'Bankruptcy's Role in the Covid-19 Crisis' (Columbia Law School, 2020) <https://ssrn.com/abstract=3567127> accessed 17 May 2020.

[34] Kristin van Zwieten, 'Corporate Rescue in India: The Influence of the Courts' (2015) 15(1) Journal of Corporate Law Studies 1; Aurelio Gurrea-Martinez, 'The Low Usage of Bankruptcy Procedure: A Cultural Problem? Lessons from Spain' (2020) 27 University of Miami International and Comparative Law Review 272.

[35] This duty to file for bankruptcy is very common in many European countries including the Czech Republic, France, Germany, Poland and Spain. While this duty to file for bankruptcy may make more sense in countries with efficient insolvency frameworks and companies with controlling shareholders (e.g., Germany), its desirability will be undermined in countries with more unattractive insolvency frameworks, as it can be in the case of Spain. See Aurelio Gurrea-Martinez, 'The Low Usage of Bankruptcy Procedure: A Cultural Problem? Lessons from Spain' (2020) 27 University of Miami International and Comparative Law Review 272.

[36] For an analysis of the definition, goals and features of pre-insolvency and out-of-court proceedings, see Jose Maria Garrido, *Out-of-Court Debt Restructuring* (World Bank Studies 2012) 2–6; Horst Eidenmuller, 'What Is An Insolvency Proceeding?' (2016) ECGI Law Working Paper Series 335/2016 <https://ssrn.com/abstract=2712628> accessed 17 May 2020; Bob Wessels and Stephan Madaus, 'Instrument of the European Institute – Rescue of Business in Insolvency Law' (2017) 183–190; Nicolaes Tollenaar, *Pre-insolvency Proceedings: A Normative Foundation and Framework* (Oxford University Press 2019) 38–98 and 188–250; Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829.

[37] Suggesting the implementation of a system of auctions in countries with inefficient insolvency frameworks, see Oliver Hart, Rafael La Porta, Florencio Lopez de Silanes, and John Moore, 'Proposal for a new bankruptcy procedure in emerging markets' in Richard Levich (ed), *Emerging Capital Flows* (Kluwer 1988) 401–419.

Unfortunately for regulators and policymakers, the adoption of an optimal regulatory strategy is not that easy. In addition to a variety of problems associated with legal transplants and cross-countries legal, economic, cultural and institutional divergences,[38] countries present mixed features. For example, a country may have companies with controlling shareholder and an unattractive insolvency framework at the same time. In these jurisdictions, imposing a duty to file for bankruptcy can do more harm than good due to the inefficiencies of the insolvency system. Therefore, even if, based on the corporate ownership structure prevailing in these jurisdictions, the duty to file for bankruptcy may make more sense, other legal, economic and institutional factors of the country may suggest a different approach. As a result, when drafting an insolvency legislation and assessing the most appropriate insolvency responses, regulators should take into account the overall features of the country.

3 Concept and features of emerging markets

3.1 What is an emerging market?

The term 'emerging market' was initially coined by the International Finance Corporation with two primary purposes.[39] First, it sought to emphasize the potential for growth and the need for foreign investments existing in these countries. Second, this new term sought to reduce the negative connotations associated with other expressions used to refer to developing countries such as "the third world".[40] In any case, it should be noted that the term 'emerging market' is used in many different ways. For example, the FTSE, MSCI, S&P, Dow Jones, and the EM bond index adopt different classifications of emerging markets.[41] Likewise, the International Monetary Fund distinguishes between 'advanced economies' and 'emerging markets and developing economies' (EMDE).[42] Likewise, within the broad concept of emerging market, some new terms have emerged in the past years. For instance, the acronym "BRIC" refers to the economies of Brazil, Russia, India, China,[43] or the term EAGLE, which stands for emerging and growth-leading economies, includes countries like Indonesia, Mexico and Turkey, along with the BRICs. By 'emerging market', this article will mainly refer to those countries that, in addition to their potential for growth, are still in the stage of developing their economies, markets and institutions. Therefore, it will be used as a synonym of developing countries and emerging economies.[44]

---

[38] Katharina Pistor, Martin Raiser, and Stanislaw Gelfer, 'Law and Finance in Transition Economies' (2000) 8 The Economics of Transition 325; David Milman, 'Personal Insolvency Law and the Challenges of a Dynamic, Enterprise-Driven Economy' (2008) 20 Singapore Academy of Law Journal 438; Simin Gao and Qianyu Wang, 'The U.S. Reorganization Regime in the Chinese Mirror: Legal Transplantation and Obstructed Efficiency' (2017) 91(1) American Bankruptcy Law Journal 139; Wai Yee Wan and Gerald McCormack, 'Transplanting chapter 11 of the US bankruptcy code into Singapore's restructuring and insolvency laws: Opportunities and challenges' (2019) 19(1) Journal of Corporate Law 69.

[39] International Financial Corporation, 'Establishing "Emerging Markets"' <https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new/ifc+history/establishing-emerging-markets> accessed 17 May 2020.

[40] International Financial Corporation, 'Establishing "Emerging Markets"' <https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new/ifc+history/establishing-emerging-markets> accessed 17 May 2020.

[41] Depending on the classification or index, some countries may be included or not as 'emerging market'. For example, MSCI has kept South Korea on its emerging market index, whereas FTSE includes South Korea on its developed market index.

[42] See International Monetary Fund, 'World Economic Outlook, April 2020' <https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020> accessed 18 May 2020.

[43] This term was popularized by Goldman Sachs. See Goldman Sachs, 'With GS Research Report, "BRICs" Are Born' <https://www.goldmansachs.com/our-firm/history/moments/2001-brics.html> accessed 18 May 2020.

[44] See *supra* note 3.

3.2 Legal, institutional and economic features of emerging markets

While there are many legal, economic, institutional and cultural differences across emerging markets, some similarities can be found. From a legal and institutional perspective, the first feature of emerging economies is that they tend to have a weak rule of law.[45] This creates uncertainty for investors, harming entrepreneurship and access to finance in the country.[46] Second, emerging economies do not generally have sophisticated judicial systems.[47] Therefore, the existence of a poor judiciary also hampers the protection of investors and the promotion of economic growth.[48] Third, emerging economies tend to exhibit higher levels of corruption than those generally found in advanced economies.[49] As a result, this aspect also harms the attractiveness of many emerging markets, especially from the perspective of foreign investors. Fourth, emerging economies often have old-fashion legislations or, when they adopt modern legal frameworks, they often do so by adopting laws and practices from developed economies, which is something that may create some undesirable side effects.[50] Fifth, intellectual property rights receive less protection in emerging economies.[51] Thus, the weak protection of intellectual property rights acts as a barrier against innovation and the growth of domestic firms.[52] Finally, many emerging economies often adopt discriminatory changes to the laws or contractual arrangements, harming investors' rights and therefore

[45] A weak rule of law is a general feature found in most emerging economies. See <https://worldjusticeproject.org/news/wjp-rule-law-index-2019-global-press-release> accessed 4 August 2020.

[46] Emphasizing the uncertainty generally existing in emerging markets and why creditors cannot generally assume that a contract will be enforced or that they will enjoy certain rights to which they are actually entitled to, see Elena Daly, 'Don't Assume' (2009) International Financial Law Review 54. For other challenges potentially existing in emerging markets, especially in the context of a debt restructuring, see Steven T. Kargman, Opportunities and Pitfalls in Emerging Market Restructurings: A Strategic Perspective' (2005) The Journal of Private Equity 89.

[47] Oliver Hart, Rafael La Porta, Florencio Lopez de Silanes, and John More, 'Proposal for a new bankruptcy procedure in emerging markets' in Richard Levich (ed), *Emerging Capital Flows* (Kluwer 1988) 402.

[48] Analyzing the importance of a good judicial system for the real economy, see Krishna B Kumar, Raghuram Rajan and Luigi Zingales, 'What Determines Firm's Size?" (2001) NBER Working Paper 7208 <https://www.nber.org/papers/w7208.pdf> accessed 19 May 2020; Simeon Djankov, Rafael La Porta, Florencio Lopez de Silanes, and Andrei Shleifer, 'Courts' (2003) The Quarterly Journal of Economics 118(2) 453; Dani Rodrik, Arbind Subramaniam and Francesco Trebbi, 'Institutions rule: the primacy of institutions over geography and integration of economic development' (2004) 9 Journal of Economic Growth 131; Dimitri Lorenzani and Federico Lucidi, 'The Economic Impact of Civil Justice Reforms' (2014) European Commission Economics Paper 530; Miguel Garcia and Juan S Mora-Sanguinetti, 'Does (average) size matter? Court enforcement, business demography and firm growth' (2015) 44(3) Small Business Economics Journal 639; Giuliana Palumbo, Giulia Giupponi, Luca Nunziata and Juan S. Mora Sanguinetti, 'The Economics of Civil Justice: New Cross-Country Data and Empirics' (2016) OECD Economics Department Working Papers 1060. More specifically, analyzing the role of courts on lending markets and firms' access to finance, see Magda Bianco, Tullio Jappelli and Marco Pagano, 'Courts and Banks: Effects of Judicial Enforcement on Credit Markets' (2005) 37(2) Journal of Money, Credit and Banking 223; Simeon Djankov, Oliver Hart, Caralee McLiesh and Andrei Shleifer, 'Debt enforcement around the world' (2008) 116(6) Journal of Political Economy 1105; Karsten Muller, 'Busy Bankruptcy Courts and the Cost of Credit' (2017) <https://ssrn.com/abstract=3088676> accessed 17 May 2020.

[49] Nicholas A Lash and Bala Batavia, 'Corruption and Doing Business in Emerging Markets' (Asian Economic and Financial Review, 29 November 2019) <http://www.aessweb.com/pdf-files/AEFR-2019-9(11)-1279-1289.pdf> accessed 17 May 2020.

[50] Katharina Pistor, 'The Standardization of Law and Its Effect on Developing Economies' (2000) G-24 Discussion Paper Series 4 <https://unctad.org/en/Docs/pogdsmdpbg24d4.en.pdf> accessed 17 May 2020; Angela Donaggio, 'Limitations of Legal Transplants and Convergence to Corporate Governance Practices in Emerging Markets: The Brazilian Case' in Sabri Doubaker and Duc Khuong Nguyen (eds), *Corporate Governance in Emerging Markets* (Springer 2014); Ruth V Aguilera and Ilir Haxhi, 'Comparative Corporate Governance in Emerging Markets' in Robert Grosse and Klaus E Meyer (eds), *The Oxford Handbook of Management in Emerging Markets* (Oxford University Press 2019).

[51] Zeke Hernandex, 'Why Strong IP Laws Matter in a Globalized World' (29 August 2018) <https://knowledge.wharton.upenn.edu/article/globalization-and-its-impact-on-inequality-for-companies/> accessed 17 May 2020.

[52] Anabel Gonzalez and Ganesh Rasagam, '5 ways to close the global innovation divide' (9 September 2015) <https://blogs.worldbank.org/voices/5-ways-close-global-innovation-divide> accessed 9 May 2020.

discouraging foreign investments in the first place.[53] Hence, from a legal and institutional perspective, the most common features found in emerging markets are the existence of weak institutions and low levels of legal uncertainty.

From an economic perspective, emerging markets usually share some features too. First, they tend to have a high potential for growth in the mid to long term.[54] Second, emerging economies usually have low per capita income. For example, China and India have a per capita income of USD$10,870 and USD$2,340 respectively whereas some advanced economies, such as the United States and the United Kingdom, have USD$67,430 and USD$40,390 respectively.[55] Thus, emerging economies have a greater need to reduce poverty and promote growth. The evidence suggests that, in the past decade, there has been an increase of the middle class in emerging markets.[56] With greater disposable income, consumption in these markets has grown exponentially with some estimates stating that annual consumption in emerging markets will reach USD$30 trillion by 2025.[57] This is contributed particularly by young consumers who are confident that income levels will continue to rise and are willing to spend in pursuit of their aspirations.[58]

Finally, other market and institutional features existing in emerging markets include the increasing use of technologies[59], the need to invest in capacity building, the lack of developed capital markets and other financing options for firms,[60] and the existence of controlled firms and many micro, small and medium-sized enterprises.[61]

---

[53] Goldman Sachs, 'Dreaming with BRICS: The Path to 2050' (1 October 2003) Global Paper No 99 <https://www.goldmansachs.com/insights/archive/archive-pdfs/brics-dream.pdf> accessed 9 May 2020.

[54] PWC, 'Emerging Markets' <https://www.pwc.com.br/pt/publicacoes/servicos/assets/consultoria-negocios/emerging-markets-tsp-13.pdf> accessed 7 May 2020.

[55] International Monetary Fund, 'GDP per capita, current prices' <https://www.imf.org/external/datamapper/NGDPDPC@WEO/OEMDC/ADVEC/WEOWORLD> accessed 30 December 2019.

