

PAKISTAN

STRENGTHENING THE INSOLVENCY REGIME

Non-Lending Technical Assistance (NLTA)

Final Report

June 23, 2011



Finance and Private Sector Development
South Asia Region (SASFP) and
Finance, Private Sector Development and Infrastructure
Legal Vice Presidency (LEGPS)
The World Bank

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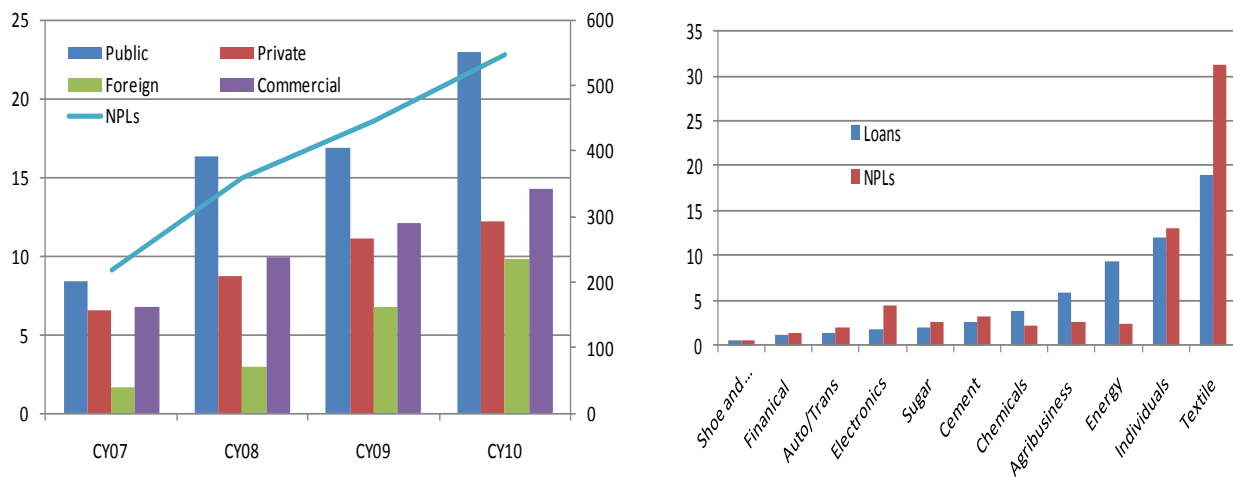
PAKISTAN
Strengthening the Insolvency Regime
NLTA Final Report

I. Introduction

1. The importance of a modern, binding and effective insolvency regime is undeniable. Nearly 90 countries around the world have reformed their bankruptcy codes since World War II, and over half of them have done so during the last decade. One of the key aspects in the reform process is the delicate balance addressed by a modern insolvency system which encourages the organization of viable firms and liquidates unviable firms. In doing so, the system should seek to minimize reorganization costs by ensuring quick and efficient procedures, by ensuring that viable firms are better off reorganized than liquidated and by incentivizing a speedy recovery of reorganized firms.

2. The financial and macroeconomic crises, as recently experienced in Pakistan, provide an opportunity for bankruptcy reform, as the potential employment impact often places the issue of insolvent companies high on the policy agenda.¹ As such, in the wake of the 2008-09 balance of payments crises, Pakistan like other jurisdictions, gave renewed attention to establishing a modern insolvency regime to effectively and efficiently liquidate non-viable companies while fostering corporate restructuring to address temporary financial distress in otherwise viable enterprises.

Chart 1
Non-Performing Loans (NPLs) in the Banking System
2007 - 2010



Source: State Bank of Pakistan, Quarterly Performance Review of the Banking System, December 2010

3. In Pakistan, the effort at bankruptcy reform was initiated in 2004-06 but lay dormant until late 2008, when rising interest rates, spikes in the commodity prices, creeping inflation and severe

¹ For example, in 2009, bankruptcy filings increased by 5 percent in Japan, 6 percent in the UK, 11 percent in Germany and 40 percent in the US. Cirmizi, Klapper, Uttamchandi, The Challenges of Bankruptcy Reform, October 2010.

energy shortages pushed many good companies to the brink of bankruptcy. The economic crises also revealed to the market the lack of international competitiveness in many other companies. From Chart 1, it is apparent that the NPLs in the banking system began to tend upward in 2008 and have continued to do each year since.

4. As of December 31, 2010, NPLs in Pakistan had increased to about 14.7 percent of loans (Rs. 548 billion) from a low of 7.6 percent (\$218 billion) at the end of 2007. With the continuous growth in NPLs since 2007, credit risk remains the biggest challenge for the banks in Pakistan. There was some slowdown in the beginning of CY10, but the fourth quarter saw a rebound in NPLs as Rs. 54 billion of NPLs were added, raising the NPL ratio from 14 to 14.7 percent in one quarter. These NPLs seem more concentrated in a few local private banks, but Chart 1 shows that all types of banks are experiencing the impact of an increasing number of distressed enterprises. Sector wise breakdown indicates that the vast majority of NPLs lie with the textile sector, which accounts for 31 percent of NPLs but only 19 percent of loans. Electronics also shows a higher share of NPLs than loans, while Chemicals, Agriculture and Energy show lower shares of NPLs than shares of loans.