[56] Mario Pezzini, 'An Emerging Middle Class' <https://oecdobserver.org/news/fullstory.php/aid/3681/An_emerging_middle_class.html> accessed 7 May 2020.

[57] McKinsey & Company, 'Winning the $30 trillion Decathlon' <https://www.mckinsey.com/~/media/mckinsey/business%20functions/strategy%20and%20corporate%20finance/our%20insights/winning%20the%2030%20trillion%20decathlon%20going%20for%20gold%20in%20emerging%20markets/emc_decathlon.ashx> accessed 7 May 2020.

[58] McKinsey & Company, 'Winning The $30 Trillion Decathlon' <https://www.mckinsey.com/~/media/mckinsey/business%20functions/strategy%20and%20corporate%20finance/our%20insights/winning%20the%2030%20trillion%20decathlon%20going%20for%20gold%20in%20emerging%20markets/emc_decathlon.ashx> accessed 7 May 2020.

[59] Harvard Business School, Tech in Emerging Markets' (7 January 2019) <https://digital.hbs.edu/editions/tech-in-emerging-markets/> accessed 7 May 2020. See also Nomura, 'How is technology transforming global emerging markets?' (April 2018) <https://www.nomuraconnects.com/focused-thinking-posts/how-will-technology-transform-global-emerging-markets/> accessed 7 May 2020.

[60] Showing the lack of developed capital markets existing in many countries around the world, including emerging economies, see Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer and Robert W. Vishny, 'Legal Determinants of External Finance' (1997) 52 Journal of Finance 1131; Luc Laeven, 'The Development of Local Capital Markets: Rationale and Challenges' (2014), IMF Working Paper 234, <https://www.imf.org/external/pubs/ft/wp/2014/wp14234.pdf> accessed on 27 July 2020. For an overview of the capital structure of companies around the world, see Michael Atkin and Jack Glen, 'Comparing corporate capital structures around the globe' (1992) 34 (5) The International Executive 369-387. Showing the levels of financial exclusion existing in many emerging economies, see <https://www.worldbank.org/en/topic/financialinclusion/overview> accessed 4 August 2020. Pointing out that the lack of access to finance is the primary problem for the growth of many small firms in emerging markets. See Yao Wang, 'What are the biggest obstacles to growth of SMEs in developing countries? – An empirical evidence from an enterprise survey' (2016) 16 Borsa Istanbul Review 167.

[61] Adriana de la Cruz, Alejandra Medina and Yun Tang, 'Owners of the World's Listed Companies' (2019) OECD Capital Market Series <http://www.oecd.org/corporate/ca/Owners-of-the-Worlds-Listed-Companies.pdf> accessed 17 May 2020; The World Bank, 'Small and Medium Enterprises (SMEs) Finance' <https://www.worldbank.org/en/topic/smefinance> accessed 17 May 2020.

3.3 The anatomy of companies in emerging markets

The majority of businesses in emerging markets are micro and small-sized enterprises.[62] While the definition of 'small firm' differs across jurisdictions, MSMEs are usually defined based on several variables such as the number of employees, their revenues and their assets.[63] Regardless of the definition in a particular country,[64] most MSMEs share some common features, including simple organizational and financial structures.[65] Moreover, many MSMEs are not incorporated. Hence, entrepreneurs do not enjoy the benefits associated with the corporate form, including the existence of limited liability.[66] Even if incorporated, the MSME's shareholder/manager often acts as a guarantor for the company's debts.[67] As a result, they will still be liable for the company's debts.[68]

---

[62] The World Bank, 'Small and Medium Enterprises (SMEs) Finance' <https://www.worldbank.org/en/topic/smefinance> accessed 17 May 2020.

[63] Since countries have different sizes and features, it actually makes sense to have different definitions of MSMEs around the world. For example, while companies with more than 50 or 100 employees in large economies can be classified as small firms, these companies can be classified as large or at least medium-sized enterprises in small countries.

[64] Even within a country, the definition of 'small firm' can differ depending on the purpose. For example, under Australian corporate law, a company is defined as a 'small company' if it satisfies at least two of the following criteria: (i) an annual revenue of less than AUD$50 million; (ii) less than 100 employees; and (ii) assets of less than AUD$25 million. For taxation purposes, the Australian Taxation Office defines a small business entity as having less than AUD$10 million aggregated turnover. For employment purposes, Fair Work Australia defines a small business as one that has less than 15 employees. See https://asic.gov.au/for-business/small-business/ (accessed 18 October 2020). Under the new insolvency framework for MSMEs implemented in Australia, an MSME will be mainly defined depending on their liabilities. Namely, a company will have access to the simplified insolvency process if its liabilities do not exceed AUD$1 million. See Corporations Amendment (Corporate Insolvency Reforms) Act 2020 (Cth), regs 5.3B.03 and 5.5.03. In Singapore, something similar occurs. For example, under Singapore company law, small firms are generally defined as companies that fulfil at least two out of the following three conditions: (i) total annual revenue of the company not exceeding S$10 million; (ii) total assets not exceeding S$10 million; (iii) number of full-time employees at the end of the financial year not exceeding 50. See Companies Act, Thirteen Schedule (2). However, for the purpose of the simplified restructuring process adopted as a response to the COVID-19 crisis, the concept of MSME refers to companies meeting the following requirements: (i) annual sales turnover not exceeding $10 million; (ii) no more than 30 employees; (iii) no more than 50 creditors; and (iv) liabilities (including contingent and prospective liabilities) not exceeding $2 million. An additional requirement of no more than S$50,000 in unencumbered assets is imposed for the initiation of the simplified *liquidation* process. See Insolvency, Restructuring and Dissolution (Amendment) Act (No. 39 of 2020), ss 72F(2) and 250F(1).

[65] Aurelio Gurrea-Martinez, 'Implementing an Efficient Insolvency Framework for Micro and Small Firms', International Insolvency Review (Forthcoming, 2021).

[66] For a general overview of the primary features of a corporation, including the existence of limited liability, see John Armour, Henry Hansmann, Reinier Kraakman and Mariana Pargendler, 'What is Corporate Law?' in John Armour, Luca Enriques et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press 2017) 5–15. For an economic analysis of the limited liability, see Frank H Easterbrook and Daniel R Fischel, 'Limited Liability and the Corporation' (1985) 52 University of Chicago Law Review 89; Stephen Bainbridge and M Todd Henderson, *Limited Liability: A Legal and Economic Analysis* (Elgar 2016).

[67] In fact, the number of shareholders/managers acting as guarantors for the company's debts is also very high in many advanced economies. For example, in a study conducted in the United States, it was found that 56% of shareholders of small companies actually have *unlimited* liability due to the existence of guarantees. See Douglas G Baird and Edward Morrison, 'Series Entrepreneurs and Small Business Bankruptcies' (2005) 105 Columbia Law Review 8.

[68] Janis P Sarra, 'Micro, Small and Medium Enterprise (MSME) Insolvency in Canada' (2016) <https://commons.allard.ubc.ca/cgi/viewcontent.cgi?article=1309&context=fac_pubs> accessed 5 October 2020. See also The World Bank, 'Saving Entrepreneurs, Saving Enterprises: Proposals on the Treatment of MSME Insolvency' (The World Bank 2018), <http://documents1.worldbank.org/curated/en/989581537265261393/pdf/Saving-Entrepreneurs-Saving-Enterprises-Proposals-on-the-Treatment-of-MSME-Insolvency.pdf> accessed 4 August 2020.

In addition to the prevalence of MSMEs, it is also common to observe other types of companies in emerging markets: large corporations with controlling shareholders.[69] Sometimes, the controlling shareholder is the state.[70] In other cases, it is the founder and/or a family.[71] Either way, most large corporations existing in emerging markets have a controlling shareholder. This is another distinctive feature of emerging markets that should be taken into account when designing the insolvency framework.

4 Insolvency framework in emerging economies

Despite the international divergences existing across jurisdictions, the insolvency frameworks existing in emerging markets generally share some common features. In terms of the *law on the books*, insolvency laws are not usually very attractive to debtors, creditors or both. From the perspective of debtors, the law still performs a punitive function in many emerging economies.[72] This aspect can be observed from many features of the legislation, including the absence of a fresh start for honest but unfortunate individual debtors and a harsh liability regime for corporate directors. Other aspects reducing the attractiveness of the insolvency legislation for debtors is the lack of an adequate system for post-petition financing, a governance of the insolvency proceeding where the managers are often replaced, the lack of an automatic moratorium upon the filing, the imposition of stringent conditions for the approval of a reorganization plan, and the existence of many formalities and procedural requirements.

Despite the unattractiveness of the insolvency framework for debtors, the situation is not much better for creditors. In many emerging economies, creditors do not play a significant role in most of the decisions that need to be made in the proceeding. Moreover, the existence of statutory priorities for tax authorities that often exists in emerging economies reduces the returns to the general body of unsecured creditors. Additionally, many emerging economies do not respect the absolute priority rule and they do not provide a type of 'best interest of creditor test' guaranteeing that the creditors will receive in reorganization at least what they would receive in liquidation. Finally, the existence of an unattractive insolvency system for debtors will also harm creditors if, for example, it discourages the early initiation of insolvency proceedings, or it does not provide viable but financially distressed debtors with effective tools to promote the reorganization of the company.

In a global society, where ideas can flow from country to country, it is not clear why the law has not been improved in many emerging economies. The reason can probably due,

[69] Mariana Pargendler, 'Corporate Governance in Emerging Markets' in Jeffrey N Gordon and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press 2018).

[70] In many countries, including China, India, Singapore, France and Brazil, the state controls many companies. See Mariana Pargendler, 'State Ownership and Corporate Governance' (2012) 80 Fordham Law Review; Curtis J Milhaupt and Mariana Pargendler, 'Governance Challenges of Listed State-Owned Enterprises Around the World: National Experiences and a Framework for Reform' (2017) ECGI Working Paper 352; Adriana de la Cruz, Alejandra Medina and Yun Tang, 'Owners of the World's Listed Companies' (2019) OECD Capital Market Series <http://www.oecd.org/corporate/ca/Owners-of-the-Worlds-Listed-Companies.pdf> accessed 17 May 2020.

[71] Subodh Mishra, 'Corporate Governance in Emerging Markets' (24 February 2019) <https://corpgov.law.harvard.edu/2019/02/24/corporate-governance-in-emerging-markets-3/> accessed 17 May 2020.

[72] In some countries, especially in Asia and the Middle East, becoming insolvent can even involve going to jail. Fortunately, this punitive sanction of insolvency law is less relevant nowadays though. Before 326 BC, the creditors were even allowed to kill their debtor and distribute their pieces. See Genaro Franciosi, '"Partes secant", tra magia e diritto' (1978) 24 Labeo 263. After the enactment of the *Lex Poetelia Papiria* in 326 BC, however, insolvency law only allowed creditors to focus on the debtor´s *assets.* For a historical analysis of insolvency law and how this punitive function can be observed in early ages of insolvency law, see Louis E Levinthal, 'The Early History of English Bankruptcy' (1919) 67 University of Pennsylvania Law Review and American Law Register 1; Umberto Santarelli, *Per la storia del fallimento nelle legislazione italiane dell´ età intermedia* (CEDAM 1964).

at least in part, to the lack of a sophisticated academic and policy debate in these countries.[73] Other factors may include corruption,[74] path dependence[75] and lack of political will to engage in complex legal reform whose benefits will only be shown in the long run.

Other emerging economies, nonetheless, have amended their insolvency legislation and, at least on the books, their insolvency legislation seems to be more appealing. Despite their efforts, however, the insolvency system might not work either. In these circumstances, the failure is probably due to the fact that the 'good practices' eventually adopted by the country have not been adjusted to the particular legal, economic and institutional features existing in a particular emerging economy. Additionally, the lack of a well-functioning insolvency system in many emerging economies is often due to their weak market and institutional environment. This latter aspect is generally observed by the lack of a sophisticated judiciary, the existence of an underdeveloped financial system, and the lack of a qualified body of insolvency practitioners.

Regardless of whether the unattractiveness of the insolvency framework is due to a poor law on the books, a poor market and institutional framework, or both, many insolvency proceedings in emerging economies end up being value-destructive for debtors and creditors.[76] Therefore, in addition to the value lost *ex post*, from an *ex ante* perspective, debtors and creditors will have incentives to reduce the risk of insolvency. The best to do so is by reducing their levels of entrepreneurship, risk-taking and debt finance.[77] Therefore, an unattractive insolvency framework may end up harming innovation, the competitiveness and financing of companies, and the promotion of economic growth in emerging markets.