II. Potential Objectives of an Insolvency Reform

5. In many jurisdictions, most of which can be considered more sophisticated and mature markets than in Pakistan, when faced with rising distress levels in the enterprise sector, would ratchet up the insolvency system in order to ensure that, despite the rising level of impaired assets, resolution would be based on the formalized “rules of the game.” Such rules, would, as a process, ensure that companies in distress go through a painful, but necessary negotiation with creditors to ultimately produce a market based outcome. The outcome would attempt to balance interests of creditors, owners and other stakeholders with the company benefiting individual well-being.

6. Insolvency is therefore, often misunderstand as a sort of legal mortuary, when in fact it is a hospital where the assets and expertise of a business injured by management mistakes or the vagaries of the free market, are recapitalized or rechanneled to renewed productivity and social benefit. In this way, the insolvency process is uniquely intertwined with the rights of entrepreneurs, workers and creditors which need to find a proper balance among themselves, if an economy is to reach its maximum potential.²

7. The three fundamental goals of any insolvency law are: (i) transparency, including a system for publicizing and indexing judgments, an accessible method for registering securing interest and an effective notice of insolvency proceedings, (ii) predictability - in terms of being fair, simple and clear, which if not achieved ends up costing more as financial institutions compensate the uncertainty with additional credit costs; and (iii) efficiency, which conceptually is clear but empirically is difficult to measure. In a narrow context, the efficient resolution of insolvency depends on the ability to reorganize viable firms and to liquidate the unviable ones at a low cost.³

² Edited by Jay Lawrence Westbrook, *The Global View of business Insolvency Systems*.

³ The World Bank, *The Challenges of Bankruptcy Reform*, E. Cirmizi, L Klaper and M. Uttamchandani, October 2010.

8. An insolvency system has significant legislative, institutional and regulatory dimensions. The level of detail of the review, in particular, the institutional and regulatory dimensions requires much greater analysis and time to provide a thorough evaluation. While a sound insolvency system is absolutely dependent on all three components, not the least of which is the effectiveness of the courts and the regulation of insolvency practitioners, the review below focuses on the legal aspects. The institutional and regulatory dimensions require considerable additional analysis and time to provide a thorough evaluation. It is important to reiterate that a sound insolvency system is dependent upon all three components, not the least of which is the effectiveness of the courts and the regulation of insolvency practitioners.

III. The Insolvency Regime in Pakistan

9. Corporate insolvency in Pakistan is governed by the 1984 Companies Ordinance – a law which is not for general application but rather covering only the corporate sector. This law deals with incorporation, management, regulation, and winding up and covers all limited liability and foreign companies registered in Pakistan. It provides for a detailed mechanism for the reorganization and winding up of companies and about dealing with the assets of the companies involved in these processes. As it was considered out of date and obsolete, a Corporate Law Review Commission (CLRC) was established to review the 1984 Companies Law, but made little progress.

10. Therefore, one issue is that the provisions only apply to those corporate entities that fall under the jurisdiction of the Ordinance. The trend globally is toward independent legislation with the subject matter of insolvency.⁴ More fundamentally, the Companies Ordinance goes into great detail with regard to liquidation and winding up - in the case of non-payment to creditors, but is much weaker when it comes to “Chapter 11” type of formalize work-out mechanisms. For example, the liquidation provisions cover 149 of the 514 sections of the Ordinance, while the rehabilitation provisions amount to six in total.

11. In the case of troubled, but viable enterprises, Pakistan’s Insolvency Regime is challenged on both the liquidation side as well as the reorganization side. As a result, the system is vastly underutilized, leading to rising NPLs in the system – both for viable and unviable firms, without the ability of the system to respond effectively. For example, when NPLs rose, the system resorted to a number of ad hoc administrative interventions over the years, including the H.U. Beg Committee in the 1980s, rescheduling of project finance loans in the 1990s, SBPs debt amnesty of 1997 and in 2002 the Committee for Revival of Sick Industrial Units (CRSIU) along with “BPD Circular 29” allowed banks to liberally write off NPLs on the basis of questionable valuation.⁵ At the same time, efforts

⁴ “Given the breadth of the topic, it may be fit for independent legislation.” CLRC Concept note, May 16 2006.

⁵ Rs. 125 billion of NPLs were settled at the cost of Rs. 75 billion of provisions - a very low write-off efficiency ratio. More specifically, banks were settling with borrowers at higher values than provided for under BPD Circular 29 where distressed assets were settled at values as low as 75 percent of principal in part due to the use of Forced Sale Value (FSV) to value the company on a liquidation basis rather than as a going concern. Valuations of distressed assets were also drawn into question. S. Sheikh, & F. Naqvi, *Corporate Rehabilitation: A Permanent Solution for the Sick Industries Problem*, Paper produced by mimeo, 2007.

were made over the past two decades to make the system more functional with the establishment of special banking courts in 1984, followed in 1997 by a complete review of banking court procedures via the Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act.

12. In 1999, the Government shifted the pendulum even further toward creditors by introducing the National Accountability Bureau Ordinance (November 16, 1999). For the first time in the history of Pakistan, failure to service a bank loan was defined as a criminal act punishable by up to 14 years in jail. This was then followed in 2000 by a new law, the Corporate & Industrial Restructuring Corporation Ordinance, 2000 and resulted in the creation of the Corporate and Industrial Restructuring Corporation (CIRC), a new state asset management company with wide-ranging powers to deal with insolvent companies and their debts. Finally, a revised law, the Financial Institutions (Recovery of Finances) Ordinance, was introduced in 2001 for banking companies which featured a provision for banks to foreclose and take possession of secured assets without the hassle and delays of judicial proceedings. This periodic recourse to these on-time incentive schemes is effectively a public admission that in the area of insolvency and corporate reorganization, the legal system has failed.⁶

13. Despite the law being focused almost entirely on the orderly liquidation of insolvent companies, in practice, voluntary and involuntary methods of liquidation have been underutilized. In part, financial institutions, do not initiate liquidation proceedings as recovery under other methods, such as the Financial Institutions Ordinance, provide them with a relatively quicker recovery method. On the other hand, debtors tend to not initiate voluntary liquidation because control by shareholders is lost and there is no relief to shareholders as a result. The liquidation provisions, though numerous, have been underutilized. For involuntary liquidation, a liquidator appointed by the court is in charge of the proceedings.⁷ Indeed, already in 2006, the concept paper for development of the corporate sector issues by the Corporate Laws Review Commission (CLRC) indicates that the process of winding up or liquidation provided under the Ordinance was cumbersome, time consuming, duplicative and archaic (para 4.46, page 20).

14. In the case of reorganization, a procedure is outlined in section 284, where a compromise or arrangement is proposed between a company and its creditors. The creditors (and in the case of wind-up, the liquidator), convene a meeting to determine the matter, and if three quarters of creditors (in terms of value) agree to the compromise, it is binding on the company. The Court must review, and has the power to make modifications to the proposed reorganizations. However, the process itself is complex, involves a heavy role for the Court, and is particularly cumbersome when a transfer of shares is involved.

15. For a so called "sick industrial unit" in a Company, section 296 of the Companies Ordinance coupled with the 1999 Rules for Rehabilitation of Sick Industrial Units, provides for a different regime when the Federal Government declares a company sick. The Banker's Committee

⁶IBID.

⁷ Internal LEGPS memorandum to SASFP, November 6, 2008.

(including the State Bank of Pakistan and the heads of other banks and financial institutions) makes a determination and a report is submitted to the Task Force constituted by the Federal Government. The Government then authorizes the drawing up of a rehabilitation plan.

16. Three aspects of this legal gap prevent effective reorganization in the face of corporate distress: (i) a legislative gap in the legal framework for bankruptcy (Companies Ordinance, 1984), (ii) the lack of an institutional set up for reorganization, and (iii) the absence of a trained cadre of insolvency experts to steer distressed companies through formal proceedings, to provide legal and business advice during such proceedings, and to provide judicial oversight of the process.

17. In a number of jurisdictions, including Pakistan, the reorganization process has proved ineffective for a variety of reasons. Even on paper, the process is considered of limited utility and is no substitute for an effective reorganization system. In particular,

- It is a voluntary process, as opposed to modern reorganization proceedings which can be forced upon a troubled debtor at the application of a creditor, thus precipitating intervention in the debtor's affair, even at the opposition of owners and managers but which nevertheless might be in the interests of the creditors as a group.
- The restructuring focuses only on the liabilities side of the debtor's balance sheet (financial restructuring), whereas a proper reorganization would frequently need to provide a framework for operational restructuring which addresses underlying problems in the debtor's business model by downsizing, consolidation of operations, sale of assets, etc.
- Restructuring can only operate in relation to the classes of claimant selected by the parties proposing the plan; the plan characteristically does not address in a comprehensive manner all the claims, assets, and affairs of the debtor in the way that a reorganization process can.
- The definition of classes is left to the parties and subject to court approval, which provides flexibility, but can be immensely complicated and contentious, subject to extensive and costly litigation. Modern reorganization regimes provide off-the-shelf definitions of classes.
- The restructuring process itself has no effective class "cramdown" mechanisms and can bind dissentients within a claimant class. At the same time, the restructuring process cannot deal with all members of a dissenting class by guaranteeing them adequate protection.
- The restructuring process has no built-in mechanisms for the procurement of post-commencement funding for the debtor, whereas there would be such a mechanism in developed reorganization processes.
- For sick units, section 296 creates a special committee.

18. Given all of these efforts, it should have become increasingly easier for banks and financial institutions to recover loaned amounts. And yet, despite one of the most creditor-friendly legal regimes in the world, the economic benefits failed to materialize. The proof of this fact came in the

form of the very generous debt forgiveness scheme introduced by the State Bank of Pakistan via BPD Circular 29 of 2002 which allowed debtors to settle their outstanding liabilities through payment of the forced sale value of their secured assets.

19. Since 1984, there have been only 12 reported cases in which insolvent companies have used the provisions of Section 284 to deal with their creditors. So far as Section 296 is concerned, the Federal Government did not even establish this committee until 2000 (i.e., 16 years after the promulgation of the Ordinance). Subsequently, the committee has dealt with a total of 388 sick units out of which it claims to have revived 196. This committee acted more as an "arbitration window", without developing a capacity to undertake deep (i.e., operational) restructuring.⁸

20. Such a lacuna in the law and its application has left many companies to flounder without the possibility to work out temporary liquidity issues, or re-circulate assets to better uses. Such system of insolvency is all the more important in the face of (i) external shocks which hit good companies as well as bad; and (ii) restructuring which requires a quick and unabated exit mechanism.