5 Enhancing the insolvency framework in emerging markets

5.1 Introduction

The optimal design of an insolvency framework requires at least three primary components: (i) an efficient insolvency law on the books; (ii) an efficient institutional framework; and (iii) a qualified industry of insolvency professionals to make sure that the insolvency rules are properly known and enforced.[78] Ideally, an emerging market interested in having an efficient insolvency framework should work on all of these factors. Unfortunately, while amending an insolvency law is relatively easy, building a strong institutional framework and having a highly qualified industry of insolvency professionals

[73] Aurelio Gurrea-Martínez, 'The Colombian Simplified Stock Corporation as a Paradigm of Legal Innovation: Thoughts about the Role of Legal Scholars in Society' in Francisco Reyes Villamizar (ed), *The Simplified Stock Corporation: Influence in Latin America* (Legis 2018).

[74] Corruption is generally considered a major issue in emerging markets. See Nicholas A Lash and Bala Batavia, 'Corruption and Doing Business in Emerging Markets' (2019) 9(11) Asian Economic and Financial Review 1279.

[75] Explaining how path dependence can help understand certain laws, institutions and market conditions in a country, see Lucian A Bebchuk and Mark J Roe, A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 Stanford Law Review 127.

[76] Oliver Hart, Rafael La Porta, Florencio Lopez de Silanes, and John More, 'Proposal for a new bankruptcy procedure in emerging markets' in Richard Levich (ed), *Emerging Capital Flows* (Kluwer 1988) 401–419; Simeon Djankov, Oliver Hart, Caralee McLiesh and Andrei Shleifer, 'Debt enforcement around the world' (2008) 116(6) Journal of Political Economy 1105; Zacharias Sautner and Vladimir Vladimirov, 'Indirect Costs of Financial Distress and Bankruptcy Law: Evidence from Trade Credit and Sales' (2018) 22(5) Review of Finance 1667.

[77] Aurelio Gurrea-Martinez, 'The Low Usage of Bankruptcy Procedure: A Cultural Problem? Lessons from Spain' (2020) 27 University of Miami International and Comparative Law Review 272.

[78] Suggesting similar recommendations to build an effective insolvency regime, see The World Bank, 'Principles for Effective Insolvency and Creditor/Debtor Regimes' (2016) <http://pubdocs.worldbank.org/en/919511468425523509/ICR-Principles-Insolvency-Creditor-Debtor-Regimes-2016.pdf> accessed 17 May 2020.

is more complicated. It will take time, resources and political will. In fact, due to a variety of factors, It will be argued that, even though, in an ideal scenario, any improvement of the insolvency framework in these countries should start by enhancing the judicial system and the sophistication of the insolvency profession, these reforms usually take time, resources and political will. In fact, due to a variety of factors, including corruption, lack of awareness about the importance of insolvency law for the promotion of economic growth, and lack of political incentives to engage in complex institutional reforms whose benefits will only be shown in the long run, they might never occur. For this reason, Section 5.2 will propose a system to deal with corporate insolvencies in emerging economies taking into account the *current* market and institutional features of these countries. Thus, if these conditions change in the future, or they do not exist in some particular emerging economies, the policy recommendations suggested in this article would need to be adjusted accordingly.

The proposed corporate insolvency framework for emerging economies is based on three primary pillars. First, workouts and hybrid procedures should be promoted as a way to avoid an insolvency system that is usually value-destructive for both debtors and creditors. Second, insolvency proceedings should be reformed to respond more effectively to the problems and features existing in emerging economies, which generally include, among other aspects, the prevalence of small firms and large companies with controlling shareholders, as well the existence of inefficient courts and the lack of a sophisticated body of insolvency practitioners. Finally, emerging economies should adopt a more contractual approach to deal with a situation of cross-border insolvency. Thus, by facilitating the choice of insolvency forum, debtors, creditors and society as a whole will be able to enjoy the benefits associated with having access to more sophisticated insolvency frameworks. Besides, since many debtors and creditors would be using foreign insolvency proceedings, this value-creating forum shopping may incentivize many Governments to invest the resources needed to improve the market and institutional environment existing in these countries, hopefully making the insolvency framework proposed in this article no longer needed.

5.2 Policy recommendations

5.2.1 Favoring workouts and hybrid procedures

In countries with value-destroying insolvency proceedings, as it generally occurs in emerging economies, the use of the formal insolvency framework should be minimized. For this reason, regulators and policymakers should favor the use of totally out-of-court debt restructuring mechanisms (“workouts”)[79] and the adoption of hybrid procedures usually under a formal pre-insolvency framework.[80]

The use of workouts can be promoted by enacting, or encouraging the private sector to enact, some guidelines to facilitate out-of-court debt restructurings.[81] Once these

[79] For a comprehensive analysis of out-of-court restructurings including purely contractual workouts, see Jose M Garrido, *Out-of-Court Debt Restructuring* (World Bank Studies 2012).

[80] By ‘pre-insolvency framework’, this article will mainly refer to the existence of a legal framework, generally available to companies not factually insolvent yet, that facilitates the financial reorganization of companies by providing them with some of the ‘insolvency tools’ usually existing in formal reorganization procedures. Therefore, the term ‘pre-insolvency framework’ will refer to the regulation of those procedures that some authors have classified as ‘hybrid procedures’. See Jose M Garrido, *Out-of-Court Debt Restructuring* (World Bank Studies 2012) 47-51. For an analysis of the concept and features of pre-insolvency proceedings, see Aurelio Gurrea-Martinez, ‘The Future of Reorganization Procedures in the Era of Pre-Insolvency Law’ (2020) 21(4) European Business Organization Law Review 829; Nicolaes Tollenaar, *Pre-insolvency Proceedings: A Normative Foundation and Framework* (Oxford University Press 2019).

[81] For example, in the United Kingdom, the British Bankers’ Association advocated for the use of the so-called ‘London Approach’, which consists of a non-statutory and informal framework supported by the Bank

guidelines are part of the business community, they will facilitate the creation of a 'rescue culture'.[82] Moreover, other factors existing in emerging markets will probably facilitate the success of many workouts. First, many companies in emerging markets are MSMEs with a few creditors.[83] Therefore, the existence of concentrated debt structures should facilitate workouts,[84] at least in the case of economically viable companies with trustworthy shareholders/managers.[85] Second, the prevalence of controlling shareholders in companies operating in emerging markets and the existence a few important creditors (typically banks) make many actors become repeated players in the market. As a result, since creditors may have business with some related companies or their controlling shareholders, there will be a higher chance to reach an agreement between debtors and creditors.[86] Finally, the inefficiency of the insolvency framework usually existing in emerging markets destroys value for both debtors and creditors. Therefore, it should be in everybody's interest to avoid the destruction of value generated by insolvency proceedings.

However, many factors, including the opportunistic behavior of some individual creditors, the negotiation costs associated with approving a reorganization plan requiring the unanimity of all the creditors, and the destruction of value associated with the inability of factually insolvent debtors to raise finance and keep their key suppliers and employees may make many workouts fail.[87] Therefore, emerging economies should implement 'enhanced workouts' or hybrid procedures generally through the adoption of formal pre-insolvency frameworks.[88] In fact, various emerging economies, such as Turkey and the

---

of England for dealing with companies or groups in financial difficulties. See John Armour and Simon Deakin, 'Norms in Private Insolvency: The "London Approach" to the Resolution of Financial Distress' (2001) 1 Journal of Corporate Law Studies 21. In Singapore, the Association of Banks has promulgated a set of principles for facilitating out-of-court workouts through its Principles & Guidelines for Restructuring of Corporate Debt ("ABS Guidelines"). The ABS Guidelines may be found at <https://www.abs.org.sg/docs/library/spore_approach.pdf> accessed 17 May 2020. Various international organizations have promoted some 'good practices' for workouts that can be helpful for emerging economies enacting, or encouraging their private sectors to enact, guidelines to promote workouts. For example, see 'A toolkit for out-of-court workouts' (2016), World Bank Group, <http://documents1.worldbank.org/curated/en/851561511964075432/pdf/121753-WP-PUBLIC-OCWToolkitFINALENGLISHWEB.pdf> accessed 4 August 2020. See also 'Statement of Principles for a Global Approach to Multi-Creditor Workouts II' (2017), INSOL International <https://www.insol.org/_files/Publications/StatementOfPrinciples/Statement%20of%20Principles%20II%20 18%20April%202017%20BML.pdf> accessed 4 August 2020.

[82] The 'rescue culture' created in countries like Singapore and the United Kingdom is probably due, at least in part, to the enactment of guidelines to promote out-of-court restructurings. See *supra* note 95.

[83] See *supra* Section 3.3.

[84] Stuart C Gilson, Kose John and Larry HP Lang, 'Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default' (1990) 27 Journal of Financial Economics 315; Edward R Morrison, 'Bargaining around Bankruptcy: Small Business Distress and State Law' (2009) 38 Journal of Legal Studies 255; See John Armour, Gerard Hertig and Hideki Kanda, 'Transactions with Creditors' in John Armour, Luca Enriques et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press 2017) 140–141.

[85] If a company is economically viable, the value of the company's assets are maximized if they are kept together under the current management team. See *supra* note 16. Therefore, the viability of the business and the reliability of the management team should be a pre-condition for a successful workout, or at least those workouts just involving financial restructuring instead of a going concern sale. Underlying the importance of the viability of the business in the context of workouts, see the guidelines and toolkits for workouts mentioned in note 88.

[86] The existence of repeated players has also been mentioned as a factor encouraging workouts in some advanced economies such as Singapore. See Aurelio Gurrea-Martinez and Samuel Loh, 'Singapore's Legal and Economic Response to the Covid-19 Crisis: The Role of Insolvency Law and Corporate Workouts' (2020) 17 International Corporate Rescue 292.

[87] These factors usually undermine the desirability of workouts. See Jose Maria Garrido, *Out-of-Court Debt Restructuring* (World Bank Studies 2012) 11–13.

[88] For the concept and features of these hybrid procedures (often referred as 'pre-insolvency proceedings'), see *supra* note 94. It should be noted, however, that while this article suggests the adoption of a formal pre-insolvency framework for emerging markets, the existence of these pre-insolvency frameworks might not be desirable or even needed in other jurisdictions. For instance, the United States has an attractive insolvency

Philippines, already have some forms of 'enhanced workouts' in place, and many jurisdictions around the world –including the United Kingdom, Singapore and the European Union– have amended their restructuring framework to create a hybrid procedure or enhance their pre-insolvency frameworks. By reducing the involvement of courts and the costs and stigma traditionally associated with formal insolvency proceedings, an enhanced workout or a hybrid procedure can maximize the advantages associated with out-of-court restructurings. At the same time, since these frameworks generally include various provisions typically existing in formal reorganization procedure, they can also provide debtors with the tools needed to achieve a successful debt restructuring. In many enhanced workouts, or in a soft form of a hybrid procedure –such as the traditional Scheme of Arrangement existing in the United Kingdom and in many common law countries– these tools just consist of a majority rule (*intra-class* cramdown) and, if so, a moratorium. In more developed pre-insolvency frameworks such as those regulated by the European Directive on Preventive Restructuring Framework, as well as in sophisticated forms of hybrid procedures like the Singapore Scheme of Arrangement after 2017, these tools also include provisions seeking to facilitate rescue financing and the restriction of *ipso facto* clauses.[89]

Compared to formal insolvency proceedings, debtors using enhanced workouts and hybrid procedures are usually subject to a lower level of scrutiny by courts and creditors. For this reason, the risk of opportunistic behavior by debtors – including bona fide debtors using these procedure when a company is not economically viable, and therefore it does not deserve to be reorganized– will probably be higher.[90] Thus, countries implementing enhanced workouts and hybrid procedures need to make sure that various safeguards are in place to protect the interests of the creditors and other stakeholders. For instance, these safeguards may include: (i) the ability of the creditors to appoint an insolvency practitioner to monitor the restructuring process;[91] (ii) the imposition of additional disclosure obligations;[92] (iii) the possibility of creating a committee of creditors

---

framework for both debtors and creditors. Moreover, it allows the commencement of a bankruptcy procedure even if the debtor is not formally insolvent yet. That might explain why the United States does not have, and it might not actually need, a formal pre-insolvency framework. See Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829, 847. Therefore, the adoption of pre-insolvency frameworks will be desirable in jurisdictions with inefficient insolvency proceedings. Nonetheless, it should be borne in mind that, while an inefficient insolvency framework usually exists in emerging markets, they can also be found in advanced economies. For example, arguing that Spain has an unattractive insolvency regime, and this factor may help explain the low usage of bankruptcy procedures in Spain, see Marco Celentani, Miguel Garcia-Posada and Fernando Gomez, 'The Spanish Business Bankruptcy Puzzle and the Crisis' (2010) FEDEA Working Paper 2010–11; Miguel Garcia-Posada and Juan S Mora-Sanguinetti, 'Why Do Spanish Firms Rarely Use the Bankruptcy System? The Role of the Mortgage Institution' (2012) Banco de Espana Working Paper 1234 <https://ssrn.com/abstract=2151810> accessed 17 May 2020; Aurelio Gurrea-Martinez, 'The Low Usage of Bankruptcy Procedure: A Cultural Problem? Lessons from Spain' (2020) 27 University of Miami International and Comparative Law Review 272.