IV. The Re-Emergence of the Corporate Rehabilitation Act

21. The Corporate Rehabilitation Act (CRA) was prepared by the State Bank of Pakistan Banking Laws Review Commission (BLRC) in 2004. While the question of revival of sick companies was looked at by the CLRC, its Concept Paper concluded that "both the revival of sick companies and liquidation of companies may be included in the company law." Therefore, this CRA was drafted and ratified by the BLRC in 2004. Since that time, however, the effort to address both the general issues of corporate law reform and/or rehabilitation of distressed companies, has been dormant.

22. Following the economic crises of 2008, and faced with a rise in corporate distress for various external and internal reasons, the Government began fast-tracking efforts to provide the missing dimension of the insolvency regime which would facilitate the sorting of cases according to their underlying prospects for recovery. As a result, the SECP and SBP were in 2008, assigned by the Government of Pakistan, to work in parallel to revise the CRA as a standalone piece of legislation and to create a Resolution Trust Corporation (RTC)-like structure that would help restructure and/or sell weak manufacturing units (mostly in the textile sector) to strong investors (mostly local groups).

23. The SECP/SBP review looked at the principals embodied in three cases: the Indian, English and American models and concluded that for a comprehensive insolvency regime for Pakistan, the American insolvency system seemed the most viable for the following reasons:

- The Indian model has been tried in Pakistan in the form of the H. U. Beg Committee and which continues to linger on in the form of the committee created under Section 296 of the Companies Ordinance, 1984. The fundamental problem with this approach is that the process of rehabilitation is driven not by the stakeholders but by an ostensibly (and actually) disinterested party. Since the government committee charged with revitalizing a sick

⁸ S. Sheikh, & F. Naqvi, IBID.

company does not profit from its effort, it does not make much of an effort.⁹ The end result of a committee-centered approach, in both India and Pakistan, has been an institution where sick companies go to die and where cases linger for years before finally expiring.

- The English model was deemed unsuitable for Pakistan since it is first necessary for the management of the insolvent company to petition the court to appoint somebody to take over all management powers in order to obtain relief under a judicial administrator. It was considered that the vast majority of even large corporations in Pakistan are run by their owners and the chances of these owners/shareholders voluntarily giving up management control in Pakistan are minimal.
- The American version embodies a guiding philosophy that society's best interest lies in giving the maximum possible opportunity for businesses to survive as viable entities. A distressed company is allowed to retain its management during bankruptcy proceedings. Entry into bankruptcy is effectively uncontested and once bankruptcy proceedings commence, all pending litigation is automatically stayed. In addition, the debtor company can access fresh funding and is provided with a minimum period of 120 days to come up with a plan of reorganization - normally required to be approved by a majority of creditors.¹⁰
- Given the particular aspects of the Pakistan situation, particularly the low level of capacity among insolvency professionals, several jurisdictions (including from emerging economies) were studied in detail. In this respect, the Mexican insolvency law of 2000 was particularly useful as it addresses issues that deal with low technical expertise in the judiciary.
- Drafting considerations take on additional aspects particular to the Pakistani situation: (i) retaining the language of the U.S. Code to the extent possible rather than trying to rewrite into simpler language in order to replicate the Code's consistency and provide a century of case law at the judges disposal, (ii) lower the time for a bankruptcy proceeding by forcing debtors to file a plan at the same time as seeking relief and requiring the process be completed in 90 days,¹¹ (iii) providing for a technical committee to advise judges on complex financial issues and (iv) treating government dues at par with unsecured debt to facilitate rehabilitation without contending with decades of accumulated government obligations and (v) discharging personal guarantees upon acceptance of a reorganization plan.

24. Finally, the CRA contains a chapter enabling the establishment of a Resolution Trust Corporation (RTC) and includes in the main text, provisions that allow for banks and creditors wishing to exit early from the rehabilitation process to sell their rights to "vulture investors" (i.e.,

⁹ BIFR has a backlog of more than 8 years of cases. Its dissolution (and replacement) has been recommended.

¹⁰ The American model requires a very high level of judicial expertise as well as a body of trained and experienced lawyers. There is also the danger that the process of rehabilitation can be dragged out at the expense of creditors. Finally, there is a moral hazard risk when companies use the law to avoid the consequence of their own mistakes.

¹¹ Furthermore, to encourage debtors to be reasonable, the CRA provides that if a plan of rehabilitation is not approved within the specified period, the company shall automatically be wound up.

investors specializing in purchasing and managing distressed assets). This provision, it was thought, would help to create a vibrant secondary market in the sale and purchase of distressed debt, but was confused by the fact that the RTC was viewed as a public corporation by many in the Government with funding for paid in capital included in the 2009-2010 Federal budget.

V. Participation by the World Bank

25. Against the background of an urgent need to build a part of the insolvency regime which has heretofore not existed in Pakistan, the Securities and Exchange Commission of Pakistan (SECP), in a letter dated May 7, 2009 to the World Bank, officially requested assistance in: (i) bringing to bear the Bank's global knowledge on insolvency regimes around the world, and (ii) suggesting a package of technical assistance (TA) to implement a new regime (Attachment 1). The SECP suggested a TA package to develop the rules, regulations, codes of conduct, and procedures, in order to put the CRA into immediate practice, and capacity building for institutions involved in corporate restructuring, including the Corporate Rehabilitation Board, judicial insolvency bench, insolvency practitioners, etc. (Attachment 2). Based on the SECP request a concept note was prepared for a Non-Lending Technical Assistance (NLTA) which envisioned the preparation of a TA activity in support of the CRA implementation (Attachment 3).