89 Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829.

90 Analyzing the opportunistic use of pre-insolvency frameworks, especially in the context of the European Union, see Horst Eidenmuller, 'Contracting for a European Insolvency Regime' (2017) 18(2) European Business Organization Law Review 273; Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829.

91 As discussed below in Section 5.2, the appointment of an insolvency practitioner acting as a monitor in *pre-insolvency proceedings* will only be required in the context of large controlled firms. For other companies using the pre-insolvency framework, the managers will remain in possession without being subject to the supervision of any insolvency practitioner, unless the appointment of a monitor is required by the creditors.

92 Some authors have showed that hybrid procedures such as the Scheme of Arrangement do not usually provide the same level of disclosure generally existing in more formal reorganization procedures such as the US Chapter 11. See Wai Yee Wan and Casey Watters, *Mandatory Disclosure in Corporate Debt Restructuring via Schemes of Arrangement: A Comparative Approach*, International Insolvency Review (Forthcoming, 2021), City University of Hong Kong School of Law Legal Studies Research Paper No. 2021(1)-001 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3807669).

if it is approved by the creditors' meeting;[93] and (iv) and the empowerment of the creditors' meeting (or the relevant committee of creditors) in the restructuring process.[94]

Finally, it should be kept in mind that the success of a debt restructuring often depends on other factors beyond the insolvency legislation. One of them is the tax treatment of haircuts in corporate reorganizations.[95] For example, if a haircut potentially agreed between debtors and creditors is treated as an income from an accounting perspective and no tax exemptions apply, the debtor may be forced to pay taxes for an income that did not actually involve any generation of cash-flows.[96] Therefore, in the absence of a favorable tax treatment to haircuts, a debt restructuring may end up worsening, rather than improving, a debtor's liquidity problems. As a result, debtors may be discouraged from initiating a restructuring procedure. Therefore, a reform of the tax system can also be needed to encourage workouts and pre-insolvency proceedings.

5.2.2 Enhancing the design of insolvency proceedings

5.2.2.1 Minimizing the involvement of courts

In the absence of a sophisticated, reliable and efficient judicial system, the use of bankruptcy courts should be minimized.[97] This can be achieved by relying more on private parties, contracts, and market-based mechanisms. Several strategies can be adopted to concrete this goal. First, the appointment of insolvency practitioners should be led by debtors and creditors.[98] This will avoid any problems associated with the existence of poorly equipped courts unable to find and appoint the most qualified candidates, as well as the problems of corruption found in the appointment of insolvency practitioners in some countries.[99] Alternatively, countries with unreliable or unequipped courts can also implement a system for the appointment of insolvency practitioners based on algorithms fed with relevant information from a qualified pool of candidates (e.g., education, years of experience, areas of expertise, experience in different industries, etc.).[100] However, since the algorithm might not capture all the variables potentially relevant for the successful supervision or management of a particular insolvency proceeding, or the pool of candidates may not include all the suitable candidates available, this system should be accompanied by the possibility of debtors and creditors to remove the trustee appointed by the algorithm.

Second, as an additional way to minimize the use of the judicial system in emerging markets, insolvency law should rely more on contracts. In fact, as some authors have

[93] A committee of creditors does not generally exist in hybrid procedures.
[94] The empowerment of creditors has been one of the primary policies adopted in India after the enactment of the Insolvency and Bankruptcy Code in 2016. For an overview of the insolvency framework in India, see Pulkit Gupta, *Corporate Restructuring and Insolvency Law in Asia* (Asian Business Law Institute, 2020) 268-317.
[95] For an analysis of the tax treatment of haircuts in financial reorganizations, see Aurelio Gurrea-Martinez and Vincent Ooi, 'The Tax Treatment of Haircuts in Financial Reorganizations' (2020) 26 Revenue Law Journal 1.
[96] Aurelio Gurrea-Martinez and Vincent Ooi, 'The Tax Treatment of Haircuts in Financial Reorganizations' (2020) 26 Revenue Law Journal 1.
[97] See Oliver Hart, Rafael La Porta, Florencio Lopez de Silanes, and John More, 'Proposal for a new bankruptcy procedure in emerging markets' in Richard Levich (ed), *Emerging Capital Flows* (Kluwer 1988) 401–419
[98] Actually, this system has been adopted successfully in countries with sophisticated judiciaries, including the United Kingdom and Singapore.
[99] Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829.
[100] A reform in this direction has been implemented in Colombia. See *Régimen de los auxiliares de la justicia de la lista de la Superintendencia de Sociedades* (Resolution 130−000383) <https://www.supersociedades.gov.co/delegatura_insolvencia/reorganizacion_empresarial/Documents/Regimen_de_los_Auxiliares_de_la_Justicia_Supersociedades.pdf> accessed 20 May 2020, 83-100.

proposed, firms can even be allowed to choose the rules potentially applicable in a hypothetical scenario of insolvency.[101] This can be done, for example, by allowing the debtor to pick a set of insolvency rules from a 'menu' provided by the legislator or, more controversially, by allowing firms to directly contract with their creditors how they want to resolve a potential situation of insolvency, and make these agreements binding for the whole community of creditors.[102] However, these proposals have been generally criticized on two primary grounds. On the one hand, it has been argued that this contractual approach might not provide adequate protection to non-adjusting creditors.[103] On the other hand, this approach has also been criticized because it may encourage the debtor to opportunistically change the insolvency rules, especially if these rules can be established in the company's constitution. Nonetheless, these problems can be easily addressed. First, non-adjusting creditors can be protected by allowing them to enjoy a preferential treatment in bankruptcy regardless of the insolvency rules potentially chosen by the debtor. After all, there are powerful reasons to give priority to non-adjusting creditors. Indeed, since they were unable to adjust *ex ante* the conditions of their claims, a priority in bankruptcy would be a way to restore *ex post* a market failure existing *ex ante*.[104] Second, if these creditors do not enjoy priority in bankruptcy, debtors can opportunistically favor their sophisticated lenders, or even themselves, at the expense of non-adjusting creditors. Third, if non-adjusting creditors do not enjoy a preferential treatment in insolvency, debtors will not be fully internalizing the costs of their potential decisions affecting non-adjusting creditors. Thus, it can create a situation of moral hazard that can generate several inefficiencies and value-destroying behavior, including negligence, environmental harm, and other externalities. Finally, the problem associated with an opportunistic change of the insolvency rules can be addressed by requiring approval from the creditors for any amendments of the company's constitution affecting the insolvency rules. As a result, an increasing reliance on contracts should not be a major concern for the resolution of financial distress.

Third, in countries with inefficient and unreliable judicial systems, the involvement of courts should only be required for the most essential aspects of the procedure (e.g., approval of a reorganization plan, sale of essential assets), and provided that these issues cannot be addressed through other market or contractual mechanisms. Additionally, the complexity of the insolvency process should be reduced, and the insolvency legislation should be drafted in a clear and simple manner.

Finally, regulators and policymakers in emerging markets should carefully implement complex restructuring tools such as the availability of rescue (or DIP) financing and a cross-class cramdown.[105] Under the system of rescue financing existing in countries like Singapore and the United States, courts can allow new lenders (DIP lenders) to obtain a super-priority status. Thus, they will have incentives to extend credit to financially

---

[101] See Robert K Rasmussen, 'Debtor's Choice: A Menu Approach To Corporate Bankruptcy' (1992) 71 Texas Law Review 51; Robert K Rasmussen, "A New Approach to Transnational Insolvencies' (1997) 19 Michigan Journal of International Law 1; Horst Eidenmuller, 'Free Choice in International Company Insolvency Law in Europe' (2005) 6 European Business Organization Law Review 423.
[102] Alan Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (1998) 107 Yale Law Journal 1807.
[103]For an analysis of the concept, problems and features of 'non-adjusting creditors', see Lucian A Bebchuk and Jesse M. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy (1996) 105 Yale Law Journal 857. For a critical assessment of the contractual approaches to bankruptcy, see Lynn M LoPucki, 'Contract Bankruptcy: A Reply to Alan Schwartz' (1999) 109(2) Yale Law Journal 365; Susan Block-Lieb, 'The Logic and Limits of Contract Bankruptcy' (2001) University of Illinois Law Review 503; Jay Lawrence Westbrook, 'The Control of Wealth in Bankruptcy' (2004) 82(4) Texas Law Review 795; Elizabeth Warren and Jay Lawrence Westbrook, 'Contracting Out of Bankruptcy: An Empirical Intervention' (2005) 118(4) Harvard Law Review 1197.
[104] This priority can actually be found in some jurisdictions (eg. Spain).
[105] For an analysis of the concept, regulation and rationale of these provisions, see Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829.

distressed firms. Generally, this super-priority status can consist of: (i) an administrative expense priority that allows the DIP lender to get paid ahead of unsecured creditors; (ii) a priority over other administrative expenses; (iii) being secured by a lien over unencumbered assets; (iv) being secured by a junior lien on a property of the estate that is subject to a lien; and (v) being secured by a senior or equal lien on the property of the estate.[106] The implementation of DIP financing provisions in emerging markets can reduce the exacerbated underinvestment problems and lack of finance faced by insolvent firms in these countries. Therefore, it should be considered a desirable policy. However, a system of DIP financing requires sophisticated judges capable of analyzing, among other aspects, the desirability of the new financing as a mechanism to enhance value,[107] the impact of the DIP financing on the outcome of the restructuring procedure,[108] and the *ex ante* effects potentially associated with authorizing a super-priority that may alter the scheme of distribution.[109] For this reason, even though the existence of DIP financing is essential for the survival of viable but insolvent firms, especially in countries without developed financial systems as it generally occurs in emerging markets, a system of DIP financing should be design to minimize the role of courts in the approval of the new financing. In fact, the decision to authorize new financing should be ideally made by the creditors. Even if many creditors are not very sophisticated either, they have something equally important: skin in the game. Therefore, even if they do not always make value-maximizing decisions, the fact that they will bear the costs and benefits of this decision makes the creditors the most suitable actors to decide whether rescue financing should be authorized, especially in countries without sophisticated courts and insolvency practitioners.

The type of creditors approving the new financing should depend on the creditors primarily affected by the priority given to the DIP lender. For instance, when the debtor seeks to provide the DIP lender with a basic administrative expense priority or with a lien over an unencumbered asset, this transaction can reduce the pie available for distribution to unsecured creditors if the DIP financing does not end up preserving or creating value. Therefore, this form of priority should be authorized by unsecured

[106] For an analysis of the regulatory framework of DIP financing in the United States, see section 364 of the US Bankruptcy Code. In Singapore, see sections 67(9) and 101(10) of the Insolvency, Restructuring and Dissolution Act 2018. For a deeper analysis of this provision in Singapore, see Ajinderpal Singh and Adriel Chioh, ‘Rescue Financing in Singapore: Navigating Uncharted Waters’ (2020) Singapore Academy of Law Practice 1. For an analysis of the economics and regulation of DIP financing in the United States, see George G Triantis, ‘Secured Debt Under Conditions of Imperfect Information’ (1992) 21 Journal of Legal Studies 225, 249–252; George G Triantis, ‘Theory of the Regulation of Debtor-in-Possession Financing’ (1993) 46 Vanderbilt law Review 901; David A Skeel Jr, ‘The Past, present and Future of Debtor-in-Possession Financing’ (2004) 25 Cardozo Law Review 1905; Barry E Adler, Douglas G Baird and Thomas H Jackson, *Bankruptcy: Cases Problems and Materials* (4th edn, Foundation Press 2007) 475–520; Richard Squire, *Corporate Bankruptcy and Financial Reorganization* (Wolters Kluwers 2016) 235–260; George G Triantis, ‘Debtor-in-Possession Financing in Bankruptcy’ in Barry Adler (ed), *Research Handbook on Corporate Bankruptcy Law* (Elgar Publishing 2020).

[107] Emphasizing the expertise needed by bankruptcy judges to understand the underinvestment and overinvestment problems faced by insolvent firms, as well as the those DIP loans that enhance value of firm and those that redistribute wealth among classes of investors and contribute to agency costs, see George G. Triantis, ‘Theory of the Regulation of Debtor-in-Possession Financing’ (1993) 46 Vanderbilt Law Review 901, 919.

[108] Analysing the costs potentially created by a system of DIP financing that favours the new lenders at the expense of the creditors as a whole, see Kenneth Ayotte and Jared Ellias, ‘Bankruptcy Process for Sale’ (2020) UC Hastings Research Paper No. 382 <https://ssrn.com/abstract=3611350> accessed 1 July 2020. See also Frederick Tung, ‘Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis’ (2020) 37 Yale Journal on Regulation 651.