26. At the same time, the Bank carried out reviews of three versions of the draft CRA as it went through changes resulting from stakeholder consultations and provided its views in written form and through video conference meetings with the SECP and the Ministry of Finance (Attachment 4). The IFC also provided guidance on legal, institutional and operational dimensions of the RTC with plans of being a co-investor.

BOX 1

NLTA Activities (In Reverse Chronological Order)

- Discussion on Insolvency Reform Planning Ministry as part of Growth Strategy: *June 2011*
- Final comments and Annotated Law Provided to GoP: *December 2010*
- High Level Mission (Director, PREM) Presented Issues to Secretary Finance: *October 2010*
- Final Report Issued to Secretary Finance: *October 2010*
- Presentation of Mission Findings to Secretary Finance: *July 2010*
- Fact Finding Mission: *July 2010*
- Government Written Responses: *April 2010, June 2010*
- Written Comments on CRA : *March 2009, June 2009, March, 2009, October 2010*
- Video Conferences with SECP & MOF: *March 2009, December 2009, January 2010*
- Concept Note: *September 2009*
- Request for Technical Assistance to Implement CRA: *May 2009*
- Draft CRA Provided to the World Bank for Comments: *November 2008*

27. During the stakeholder consultation, however, the Bank team noted a significant deterioration in the application of good insolvency principals in the final draft. The third review revealed significant deficiencies in the principals underpinning the law and communicated its views during Video Conferences on March 26, 2010, to confirm and fully understand the policy issues behind the CRA. The Bank's comments were provided informally to the technical team at SECP and MOF during the March 26 video conference. Each provided written replies on April 27 2010, and June 15 2010, respectively (Attachment 5). In summary, the Bank's view was that policy choices embodied in the final drafting of the CRA seemed to favor a system which allowed bailing out of debtors, without restructuring and without protection of creditor rights.

BOX 2

CITATION IN IMF THIRD REVIEW:

Consultations on the new bankruptcy law (Corporate Rehabilitation Act) have reached a final stage. The new law will help both the corporate and financial sectors by strengthening the legal basis for rehabilitation of viable but struggling corporate borrowers and speeding up the process of liquidation of unviable entities. Submission of the draft law to parliament has been delayed in order to allay concerns raised by financial institutions regarding creditor protection. The revised law was submitted to the Minister of Finance on November 16, 2009.

28. The policy issues were strategically important enough to be taken up with the Government in the context of the new series of budget support operations, the Poverty Reduction and Support Credit (PRSC) discussions. Formulations of an acceptable CRA were entrenched as a prior action in either the PRSC I or II (depending on progress.) As the analysis by the Bank revealed fundamental divergences between the CRA as drafted and the policy goals expressed by the Government of Pakistan, as well as departures in important areas from international best practice, the Bank's views were taken seriously by the Ministry of Finance as represented by the Finance Secretary. At the same time, the IMF in its review of its three year program, took note of activity to revise the CRA which helped bring high level attention to the dialogue on this issue. Box 2 provides the wording in the third review (Box 2).

29. As a result, during the April 2010 Annual Meetings, the Finance Secretary requested that the Bank team visit Islamabad to carry out a brief due diligence and analysis. The analysis took place in July 2010 and the report was provided to the Finance Secretary himself, during the wrap up meeting on July 23 (Attachment 6) and then in a more detailed form through correspondence transmitted on October 17, 2010 (Attachment 7). At the Finance Secretary's explicit request, an annotated version of the law was provided (Attachment 8).

VI. Final Analysis of the CRA

30. The Bank's review of the final version of the CRA revealed significant issues, which if sustained into law, would represent a unique approach to insolvency reform in the world. Moreover, the balance and approach embodied in the CRA appeared to the Bank team to be inconsistent with the expressed policy goals of the Government, including the goal of creating a viable and economically sustainable mechanism for corporate restructuring.

31. In sum, the CRA appeared to propose a centralized mechanism for the protection of existing shareholders for a small percentage of the largest Pakistani business enterprises. The CRA also appeared to allow the possibility of entrenching existing management at the expense of the interests of other stakeholders, without regard to the viability of the enterprise and without necessary checks and balances. Taken together, the provisions -- many of them highly unusual in their own right, and unique as a set -- seemed to create a serious risk that the CRA framework would be a vehicle for abuse, to defeat creditor rights and allow either the continuation of non-viable entities, or more likely, the continuing ownership and management of distressed businesses by incompetent people who no longer retained the confidence of creditors: the very group whose money (and not any longer the shareholders') would be directly at stake in the enterprise.

32. The Bank team viewed the very weak creditor rights regime as likely to cause the banks to bear heavy losses in relation to loans made to companies invoking the CRA, which could have systemic effects on lending and risk taking. On the other hand, the operations of the partly state-funded RTC may encourage banks to rid themselves of their bad loans, but would be highly likely to result in net losses to the public purse for little or no social welfare gain. Most importantly it would represent a hindrance to the Government goal of building fiscal and financial discipline into the system.

33. The specific comments provided to the Government, include the following:

- At the heart is what appears to be a framework to restructure -- or indeed, simply to write down or write off -- the existing liabilities of **a handful of the largest companies** in the economy.¹²
- The proposed procedure would allow this to be done through a restructuring plan **even if each and every creditor of a company had voted against this plan**, through court order (possibly at the advice of a proposed Technical Assistance Committee, a quasi non-governmental organization appointed by the Chairman of the SECP and the Governor of the SBP.
- **There need not be a proper market-referenced valuation of the collateral** to determine whether the debtor was indeed insolvent; whether it had a going concern surplus and thus ought to be rescued rather than liquidated; or how badly insolvent it was, with a view to determining which claimant classes are underwater.