[109] This latter aspect has actually led some countries to be sceptical about the possibility of implementing rescue financing provisions. For example, the harmful impact of the adoption of DIP financing on lending markets was one of the arguments mentioned by the insolvency industry in the United Kingdom to be sceptical about the implementation of these provisions. See <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachmentdata/file/578524/Summary_of_responses_26-10-16_Redac ted.pdf>, p 11, accessed 4 July 2020.

creditors. If the DIP lender intends to obtain a super priority to get paid ahead of both unsecured creditors and other administrative expenses, the new financing should be approved by both types of creditors. Finally, if the new financing seeks to provide the DIP lender with a senior lien over a secured asset, the transaction should be authorized by the secured creditor affected by the new financing. Even if the affected secured creditors will unlikely authorize the new financing *unless* they are under-secured and the new financing can clearly be value-enhancing, this situation is not very different from those existing countries where the approval is given by courts, as it happens in Singapore and the United States. As it has been mentioned, granting this form of super priority in Singapore and the United States is not common. Various stringent conditions should be met, including providing adequate protection to the affected secured lender. For that reason, this priority is not often provided in the United States, and it has not been used in Singapore since the new rescue financing provisions were adopted in 2017. In fact, the low usage of this provision makes sense: if pre-existing secured creditors are not adequately protected, and it is not always easy to provide adequate protection, the new financing should not be authorized. Otherwise, the value of their security interest will be diluted, and they will respond by becoming more reluctant to extend credit in the first place. Therefore, the existence of stringent conditions for this fifth form of priority seems a desirable policy.

Something similar occurs with the adoption of a cross-class cramdown, that is, a provision allowing the imposition of a reorganization plan on dissenting *classes* of creditors. This provision is generally desirable because it can reduce negotiation costs and holdout problems.[110] Therefore, it can facilitate the approval of economically desirable reorganization plans. However, in countries with cramdown provisions, such as the United States, the United Kingdom and Singapore, the imposition of a plan on dissenting classes of creditors only takes place if a court finds that various requirements are met. These requirements usually imply conducting various complex tests to determine the desirability, suitability, and fairness of the reorganization plan.[111] Therefore, in countries with inefficient or unsophisticated bankruptcy courts, adopting these provisions may create unpredictability, delays, and other undesirable outcomes. For this reason, when it comes to the implementation of cramdown provisions in emerging markets, the decision of whether a plan should be imposed on dissenting classes of creditors should also be made by the creditors. Namely, a reorganization plan could be imposed on dissenting classes of creditors if, in addition to meeting some safeguards not generally requiring the involvement or a significant involvement of courts (e.g., respect of the absolute priority rule and approval of at least *one class* of impaired creditors), the plan is approved by a qualified majority of *all* the company's creditors.[112] Thus, by reducing the discretion of the court and conferring more power to the creditors, emerging markets could enjoy the benefits of having access to a cross-class cramdown without bearing the costs associated with letting unequipped courts decide on complex bankruptcy matters that require a high level of expertise.

5.2.2.2 Reducing the involvement of insolvency practitioners

[110] For the rationale of cramdown provisions, see Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829, 838-841. Arguing that solving holdout problems should be the primary role of corporate insolvency law, see Anthony J Casey, 'Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy' (2020) 120(7) Columbia Law Review 1709.

[111] Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829, 839-840.

[112] These objective requirements reducing the involvement of courts can avoid an undesirable increase in the cost of debt associated with the adoption of cramdown provisions. See Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829, 840-841.

In countries without a sophisticated body of insolvency practitioners, the imposition of a supervisor or trustee might not generate value. For instance, if insolvency practitioners do not have a proper training in economics, accounting, business and finance and they are not able to distinguish between viable and non-viable firms,[113] the legislator should rely more on market-based solutions such as auctions.[114] Alternatively, the system could also favor *ex ante* contractual arrangements between debtors and creditors,[115] or the legislator could rely on a debtor in possession-style governance system of insolvency proceedings.

The adoption of a debtor-in-possession governance system of insolvency proceedings, however, can be riskier in emerging markets due to the existence of many MSMEs and companies with controlling shareholders. Therefore, if this system is adopted, various safeguards should be adopted. First, creditors should have greater powers in bankruptcy. These powers may include the ability to appoint an insolvency practitioner that they may find appropriate, as well as the ability to initiate derivative actions and other legal remedies against the directors.[116] Second, the debtor in possession should be required to run the company for the best interest of the creditors. Since this mandate will generally imply maximizing the value of the firm, the interest of the creditors should not interfere with the interest of the shareholders. However, whenever the interests of the

---

[113] Kenneth Ayotte and Hayong Yun, 'Matching Bankruptcy Laws to Legal Environments' (2007) 25 The Journal of Law, Economics and Organization 1, arguing the optimal trade-off between *ex ante* and *ex post* efficiency in the design of bankruptcy law depends on the ability and expertise of the third parties (e.g., judges and insolvency practitioners) to efficiently assign control rights in bankruptcy. If these parties have the authority and expertise to (promptly) separate viable and non-viable firms, bankruptcy law should make use of their abilities to promote *ex post efficiency*. By contrast, when judges and/or insolvency practitioners lack the ability to discern between viable and non-viable firms, it might make sense for the legislator to favor *ex ante efficiency*, and therefore to design a more creditor-oriented bankruptcy law. Finally, and perhaps more importantly for the purpose of this paper, the authors conclude that when bankruptcy codes do not provide enough creditor protection to achieve *ex post* efficiency, lenders have incentives to write their contracts to resolve financial distress *outside* of bankruptcy. Therefore, poor creditor protection in bankruptcy can be ultimately associated with a low usage of bankruptcy procedures. See Marco Celentani, Miguel Garcia-Posada and Fernando Gomez, 'The Spanish Business Bankruptcy Puzzle and the Crisis' (2010) FEDEA Working Paper 2010–11; Miguel Garcia-Posada and Juan S Mora-Sanguinetti, 'Why Do Spanish Firms Rarely Use the Bankruptcy System? The Role of the Mortgage Institution' (2012) Banco de Espana Working Paper 1234 <https://ssrn.com/abstract=2151810> accessed 17 May 2020; Aurelio Gurrea-Martinez, 'The Low Usage of Bankruptcy Procedure: A Cultural Problem? Lessons from Spain' (2020) 27 University of Miami International and Comparative Law Review 272.

[114] Proposing a system of auctions that minimizes judicial intervention in insolvency proceedings, see Oliver Hart, Rafael La Porta, Florencio Lopez de Silanes, and John More, 'Proposal for a new bankruptcy procedure in emerging markets' in Richard Levich (ed), *Emerging Capital Flows* (Kluwer 1988) 401–419. Analyzing the use of auctions in bankruptcy, see Karin S Thorburn, 'Bankruptcy Auctions: Costs, Debt Recovery and Firm Survival' (2000) 58 Journal of Financial Economics 337; B Espen Eckbo and Karin S Thorburn, 'Bankruptcy as an Auction Process: Lessons from Sweden' (2009) 21(3) Journal of Applied Corporate Finance 38. For other market-based solutions suggested by the literature to reduce the role of court in valuation disputes and the allocation of value in bankruptcy, see Mark Roe, 'Bankruptcy and Debt: A New Model for Corporate Reorganization' (1983) 83 Columbia Law Review 527; Lucian A Benchuk, 'A New Approach to Corporate Reorganizations' (1988) 110(4) Harvard Law Review 775; Philippe Aghion, Oliver Hart and John Moore, 'The Economics of Bankruptcy Reform' (1992) 8 Journal of Law, Economics and Organization 523.

[115] Kenneth Ayotte and Hayong Yun, 'Matching Bankruptcy Laws to Legal Environments' (2007) 25 The Journal of Law, Economics and Organization 1.

[116] For an analysis of the derivative action in various jurisdictions, see Pearlie Koh, 'The Statutory Derivative Action in Singapore: A Critical and Comparative Examination' (2001) 13(1) Bond Law Review 64; Xiaoning Li, *A Comparative Study of Shareholders' Derivative Actions: England, the United States, Germany, and China* (Kluwer Law International 2007); Arad Reisberg, *Derivative Actions and Corporate Governance* (Oxford University Press 2007); Mathias M Siems, 'Private Enforcement of Directors' Duties: Derivative Actions as a Global Phenomenon' in Stefan Wrbka, Steven Van Uytsel and Mathias Siems (eds), *Collective Actions: Enhancing Access to Justice and Reconciling Multilayer Interests?* (Cambridge University Press 2012) 93; Martin Gelter, 'Why Do Shareholder Derivative Suits Remain Rare in Continental Europe?' (2012) 37(3) Brooklyn Journal of International Law 843; Dan W Puchniak, Harald Baum and Michael Ewing-Chow (eds), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012).

shareholders are in conflict with the interests of the creditors (for example, due to the existence of a project that, while potentially profitable, is very risky), the interest of the latter should prevail. Third, the debtor in possession should be subject to a more severe liability regime, especially for any breach of the duty of loyalty. Thus, while the managers can enjoy certain managerial discretion, and it can be even protected by the business judgment rule,[117] they will be prevented from engaging in related party transactions and other opportunistic behaviors that may harm the interest of the creditors. Finally, this debtor in possession regime should only apply, if so, for MSMEs. Since the costs of insolvency proceedings are proportionally higher for these companies,[118] and the human capital becomes particularly important for small firms, the debtor in possession might make more sense in this type of companies. However, as these factors might not be *that* relevant for large companies with controlling shareholders,[119] these latter companies should still be subject to the *mandatory* appointment of an insolvency practitioner in a formal bankruptcy procedure.[120]

5.2.2.3 Simplified insolvency regime for small firms

With a few exceptions, most insolvency jurisdictions around the world subject MSMEs to the same framework and insolvency proceedings existing for large companies.[121] While this is a problem for any country, including advanced economies, it becomes particular harmful for emerging economies due to the importance of MSMEs in these countries.[122]

The ordinary insolvency system can be very costly for MSMEs, especially taking into account that many of these firms might not even have assets to fund the costs of the procedure.[123] Therefore, initiating an insolvency proceeding is a luxury that many MSMEs cannot afford.[124] Even if they can, they face a second problem: the insolvency procedure may not be suitable for these firms. Even if it is, there is a third problem: many insolvency jurisdictions around the world do not provide an effective discharge of debts

---

[117] See Aurelio Gurrea-Martínez, 'Re-examining the law and economics of the business judgment rule: Notes for its implementation in non-US jurisdictions' (2018) 18(2) Journal of Corporate Law Studies 417.

[118] Edward R Morrison, 'Bargaining around Bankruptcy: Small Business Distress and State Law' (2009) 38 Journal of Legal Studies 255.

[119] Of course, there are many exceptions, and many large companies have controllers with a unique and value-creating vision. See Zohar Goshen and Assaf Hamdani, 'Corporate Control and Idiosyncratic Vision' (2015) 125 Yale Law Journal 560.

[120] This argument will be developed in Section 5.2.2.4.

[121] There are some notable exceptions though. For example, Myanmar has implemented special insolvency rules for micro and small firms. See Scott Atkins, *Corporate Restructuring and Insolvency Law in Asia* (Asian Business Law Institute, 2020) 522-529. A new regime for micro and small companies has also been adopted in Australia in 2021. See https://asic.gov.au/about-asic/news-centre/news-items/insolvency-laws-for-small-business-are-changing/ Singapore has also adopted a temporary framework for small and medium size companies, available from 29 January 2021. See https://www.mlaw.gov.sg/news/press-releases/simplified-insolvency-programme-commences In 2019, the United States adopted an insolvency framework for small firms through the Small Business Reorganization Act. Likewise, the United Nation Commission on International Trade Law (UNCITRAL) Working Group V (Insolvency Law) has published a drafted on a simplified insolvency regime for small firms. The text is available on the UNCITRAL´s Working Group V website <https://undocs.org/en/A/CN.9/WG.V/WP.168> accessed 17 May 2020.

[122] For a comprehensive analysis of the problems and features of MSMEs in insolvency, see Riz Mokal, Ronald Davis, Alberto Mazzoni, Irit Mevorach, Madam Justice Barbara Romaine, Janis Sarra, Ignacio Tirado, and Stephan Madaus, *Micro, Small, and Medium Enterprise Insolvency: A Modular Approach* (Oxford University Press 2018).

[123] Highlighting the significant costs of insolvency proceedings for MSMEs, see Merton Miller, 'Leverage' (1990) 46(2) The Journal of Finance 479, 484; Julian Franks and Oren Sussman, 'Financial Distress and Bank Restructuring of Small to Medium Size UK Companies' (2005) 9 Review of Finance 65.

[124] Emphasizing the lack of assets of MSMEs and their problems to fund an insolvency proceeding, see The World Bank, 'Report on the Treatment of MSME Insolvency' (2017) <https://openknowledge.worldbank.org/handle/10986/26709> accessed 17 May 2020. See also Jason Harris and Michael Murray, 'Insolvency law failing small business' (2020) <https://www.sydney.edu.au/law/news-and-events/news/2020/08/06/insolvency-law-failing-small-business.html> accessed 7 August 2020.

for individuals. Therefore, since sole traders and shareholders/managers often act as guarantors for the company's debts, there should be more coordination between the systems of corporate and personal insolvency.[125] Otherwise, honest but unfortunate sole traders and shareholders/managers of small companies will not find the insolvency system appealing even if, despite the potential attractiveness of the corporate insolvency framework, they do not enjoy an effective discharge of debts under the personal insolvency system.

An efficient insolvency framework for MSMEs in emerging markets should be based on several pillars.[126] First, workouts should be promoted.[127] While this recommendation has been suggested for any company in emerging markets, this solution is even more desirable in the context of MSMEs. On the one hand, an out of court restructuring can save the significant costs associated with the commencement of an insolvency proceeding for MSMEs. On the other hand, MSMEs often have very simple financial structures with a few creditors. Therefore, reaching an out of court agreement is more feasible for these firms.

Second, if the out of court restructuring fails, there will be reasons to believe that the company is not economically viable or the creditors do not trust the shareholders/managers. In those cases, the company should not be reorganized. Therefore, even though it is possible that the workout failed due to various factors other than the viability of the business (e.g., holdout problems, bad negotiations/advisors, etc), the insolvency system should prevent the use of reorganization procedures by non-viable businesses.[128] A desirable way to deal with this problem while still providing viable businesses the opportunity to stay alive may consist of implementing a fast-track, single-entry insolvency procedure for MSMEs based on a system of auctions.[129] Under this system, any interested party - including the existing shareholders/managers - should be allowed to bid for the company's assets, and non-cash offers (including reorganization plans) would be accepted.[130] Then, the creditors would choose among the different offers. Thus, the procedure could end up with a reorganization plan (if the reorganization plans potentially submitted by a bidder is accepted by the creditors), a going concern sale (if the business is bought by a third party) or a piecemeal liquidation (if the assets are sold separately).

To make this single-entry, simplified insolvency procedure based on a system of public auction work in a transparent, efficient and competitive manner, regulators should promote the use of technology and internet-enabled platforms.[131] Thus, people from all

[125] Janis P. Sarra, Micro, Small and Medium Enterprise (MSME) Insolvency in Canada (2016), < https://commons.allard.ubc.ca/cgi/viewcontent.cgi?article=1309&context=fac_pubs> accessed on 5 October 2020.

[126] See Aurelio Gurrea-Martinez, 'Implementing an Efficient Insolvency Framework for Micro and Small Firms', International Insolvency Review (Forthcoming, 2021).

[127] Ibid.

[128] Emphasizing the costs associated with liquidating viable companies and keeping alive non-viable firms, see Michelle J White, *The costs of corporate bankruptcy: A US-European comparison*, in Jagdeep S Bhandari and Lawrence A Weiss (eds), *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge University Press 1996) 489. Analysing how many non-viable business may use reorganization procedures opportunistically, see Horst Eidenmuller, 'Contracting for a European Insolvency Regime' (2017) 18 European Business and Organization Law Review 273; Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829.

[129] See Aurelio Gurrea-Martinez, 'Implementing an Efficient Insolvency Framework for Micro and Small Firms', International Insolvency Review (Forthcoming, 2021).

[130] Oliver Hart, Rafael La Porta, Florencio Lopez-de-Silanes, and John Moore, 'Proposal for a New Bankruptcy Procedure in Emerging Markets' in Richard Levich (ed), *Emerging Capital Flows* (Kluwer 1988) 401–419;

[131] See Aurelio Gurrea-Martinez, 'Implementing an Efficient Insolvency Framework for Micro and Small Firms', International Insolvency Review (Forthcoming, 2021).

over the world would be allowed to submit offers. This global reach of the auction process will also reduce the risks of experiencing fire sales.[132] Moreover, the costs formalities of the procedure should be reduced. This can be done in several ways. For instance, most of the decisions, including the initiation of the procedure, the allowance of claims, and the auction and voting process, should take place electronically.[133] Additionally, unless the auction process concludes with a reorganization plan that keeps the legal entity alive, the company should dissolved after the auction process. Any investigation of the debtor's behaviour or the initiation of avoidance actions should be conducted separately. Moreover, they should be funded by the creditors or any other parties.[134] While the auction takes place, however, the procedure needs to be managed. Unfortunately, many insolvent MSMEs cannot afford the appointment of an insolvency practitioner.[135] In countries with reliable institutions and efficient public administrations, as it happens in many advanced economies, the appointment of a public trustee might be a reasonable solution.[136] In emerging markets, however, a market-based solution will probably be more desirable. For this reason, letting the managers remain in possession can be a solution, provided that the creditors are provided with various safeguards.[137]

Third, honest but unfortunate entrepreneurs should enjoy a discharge of debts.[138] This aspect becomes particularly important in emerging markets due to the fact that a significant number of businesses are MSMEs, and many MSMEs are not incorporated and, even if they are, the shareholders/managers usually act as guarantors for the company's debts.[139] For the adoption of an effective discharge of debts for honest but unfortunate entrepreneurs, regulators need to coordinate their corporate and personal insolvency laws.[140] Ideally, the discharge of debts during the simplified insolvency process. Thus, the individual debtor behinds the MSMEs would not need to initiate a separate process, making this solution less costly for the debtor, the judicial system, and society as a whole.[141]

---

132 Ibid.

133 Advocating for the use of technologies in insolvency proceedings for MSMEs, see The World Bank, 'Saving Entrepreneurs, Saving Enterprises: Proposals on the Treatment of MSME Insolvency' (2018), <http://documents1.worldbank.org/curated/en/989581537265261393/pdf/Saving-Entrepreneurs-Saving-Enterprises-Proposals-on-the-Treatment-of-MSME-Insolvency.pdf> accessed 4 August 2020.

134 A similar solution has been adopted in Myanmar. See *supra* note 134. See also Aurelio Gurrea-Martinez, 'Implementing an Efficient Insolvency Framework for Micro and Small Firms', International Insolvency Review (Forthcoming, 2021).

135 Jason Harris and Michael Murray, 'Insolvency law failing small business' (2020) <https://www.sydney.edu.au/law/news-and-events/news/2020/08/06/insolvency-law-failing-small-business.html> accessed 7 August 2020.

136 Ibid

137 Suggesting several safeguards, see Aurelio Gurrea-Martinez, 'Implementing an Efficient Insolvency Framework for Micro and Small Firms', International Insolvency Review (Forthcoming, 2021).

138 Janis P. Sarra, Micro, Small and Medium Enterprise (MSME) Insolvency in Canada (2016), < https://commons.allard.ubc.ca/cgi/viewcontent.cgi?article=1309&context=fac_pubs> accessed on 5 October 2020; The World Bank, 'Saving Entrepreneurs, Saving Enterprises: Proposals on the Treatment of MSME Insolvency' (2018), <http://documents1.worldbank.org/curated/en/989581537265261393/pdf/Saving-Entrepreneurs-Saving-Enterprises-Proposals-on-the-Treatment-of-MSME-Insolvency.pdf> accessed 4 August 2020; World Bank (Saving Businesses.... 2017), Aurelio Gurrea-Martinez, 'Implementing an Efficient Insolvency Framework for Micro and Small Firms', International Insolvency Review (Forthcoming, 2021).

139 See supra Section 3.3

140 Janis P. Sarra, Micro, Small and Medium Enterprise (MSME) Insolvency in Canada (2016), < https://commons.allard.ubc.ca/cgi/viewcontent.cgi?article=1309&context=fac_pubs> accessed on 5 October 2020.

141 The World Bank, 'Saving Entrepreneurs, Saving Enterprises: Proposals on the Treatment of MSME Insolvency' (2018), <http://documents1.worldbank.org/curated/en/989581537265261393/pdf/Saving-Entrepreneurs-Saving-Enterprises-Proposals-on-the-Treatment-of-MSME-Insolvency.pdf> accessed 4 August 2020; World Bank (Saving Businesses.... 2017), Aurelio Gurrea-Martinez, 'Implementing an Efficient Insolvency Framework for Micro and Small Firms', International Insolvency Review (Forthcoming, 2021).

Fourth, various legal strategies should be implemented to reduce the stigma of insolvency proceedings.[142] While addressing this problem is essential for all types of companies, it becomes even more important for MSMEs due to the fact that the reputation of the entrepreneurs behind an MSME is closely linked to the fate of the business.[143] Potential solutions to reduce the stigma of insolvency proceedings may include the use of the term 'debtor' instead of 'bankrupt', and separating insolvency law from criminal law – an association still existing in many countries.[144] More interestingly, in Chile, the institution in charge of overseeing insolvency proceedings was named 'Superintendence of Insolvency and *Re-entrepreneurship*'.[145] Therefore, this innovative solution could be adopted in countries seriously considering getting rid of the bad connotations traditionally associated with insolvency proceedings.

5.2.2.4 Insolvency rules for large controlled firms

Even though MSMEs represent the majority of firms in emerging economies, it is also common to find many large companies with controlling shareholders in these countries.[146] Therefore, due to the existence of a strong shareholder influencing the company's business decisions, corporate insolvency law in these countries, at least in the context of these companies, should focus on reducing the risk of opportunism of shareholders *vis-a-vis* creditors.

In order to solve this problem, legislators should adopt two primary responses. First, as mentioned in Section 2, the duty to file for bankruptcy makes more sense in countries where companies usually have controlling shareholders. However, it was also argued that the imposition of this duty may do more harm than good if the insolvency proceeding is not very efficient – as is usually the case in emerging economies. For this reason, while imposing a duty to file for bankruptcy can be desirable in countries with controlling shareholders but efficient insolvency frameworks,[147] it might be undesirable in countries with value-destroying proceedings.[148]

---

[142] Ibid.

[143] See Aurelio Gurrea-Martinez, 'Implementing an Efficient Insolvency Framework for Micro and Small Firms', International Insolvency Review (Forthcoming, 2021).

[144] Ibid.

[145] For an analysis of the role and functions conducted by this institution, see <http://www.superir.gob.cl> accessed 17 May 2020.

[146] Rafael La Porta, Florencio Lopez de Silanes and Robert Vishny, 'Corporate Ownership Around the World' (1999) 54 Journal of Finance 471; Stijn Claessens, Simeon Djankov and Larry HP Lang, 'The Separation of Ownership and Control in East Asian Corporations' (2000) 58 Journal of Financial Economics 81; Lucian A Bebchuk, Reinier Kraakman and George Triantis, 'Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights' in Randall K Morck (eds), *Concentrated Corporate Ownership* (National Bureau of Economic Research 2000); Ronald W Masulis, Peter Kien Pham and Jason Zein, 'Family Business groups around the World: Financing Advantages, Control Motivations, and Organizational Choices' (2011) 24(11) The Review of Financial Studies 3556; Mariana Pargendler, 'Corporate Governance in Emerging Markets' in Jeffrey N Gordon and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press 2018).

[147] An example of a country with controlled firms and efficient insolvency frameworks can be Germany, which actually imposes a duty to file for bankruptcy. Therefore, the Germany solution seems to be economically justified. For a discussion on the desirability of the German duty to file for bankruptcy, see Thomas Bachner, 'Wrongful Trading – A New European Model for Creditor Protection?' (2004) 5 European Business Organization Law Review 293; Paul Davies, 'Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency' (2006) 7 European Business Organization Law Review 301; Horst Eidenmuller, 'Trading in Times of Crisis: Formal Insolvency Proceedings, workouts and the Incentives for Shareholders/Managers' (2006) 7 European Business Organization Law Review 239.