¹² Companies are eligible to invoke the CRA process only if they have debts (nb. not turnover) of more than Rs 50m i.e. approximately US\$ 0.6m. By contrast, the median (nb. not minimum) debt of companies in US Bankruptcy Code Chapter 11 proceedings is around US\$1.2m.) It is estimated that the Total number of Pakistani corporate enterprises is 64,559 with 216 Pakistani companies with sales revenue (nb. not debt) over Rs 30m and 32 Pakistani companies employing more than 1,000 people. Therefore the law covers only a handful of large debtors. .

- The benefit of the enforcement moratorium would **extend to the debtor's guarantors**, which would usually be its owners. In policy terms, it is difficult to identify a legitimate rationale for this provision, since the enforcement moratorium is intended to protect the company's going concern, not the financial interests of third parties like shareholders.
- The procedure would allow for the **subordination - to the point of *de facto* extinguishment -- of pre-existing claims** by new loans. *De facto* extinguishment would occur when the new loans exceeded the value of the company's assets and/or the present value of its future cash-flows.
- The **approval of a plan would *prima facie* discharge the debtor's natural-person guarantors**. Again, this is a highly unusual provision, showing extraordinary concern not for the continuation of the company's going concern, the position of its employees, or indeed the rights of creditors, but with the interests of its owners, who would usually be the guarantors of its liabilities.
- A state supported **Resolution Trust Corporation** could distort the operations of the markets for NPLs and for distressed assets, and could also retard their development. Even more problematically, it could -- indeed, would be designed to -- buy claims from financial institutions in circumstances where the debtor had invoked or was likely to invoke the CRA procedure and the claims were at risk of being reduced or extinguished in the way described above.

34. The conclusion is that the CRA as written has a high potential for abuse by both debtor and its owners. Specifically, a CRA procedure can be initiated by the company itself while the company continues to operate.¹³ The company's guarantors (i.e., its owners) get the benefit of the enforcement moratorium and the claims against the company cannot even be "assessed."¹⁴ The company can then defeat pre-existing creditors by obtaining new secured or unsecured loans enjoying priority over pre-existing claims.¹⁵ Pre-existing secured creditors are accorded only notional protection which does not relate to on any actual market valuation of the collateral.¹⁶ Finally, the confirmation of enforcement against assets may break up the going concern, but assessment of creditor claims does not. The intention here appears to be to hamper all creditor efforts.

VII. Next Steps

35. While the TA for implementation of the CRA was not deployed due to the lengthy discussions on policy issues around the law, there has been a strong receptivity on the part of the Government to the Bank's intervention in this matter. In March 2011, the Ministry of Finance was reviewing the specific provisions in the law where issues were raised in the context of the Bank's interventions described above. The review, has led to some redrafting by the drafting committee and resubmission to the Cabinet for review.¹⁷ The Bank team continues to remains ready to help the Government (i) finalize the specific provisions in the CRA, (ii) formulate rules and procedures for implementation of the law, and (iii) design, and fund and help implement capacity building for insolvency professionals and regulators.

¹³ Article 12, Article 13(4), and Article 22, dealing with both types of cases. Article 37(2).

¹⁴ Article 37(1)(f). Enforcement against assets may break up a going concern, but assessment of claims does not.

¹⁵ Articles 40, read together with Article 22.

¹⁶ Articles 40(4)(b) and 45(2), and point 2, above.

¹⁷ The Planning Ministry in the context of its Growth Strategy has placed insolvency reform as one its four focus areas for implementation

Attachment 1



SECURITIES AND EXCHANGE COMMISSION
OF PAKISTAN

NIC Building, 63-Jinnah Avenue, Islamabad

Salman Ali Shaikh
Chairman

No. SCD/NBFCD/D/R&NI/1/2009

May 7, 2009

Mr. Said Al Habsy
Acting Head
The World Bank - Islamabad Office
20A Shahrah-e-Jamhuriat
Sector G-5/1
Islamabad



Subject: WORLD BANK ASSISTANCE ON CORPORATE
REHABILITATION ACT (CRA)

Dear Sir,

I would like to thank you on behalf of the Securities and Exchange Commission of Pakistan for your kind letter dated 20 April 2009 on the captioned subject.

Briefly, I would like to apprise you that the draft CRA was ratified by the Banking Law Review Commission (BLRC) and presented to the Ministry of Finance back in 2004. Pursuant to my meeting with Mr. Shaukat Tarin, Advisor to the Prime Minister on Finance in January this year, it was decided that given the growing closures in industrial sector and the ever increasing NPLs in the banking sector, the CRA was the need of the hour. A Committee was therefore constituted by the Ministry of Finance to review the draft law on a fast track basis and update and modify the law, if needed, in the light of developments that have taken place in the last half decade.

The Committee has held several meetings till date. The latest was held with representatives of Pakistan Banks' Association (PBA) on 4 May 2009. During these meetings the industry stakeholders were invited to share their views with the Committee members on the draft CRA. Detailed presentations were also made to the Committee members, by representatives from different sectors, such as textile and its sub-sectors, cement, automobile, downstream engineering and vendor industry, sick industrial sector of NWFP, etc.

Apart from the above meetings, a sub-group of lawyers has been constituted from within the Committee Members who are undertaking comprehensive review of the draft CRA. This sub-group includes: Mr. Sultan Mazhar Sher, Director Law, SECP; Mr. Muneeb Zia, Legal Expert (ERU), Finance Division; Mr. Raja Akhlaq Hussain, Additional Draftsman, Law and Justice Division and Mr. Feisal Naqvi, Advocate, Bhandari Naqvi and Riaz. The lawyers sub-group reports progress to the other committee members on the regular meetings of the Committee. The lawyers have completed almost 80% of the work in this regard. To cover a wider universe of stakeholders, copies of the draft law were sent to more than eighty (80) individuals for their views and suggestions on the draft CRA.

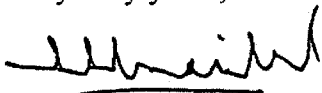
We are grateful to the World Bank for arranging the discussion forum with Mr. Mahesh Uttamchandani and his team from Washington as well as with Mr. Adolfo Rouillon from Argentina. In the meanwhile, we have also met Mr. Bruno Navarro, IFCs expert on global distressed assets who visited Pakistan in the first week of April 2009, on our request. We discussed in detail with Mr. Navarro, the concept of Corporate Restructuring Company (CRC)/Resolution Trust Corporation (RTC) as well as his views on the draft CRA. IFC has also agreed in principle to provide funding for Government of Pakistan backed CRC (which will be formed under the CRA).

As regards technical assistance from the World Bank, we would like to thank you for agreeing to provide the technical assistance for building institutional aspects of CRB. It has been rightly pointed out in your letter that the capacity development should begin as soon as possible. We strongly feel that there is a need for SECP capacity building as well as institutional capacity building (e.g. Institute of Valuers, Institute of Administrators, etc.) both at the time of pre-enactment and post-enactment of CRA. In this regard, we would like to explore the following specific areas of assistance with the World Bank:

1. Training of at least 10 judges of the Provincial High Courts/Supreme Court of Pakistan in USA for advanced Chapter 11 training for one month during the summer recess session of the Judges.
2. Four officials of SECP may be sent for INSOL Fellowship for the year 2009 –A nine month post graduate certification program (mostly on-line) with only two visits abroad (to Vancouver, Canada and London, UK for three days each). The total cost of the four participants will be less than Rs. 6 million.
3. Capacity Building of SECP officials in the areas of subordinated legislative framework to regulate CRC. This may include specific training programs like 3-day intensive course on “Corporate Financial Restructuring” scheduled in August 2009 in South Africa, “Problem Loan Workout, Policy & Loan Restructuring” scheduled in USA in November 2009, study tour to look at the models followed by different jurisdictions with regards to CRC/RTC.
4. A week or 10 day visit of Mr. Adolfo Rouillon to Pakistan to impart training on the setting up of CRB and related subordinated legislation, training modules, qualification criteria, etc. SECP will host Mr. Rouillon’s stay and travel within Pakistan.

With kind regards,

Very truly yours,



(Salman Ali Shaikh)
Chairman

c.c to:

1. Mr. Salman Siddique, Secretary, Finance Division
2. Mr. Asif Bajwa, Additional Secretary, Finance Division
3. Ms. Nazrat Bashir, Additional Secretary, Finance Division
4. Mr. Arif Azim, Additional Secretary, Economic Affairs Division
5. Mr. Muneeb Zia, Legal Advisor, Economic Reform Unit, Finance Division

Attachment 2

TECHNICAL ASSISTANCE PROJECT PROPOSAL

Supporting for a Corporate Reorganization Regime

Background

Based on the Government's desire to urgently build a part of the insolvency regime which has heretofore not existed in Pakistan, the Ministry of Finance and the Planning Commission's seeks assistance in (i) bringing to bear the World Bank's and other's global knowledge on insolvency regimes around the world, (ii) the provision of technical assistance with the development of the rules, regulations, codes of conduct, procedures, etc to put the CRA into immediate practice, and (iii) capacity building for institutions involved in corporate restructuring, including the Corporate Rehabilitation Board, judicial insolvency bench, insolvency practitioners, etc

Objective and Scope

A World Bank team (The Team) will provide Non-Lending Technical Assistance (NLTA) to the Government of Pakistan to facilitate the implementation of the CRA into Pakistani law. The technical assistance would be provided in two stages.

Stage 1: Facilitating Implementation of the CRA: It is essential that the proposed new law be effectively and meaningfully absorbed into the current body of Pakistani law and practice. Accordingly, the project plan is based on understanding the current legal and regulatory context and the ways in which the broader system may have to be supplemented or modified in order to ensure successful implementation of the new statute.

In this regard, as a first step, the Team will formulate an implementation plan to identify and understand

- implementation priorities of the Pakistani government;
- current functioning of the legal system in the ICR arena;
- ways in which the new law could be expected to change the incentives and practices of parties to corporate distress and their legal and other advisors,
- ways in which the new law could be expected to alter practices of the judicial and executive state organs concerns with the adjudication of disputes and enforcement of claims and judgments;
- the threshold policy questions that need to be examined, and identification of the practical steps that will be required, to effectively implement a regulatory environment for 'Administrators' as defined in the draft CRA; and
- the extent to and manner in which existing legal and regulatory structures would have to be supplemented or modified to assist the healthy function of the proposed new distress resolution regime

This analysis would enable the Team to prepare a detailed implementation plan, taking into account the identified goals of the Pakistani government for the application of the CRA and the specific legal and regulatory environment into which the new statute would be implemented.