[148] While these proceedings are generally found in emerging markets, many advanced economies also have unattractive insolvency frameworks. See Simeon Djankov, Oliver Hart, Caralee McLiesh and Andrei Shleifer, 'Debt enforcement around the world' (2008) 116(6) Journal of Political Economy 1105; Marco Celentani, Miguel Garcia-Posada and Fernando Gomez, 'The Spanish Business Bankruptcy Puzzle and the Crisis' (2010) FEDEA Working Paper 2010–11; Aurelio Gurrea-Martinez, 'The Low Usage of Bankruptcy

Nonetheless, as the existence of controlling shareholders increases the risk of opportunism of shareholders *vis-a-vis* creditors, a regulatory intervention should be imposed. Some authors have argued that corporate insiders should have a duty to sell the company to the highest bidder.[149] However, since the debtor would still remain in possession, and these duties cannot be easily enforced, I do not think this solution would credibly address the problem of opportunistic behavior of shareholders *vis-à-vis* creditors. Besides, due to the existence of controlling shareholders, the debtor will probably be more reluctant to sell the company unless, of course, there is a good deal on the table. As a result, this solution will not be credible enough. And if so, creditors can respond from an *ex ante* perspective with an increase in the cost of debt, exacerbating the problems of financial exclusion generally existing in emerging economies.[150] In my opinion, a more desirable solution may consist of the imposition of a duty to initiate *pre-insolvency* proceedings if the company is economically viable. The initiation of this procedure would be required if a company is factually insolvent, and it would be optional if the company is just foreseeing financial difficulties. Due to the attractiveness of pre-insolvency frameworks compared to formal insolvency proceedings, many debtors should have incentives to initiate these procedures voluntarily. In any case, if they do initiate the procedure once the company becomes factually insolvent, creditors should be allowed to put the company in a formal insolvency proceeding, and the directors should be liable for the failure to initiate a pre-insolvency proceeding once the company became insolvent. Namely, they can be liable for damages, and they can also be subject to disqualifications, as it actually happens in many systems where corporate directors are subject to a duty to file to initiate insolvency proceedings once a company becomes factually insolvent.[151] Therefore, my proposal would involve a similar regime of directors' duties and liability than those existing in countries where corporate directors are required to initiate insolvency proceedings. There would be a *major* difference though: under my proposal, the directors of viable but financially distressed companies should not be required to initiate insolvency proceedings but the pre-insolvency framework suggested in Section 5.2.1. Thus, the system would provide a more effective response to protect creditors without forcing companies to bear the significant costs associated with formal insolvency proceedings.

Likewise, while the debtor in possession as a system of governance in insolvency proceedings was justified for MSMEs provided that some conditions are met, some of these policy justifications do not exist for large firms. First, large companies are in a better position to bear the minimum costs associated with insolvency proceedings. Second, the human capital of these companies, while still important, might be less relevant than in small businesses.[152] Therefore, the imposition of an insolvency practitioner to manage or supervise the company can be less disruptive. Third, these companies generally have

---

Procedure: A Cultural Problem? Lessons from Spain' (2020) 27 University of Miami International and Comparative Law Review 272.

[149] See Akshaya Kamalnath, 'Corporate Insolvency Resolution Law in India – A Proposal to Overcome the "Initiation Problem"' (2020) University of Missouri-Kansas City Law Review (Forthcoming) <https://ssrn.com/abstract=3387001> accessed 17 May 2020.

[150] See <https://www.worldbank.org/en/topic/financialinclusion/overview> accessed 4 August 2020. See also *supra* note 59.

[151] This duty to initiate insolvency proceedings is very common in Europe but it is not generally observed elsewhere. Countries imposing directors' duties to initiate insolvency proceedings include Germany, Czech Republic, France, Spain, Luxembourg , Poland and Portugal. See Aurelio Gurrea-Martinez, Towards an Optimal Model of Directors' Duties in the Zone of Insolvency: An Economic and Comparative Approach, Singapore Management University School of Law Research Paper No. 22/2020 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3717631> accessed 21 February 2021.

[152] Of course, there are many exceptions, and many large companies have controllers with a unique and value-creating vision. See Zohar many exceptions, and many large companies have controllers with a unique and value-creating vision. See Zohar Goshen and Assaf Hamdani, 'Corporate Control and Idiosyncratic Vision' (2015) 125 Yale Law Journal 560.

more creditors, employees and other third-party stakeholders. Therefore, the appointment of an insolvency practitioner can create more value, not only because it can provide credibility and expertise, but also because it can reduce asymmetries of information and coordination costs.

Therefore, the appointment of an insolvency practitioner seems to be justified for large companies *even in* the context of pre-insolvency procedures. However, in order to make the appointment of these insolvency practitioners more desirable in countries where courts and insolvency professionals might not be sophisticated, various safeguards and additional measures should be imposed. First, the insolvency practitioner should be appointed by the debtor among those candidates meeting certain requirements in terms of qualification and expertise. The appointment by the debtor will save coordination costs and it will also reduce other problems mainly associated with the asymmetries of information and different incentives potentially faced by the creditors. Moreover, it will incentivize a market for insolvency practitioners, thus increasing the incentives of the insolvency profession to invest in knowledge and expertise. Simultaneously, however, creditors should have the ability to remove the insolvency practitioner. Thus, this power, in addition to a variety of legal and market incentives,[153] will increase the chances that insolvency practitioners perform their functions in an independent and professional manner without favoring the interests of the person appointing them.

Second, instead of imposing an administrator, as it is very common in many reorganization procedures around the world,[154] the insolvency practitioner should just act as a *supervisor* during the pre-insolvency proceeding and, if so, even during a formal reorganization procedure. Therefore, the debtor would remain in possession subject to the supervision of an independent insolvency practitioner.[155] Thus, the debtor would be less reluctant to initiate the procedure at a timely manner, and this system could maximize the benefits associated with having a debtor in possession (particularly in terms of the expertise and connections provided by the managers) while minimizing the costs of this model mainly associated with the risk of opportunistic behavior of shareholders *vis-a-vis* creditors potentially existing in a situation of insolvency. The replacement of the directors should only take place in cases of mismanagement or if the procedure ends up in liquidation.[156]

---

[153] Among the legal incentives to perform their functions in an independent manner, the fact of being exposed to personal liability may act as a powerful deterrence, provided that there are mechanisms in place to make the enforcement of this liability credible. Likewise, insolvency practitioners will be exposed to a variety of market mechanisms that will encourage them to behave in an honest and independent manner. Otherwise, they may end up losing their licenses, as well as their reputation, and they can be prevented from obtaining the future rents associated with this work. This latter idea has been developed in the audit literature. See Martin Gelter and Aurelio Gurrea-Martinez, 'Addressing the Auditor Independence Puzzle: Regulatory Models and Proposal for Reform' (2020) 53 Vanderbilt Journal of Transnational Law 787. See also Linda Elizabeth DeAngelo, 'Auditor independence, "low balling" and disclosure regulation' (1981) 3(2) Journal or Accounting and Economics 113, 115; Chi-Wen Jevons Lee and Zhaoyang Gu, 'Low Balling, Legal Liability and Auditor Independence' (1998) 73(4) The Accounting Review 533; Mark DeFond and Jieying Zhang, 'A review of archival auditing research' (2014) 58 Journal of Accounting and Economics 275, 297.

[154] Reorganization procedures imposing an administrator include Australia, Singapore, and the United Kingdom. These administrators are not generally appointed, however, in pre-insolvency proceedings such as the scheme of arrangement. See Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829.

[155] This is the system generally existing in formal reorganization procedures in many countries in Europe and Latin America. In pre-insolvency proceedings, however, the appointment of an insolvency practitioner has not generally been required. It is starting to be required in certain jurisdictions implementing more comprehensive preventive frameworks, such as the United Kingdom and the European Union.

[156] This is the solution existing, for example, in the United States. See Jonathan C Lipson, 'Understanding failure: examiners and the bankruptcy reorganization of large public companies' (2010) 84 American Bankruptcy Law Journal 1.

5.2.2.5 Abolishing statutory priorities of public agencies

Public authorities, and particularly tax agencies, enjoy a preferential status in the ranking of claims in many insolvency jurisdictions around the world.[157] However, if there are reasons to be skeptical about these statutory priorities in advanced economies,[158] the case for abolishing this preferential treatment of public claimants is even stronger in emerging markets as a result of several factors. First, one of the arguments traditionally given to keep the preferential treatment of public claimants is that the resources collected by these creditors can then be spent by public authorities for the benefit of society as a whole.[159] However, due to the problems of corruption and the lack of efficient public sectors in many emerging markets, it would seem more desirable if these resources are directly spent by the private sector. Therefore, the abolition of the preferential treatment of public claimants would facilitate this outcome.

Second, companies in emerging economies generally have fewer financing options available.[160] Therefore, a deterioration of their financial position can jeopardize the survival of many viable companies. As a result, since a preferential treatment of public claimants would put private creditors –many of them small businesses– in a worse financial position due to the fact that their recoveries would be reduced in bankruptcy, even leading to a situation of insolvency of those creditors more exposed to the debtor, the abolition of this preferential treatment of public creditors would be more beneficial in emerging markets.

5.2.3 Favoring a contractual approach in cross-border insolvency

The final pillar of my proposal deals with the regulation of cross-border insolvency in emerging markets. For that purpose, it is worth starting by keeping in mind that, in most (if not all) jurisdictions around the world, corporate insolvency law is generally considered mandatory law.[161] In other words, parties cannot formally 'opt out' of the insolvency

[157] These jurisdictions include both emerging and advanced economies. Exceptions to this preferential treatment of tax authorities can be found in Australia and various European countries. See Barbara K Morgan, 'Should the Sovereign be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy' (2000) 74 American Bankruptcy Law Journal 461. See also International Insolvency Institute, 'Governmental Tax Priorities in Bankruptcy Proceedings' (March 2006) <https://www.iiiglobal.org/sites/default/files/media/1_Day_Governmental_Tax.PDF> accessed 17 May 2020. In the United States and Australia, see Christopher F Symes, 'Reminiscing the Taxation Priorities in Insolvency' 2005 2(1) Journal of the Australasian Tax Teacher Association 435.

[158] See Barbara K Morgan, 'Should the Sovereign be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy' (2000) 74 American Bankruptcy Law Journal 461; Christopher F Symes, 'Reminiscing the Taxation Priorities in Insolvency' 2005 2(1) Journal of the Australasian Tax Teacher Association 435; John Duns and John Glover, 'The Taxation Priority in Insolvency: An Australian Perspective' (2005) 14 International Insolvency Review 171.

[159] This argument has been emphasized by R3, a leading association of insolvency professionals in the United Kingdom, arguing that the reestablishment of a preferential status of tax claimants in insolvency and restructuring proceedings in the United Kingdom will harm the economy as whole. See 'R3 warns of consequences of Finance Bill insolvency creditor changes', <https://www.r3.org.uk/press-policy-and-research/news/more/29494/r3-warns-of-consequences-of-finance-bill-insolvency-creditor-changes/> accessed 4 August 2020.

[160] See *supra* note 60.

[161] Justifying this policy option, see Thomas H. Jackson, *The Logics and Limits of Bankruptcy Law* (Harvard University Press 1986) 7-19. Advocating for a contractual approach to deal with corporate insolvency, see Robert K Rasmussen, 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy' (1992) 71 Texas Law Review 51; Alan Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (1998) 107 Yale Law Journal 1807.

regime.[162] In fact, they are not generally free to decide their insolvency forum,[163] and even if they were, third countries might not allow the commencement of insolvency proceeding of foreign companies, or their local jurisdictions may not recognize the insolvency-related judgments of these foreign countries.

In the past decades, many countries and authors have been debating about the nature of insolvency law, and the best way to deal with a situation of cross-border insolvency. Basically, the former discussion has been focused on analyzing whether insolvency law should be mandatory law or it should have a more contractual basis.[164] The latter has focused on how to deal with a situation of cross-border insolvency.[165] For that purpose, three primary regulatory models have been suggested: (i) universalism, advocating for the adoption of a single insolvency forum for the commencement of an insolvency proceeding with an international component;[166] (ii) territorialism, consisting of opening insolvency proceedings in those places where the debtors have assets and creditors;[167] and (iii) a contractual approach, suggesting that debtors should have the ability to decide where to initiate insolvency proceedings[168]. Then, there have been various intermediate approaches, including modified universalism,[169] which is form of universalism with some elements of territorialism, and cooperative territorialism.[170] By far, the most successful model implemented internationally has been the modified universalism, which was the regulatory approach adopted by the United Nation Commission on International Trade Law (UNCITRAL) and it has been implemented in many countries around the world.[171] According to this model, there will be a single insolvency forum to deal with the main insolvency proceeding, even if non-main procedures can be opened in other countries and the successful management of the proceeding requires a strong level of international

[162] However, there are informal mechanisms to do so. See Douglas G Baird and Anthony J Casey, 'No Exit? Withdrawal Rights and the Law of Corporate Reorganizations' (2013) 113 Columbia Law Review 1; Julian Franks and Oren Sussman, 'The Privatization of Bankruptcy: Evidence from Financial Distress in the Shipping Industry' (2017) European Corporate Governance Institute (ECGI) – Finance Working Paper No 505 <https://ssrn.com/abstract=2880751> accessed 17 May 2020.

[163] For an analysis of the determinants of the choice of an insolvency forum, see Chien-An Wang, 'Determinants of the Choice of Formal Bankruptcy Procedure: An International Comparison of Reorganization and Liquidation' (2012) 48 Emerging Markets Finance and Trade 4.

[164] For the debate on the nature of insolvency law, see *supra* note 173.

[165] For a general discussion on the features, challenges and regulatory models in cross-border insolvency, see Ian F Fletcher, *Insolvency in Private International Law* (2nd Ed, Oxford University Press 2007); Bob Wessels, Bruce A Markell and Jason Kilborn, *International Cooperation in Bankruptcy and Insolvency Matters* (Oxford University Press 2009); Reinhard Brok, *Principles of Cross-Border Insolvency Law* (Intersentia 2017).

[166] Lucian A Bebchuk and Andrew T Guzman, 'An Economic Analysis of Transnational Bankruptcies' (1999) 42 Journal of Law and Economics 775; Jay L Westbrook, 'A Global Solution to Multinational Default' (2000) 98 Michigan Law Review 2276; Andrew T Guzman, 'International Bankruptcy: In Defense of Universalism' (2000) 98 Michigan Law Review 2177; Jay L. Westbrook, 'Global Insolvency Proceedings for a Global Market: The Universalist System and the Choice of a Central Court' (2018) 96 Texas Law Review 1473.

[167] Lynn M LoPucki, 'Cooperation in International Bankruptcy: A Post-Universalist Approach' (1999) 84 Cornell Law Review 696.

[168] Robert K Rasmussen, 'A New Approach to Transnational Insolvencies' (1997) 19 Michigan Journal of International Law 1; Horst Eidenmuller, 'Contracting for a European Insolvency Regime' (2017) 18 European Business Organization Law Review 272.

[169] For an analysis of this model, see Jay L. Westbrook, 'Universalism and Choice of Law' (2005) 23 Penn State International Law Review 625; Irit Mevorach, 'Modified Universalism As Customary International Law' (2018) 96 Texas Law Review 1403; Gerard McCormack and Wai Yee Wan, Model Law on cross-border insolvency comes of age: New times or new paradigms (2019) 54 (2) Texas International Law Journal 273.

[170] Lynn M LoPucki, 'The Case for Cooperative Territoriality in International Bankruptcy' (2000) 98 Michigan Law Review 2216.

[171] By the end of 2020, the Model Law on Cross-Border Insolvency has been adopted by 49 countries, including Australia, United Kingdom, United States, Japan, Singapore and many emerging economies. For the full list of countries that have adopted the Model Law, see <https://uncitral.un.org/en/texts/insolvency/modellaw/cross-border_insolvency/status> accessed 21 February 2021.

cooperation.[172] Therefore, the main insolvency proceeding will be conducted in one single jurisdiction identified by the debtor's center of main interest ("COMI"), which is generally the place of the debtor's registered office.[173] As a result, if the debtor's COMI is located in an emerging economy, the main proceeding should be opened in that jurisdiction regardless of the attractiveness of the insolvency framework.

While several reasons may justify the adoption of modified universalism in advanced economies,[174] the particular features of emerging markets make this approach less desirable for these countries. In my opinion, the unattractiveness of the insolvency framework in these markets should encourage them to adopt a more contractual approach to cross-border insolvency. Thus, debtors with a COMI in emerging markets would not be forced to bear the costs associated with an insolvency system that may actually be value-destructive. Instead, they should be free to choose their insolvency forum. For instance, they can do so by including the insolvency forum in the company's constitution.[175] Then, the role of local courts should just consist of making sure that foreign decisions are enforced and recognized internally. By giving more contractual freedom when it comes to choosing insolvency forum, companies, lenders and society as a whole would be able to enjoy the benefits associated with having access to a sophisticated insolvency framework. Hence, this contractual approach foster entrepreneurship, access to finance growth in developing economies.

However, the implementation of a contractual approach faces several challenges. First, the debtor, usually in conjunction with some sophisticated lenders, may choose an insolvency forum that cannot be beneficial for non-adjusting or poorly adjusting creditors.[176] However, as it was mentioned in Section 5.2.2, this problem can be addressed by giving priority to these creditors *regardless* of the position of these creditors in the ranking of claims of the jurisdiction chosen by the debtor. The second problem for the successful implementation of this approach may consist of the possibility of having access to foreign insolvency jurisdictions. This challenge, however, does not depend on the local jurisdiction. Instead, it depends on the eligibility criteria existing in other countries. For instance, many countries, including the United States and Singapore, allow the commencement of insolvency proceedings if the debtor proves a connection

[172] Analyzing some challenges for the success of the Model Law on Cross-Border Insolvency, see Kannan Ramesh, 'The Gibbs Principle: A Tether on the Feet of Good Forum Shopping' (2017) 29 Singapore Academy of Law Journal 42; Irit Mevorach, *The Future of Cross-Border Insolvency: Overcoming Biases and Closing Gaps* (Oxford University Press 2018); Adrian Walters, 'Modified Universalisms and the Role of Local Legal Culture in the Making of Cross-Border Insolvency Law' (2019) 93 American Bankruptcy Law Journal 47; Sundaresh Menon, 'The Future of Cross-Border Insolvency: Some Thoughts on a Framework for a Flattening World' (Keynote address, 18th Annual Conference of the International Insolvency Institute, 2018) <https://www.supremecourt.gov.sg/Data/Editor/Documents/(III%20Conference%202018)%20Keynote%20address%20by%20Sundaresh%20Menon%20CJ.pdf> accessed 18 May 2020.

[173] See 16.3 of the Model Law on Cross-Border Insolvency. The presumption of the registered office, however, can be rebutted. The rebuttal of this presumption is generally complicated, and it requires the party alleging this to show that the debtor conducts the administration of his interests on a regular basis in a different country, and that this is ascertainable by third parties. See UNCITRAL, 'Model Law on Cross-Border Insolvency: Guide to Enactment and Interpretation' (2013) <https://www.uncitral.org/pdf/english/texts/insolven/1997-Model-Law-Insol-2013-Guide-Enactment-e.pdf> accessed 21 May 2020, 70-71.

[174] Andrew T Guzman, 'International Bankruptcy: In Defense of Universalism' (2000) 98 Michigan Law Review 2177; Jay L Westbrook, 'A Global Solution to Multinational Default' (2000) 98 Michigan Law Review 2276.

[175] Robert K Rasmussen, 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy' (1992) 71 Texas Law Review 51.

[176] Contractual approaches to corporate insolvency have often been criticized on the basis of this argument. See Lynn M LoPucki, 'Contract Bankruptcy: A Reply to Alan Schwartz' (1999) 109(2) Yale Law Journal 365; Susan Block-Lieb, 'The Logic and Limits of Contract Bankruptcy' (2001) University of Illinois Law Review 503; Jay Lawrence Westbrook, 'The Control of Wealth in Bankruptcy' (2004) 82(4) Texas Law Review 795; Elizabeth Warren and Jay Lawrence Westbrook, 'Contracting Out of Bankruptcy: An Empirical Intervention' (2005) 118(4) Harvard Law Review 1197.

with the country.[177] Therefore, debtors just need to make sure that, when choosing their insolvency forum, they choose a country where, in their condition of foreign companies, they would be allowed to initiate an insolvency proceeding.

A third challenge for the implementation of this approach consist of making sure that debtors are not opportunistically choosing their insolvency forum. In order words, while choosing an insolvency forum is not necessarily undesirable, and it can actually create value if the new forum provides a more efficient insolvency framework, there is also the possibility that the debtor chooses a forum that can be beneficial for the company or some of their lenders even if it is at the expense of the creditors as a whole.[178] At the moment of setting up the company, the debtor should have incentives to choose in the company's constitution an insolvency forum that looks attractive to creditors. Otherwise, the debtor may have trouble having access to debt finance, since sophisticated lenders will likely pay attention to this provision of the constitution. Likewise, as non-adjusting and poorly adjusted creditors would enjoy a priority in insolvency, they should not be affected. Therefore, this contractual approach should not generate any issue at the early stages of the company. The primary issue potentially generated by this approach would be *ex post,* that is, once the company is operating and the debtor has borrowed money from a variety of creditors. In these situations, a debtor – particularly if it is foreseeing a situation of insolvency– may have incentives to opportunistically change the insolvency forum. Thus, it can pick an insolvency forum that provides a better treatment for the debtor, even if it is at expense of the creditors.

This situation, however, can be easily solved. As suggested in Section 5.2.1, this problem can be addressed by requiring creditor approval for any change in the company's constitution affecting the insolvency forum.[179] In fact, given the fact that the change of insolvency forum can affect creditors' rights, this change should be approved by all the creditors.[180] Therefore, if the debtor does not get unanimous support from the creditor, the change of insolvency forum should not be valid. Alternatively, countries seeking to provide more flexibility may permit this change if, even if some creditors do not approve the shift of insolvency forum, the debtor shows that the new insolvency forum will not make any creditor worse off. As a result, the adoption of a contractual approach can be done without harming creditors' rights.

The choice of insolvency forum will allow debtors and creditors in emerging markets to have access to more sophisticated insolvency frameworks. Therefore, it can serve as a valuable mechanism to foster entrepreneurship, access to finance and economic growth

[177] In Singapore, the law requires a *substantial* connection which can be shown through a variety of mechanisms, including proving that the debtor: (i) has its center of main interest in Singapore; (ii) is carrying on business in Singapore or has a place of business in Singapore; (iii) has substantial assets in Singapore; (iv) has chosen Singapore law as the law governing a loan or other transactions; or iv) has submitted to the jurisdiction of the Singapore Courts in the resolution of one or more disputes relating to a loan or other transactions. See section 63(3) read with sections 246(1)(d) and 246(3) of the Insolvency, Restructuring and Dissolution Act. In the United States, the basis for this connection is having 'property' in the United States, as required in section 109(a) of the Bankruptcy Code. However, courts have interpreted the concept of property very broadly in this context, mentioning that this concept may include 'having a dollar, a dime or a peppercorn located in the United States'. See *In re Global Ocean Carriers Ltd* 251 B.R. (Bankr. D. Del. 2000). However, a debtor cannot opportunistically place property in the United States with the sole purpose of being eligible to file for bankruptcy. If so, this petition can be considered in bad faith, and the case would be dismissed. See *In re McTague* 198 B.R. 428, 43 (Bankr. W.D.N.Y. 1996).

[178] For a discussion on the desirability of 'forum shopping', see Wolf-Georg Ringe, 'Insolvency Forum Shopping, Revisited' (2017) Hamburg Law Review 38; Horst Eidenmuller, 'The Rise and Fall of Regulatory Competition in Corporate Insolvency Law in the European Union' (2019) 20 European Business Organization Law Review 547.

[179] Robert K Rasmussen, 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy' (1992) 71 Texas Law Review 51.

[180] *Ibid.*

in countries where the insolvency framework cannot effectively contribute to these goals. Additionally, since many debtors and creditors would be using foreign insolvency proceedings, this value-creating forum shopping may incentivize many Governments to invest the resources needed to improve the insolvency, market institutional environment in these countries.[181]

6 Conclusion

A well-functioning corporate insolvency system can serve as a valuable tool to promote entrepreneurship, innovation, access to finance and economic growth. Therefore, if having an efficient insolvency framework is essential for any country, it becomes even more important for emerging economies due to their potential for growth and their greater financial needs. Unfortunately, the academic literature has generally paid more attention to the regulation of corporate insolvency in advanced economies.

This article has sought to fill this gap in the academic literature by analyzing the problems and features of insolvency law in emerging markets. It has been argued that, even though, in an ideal scenario, any improvement of the insolvency framework in these countries should start by enhancing the judicial system and the sophistication of the insolvency profession, these reforms usually take time, resources and political will. In fact, due to a variety of factors, including corruption, lack of awareness about the importance of insolvency law for the promotion of economic growth, and lack of political incentives to engage in complex reforms whose benefits will only be shown in the long run, they might never occur. For this reason, this article has suggested a corporate insolvency framework for emerging economies taking into account the current market and institutional features of these countries. If these conditions change over time, or they do not exist in some particular countries, the proposed framework suggested in this article would need to be adjusted accordingly.

While the institutional and market environment in emerging economies improves, this article has argued that an efficient corporate insolvency framework in emerging markets should be based on three fundamental pillars. First, workouts and hybrid procedures should be promoted as a way to avoid a formal insolvency framework that is usually value-destructive for both debtors and creditors. Second, insolvency proceedings should be reformed to respond more effectively to the problems and features existing in emerging economies, which generally include, among other aspects, the prevalence of small firms and large companies with controlling shareholders, as well the existence of inefficient courts and the lack of a sophisticated body of insolvency practitioners. Finally, emerging economies should adopt a more contractual approach to deal with a situation of cross-border insolvency. Thus, by facilitating the choice of insolvency forum, debtors, creditors and society as a whole will be able to enjoy the benefits associated with having access to more sophisticated insolvency frameworks. Besides, since many debtors and creditors would be using foreign insolvency proceedings, this value-creating forum shopping may incentivize many governments in emerging economies to invest the resources needed to improve the market and institutional environment existing in these countries, hopefully making the insolvency framework suggested in this article no longer needed.

[181] For an analysis of the concept of this type of value-creating forum shopping, see Kannan Ramesh, 'The Gibbs Principle: A Tether on the Feet of Good Forum Shopping' (2017) 29 Singapore Academy of Law Journal 42.