Stage 2: Implementing the Technical Assistance: The second stage of the technical assistance will be primarily geared toward

- advice on modes and models of various insolvency related institutions, from which Pakistan may model its own;
- assisting in the development of rules, regulations, procedures, codes, etc for any new legal dimensions of the new distress resolution regime;
- assisting with the implementation of a regulatory environment for insolvency Administrators, including the development of modes of licensing, qualification criteria and codes of conduct;
- the provision of indirect (e.g. training materials), and direct (e.g. capacity building advisory services) support for the institutions involved in the new insolvency regime, particularly the experts on and serving the Corporate Rehabilitation Board (CRB), and the judiciary involved with insolvency cases,; and
- the development of a licensing scheme (including related regulation and enforcement) so that the CRB can fulfill one of the core functions assigned to it under the draft CRA.
- develop training needs assessment and seek funding

The technical assistance may also consider outreach and communication strategies for potential participants of the system. The work will evaluate the importance of reform of other aspects of the insolvency regime as next steps and propose a design for follow-on activities by the Government and the Bank. An assessment will also be made regarding the degree to which the proposed Resolution Trust Corporation (RTC) impacts the other parts of the insolvency systems proposed by the CRA and to the extent that the impact is deemed adverse, recommends mitigating measures for its implementation.

Timeline:

Broadly, the work will be phased and guided according to the legislative process for the draft CRA, including its finalization by cabinet and submission to Parliament.

Once we have agreed on the basic contours of the work, the mode of delivery and the time line of activities, the conduct of the implementation study is expected to follow the following timeline:

- identification and engagement of local counsel (2 weeks, subject to some delay due to local holidays);
- review of regulatory implementation environment by local counsel and by the Bank's Insolvency Initiative team (4 weeks);

- preparation by the Bank's Insolvency Initiative team of a draft implementation plan for the Government of Pakistan following completion of desk review (2 weeks).

Following on from the completion of the implementation analysis and plan, the conduct of the technical assistance should broadly involve the following steps:

- identification of legal and regulatory reforms necessitated by the enactment of the CRA (4 weeks); and
- formulation of proposals for developing a cadre of insolvency professionals (4 weeks).

It is envisaged that a mission of approximately 5-7 working days will take place in course of progressing the implementation study and technical assistance, to inform the practical context for the advice provided.

The total duration of this technical assistance would be 2 years with this phase of work to be completed prior to end June 2011.

DRAFT TECHNICAL ASSISTANCE PROJECT PROPOSAL

Background

The objective of the draft Corporate Rehabilitation Act ("CRA") is to introduce a comprehensive legal framework to address the rehabilitation issues of distressed industry in Pakistan and develop an effective insolvency and creditor rights system. Several attempts have been made in the past decade to crack down on delinquent debtors by making the process as creditor-friendly as possible. Such attempts have resulted in a serious imbalance of legal remedies between creditors and debtors.

The Government of Pakistan has in the past resorted to ad-hoc solutions like establishment of special banking courts, comprehensive review of banking court procedures via the Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act, 1997 and the introduction of the National Accountability Bureau Ordinance in 1999 wherein the failure to pay back a bank loan was defined as a criminal offence punishable by up to 14 years of imprisonment.

The Corporate & Industrial Restructuring Corporation Ordinance, 2000 resulted in the creation of the Corporate and Industrial Restructuring Corporation which was a state entity with wide-ranging powers to deal with insolvent companies and their debts. Later, the Financial Institutions (Recovery of Finances) Ordinance, 2001 was promulgated for banking companies which featured a new provision whereby banks could foreclose and take possession of secured assets without enduring the hassle and delays of judicial proceedings. Moreover, the fear about loan defaults has resulted in a trigger-happy culture where bank officials would much rather see a promising company go into liquidation rather than run even the slightest chance of less than full recovery. The net result of all this has been reflected in the fact that even local investment in the economy has been hard to come by. Last but not the least was the SBP's BPD Circular 29 in 2002, which allowed debtors to settle their outstanding liabilities through payment of the forced sale value of their secured assets.

All of the aforementioned efforts should have made the recovery of loans easier for banks and financial institutions. However, despite having one of the most creditor-friendly legal regimes in the world, the economic benefits failed to materialise. The non-performing loans, industrial closures and unemployment rose despite all the efforts.

The decision to develop and promulgate a comprehensive corporate rehabilitation regime was therefore guided by the concern that businesses should be kept operational. Risk is an inherent part of the banking business and focus therefore must be on managing and identifying financial risk rather than eliminating risk.

The initial draft of CRA was prepared back in 2004, after considering a number of corporate rehabilitation models worldwide and was ratified by the Banking Law Review Commission and submitted to the Ministry of Finance.

On January 31, 2009 the Ministry of Finance constituted a Committee to review and finalize the draft law prepared in 2004. The Committee was mandated to update and modify the draft law in light of developments that have taken place in the last half decade. Several meetings of the review committee were held for removal of economic and legal impediments. During these meetings the representatives of the affected industries (such as textile sub-sectors, cement, automobile, downstream engineering and vendor industry, sick industrial sector of NWFP, etc) gave detailed presentations to the committee members and sector specialists were also invited to share their views on the draft CRA and to discuss the issues pertaining to rehabilitation and insolvency of the distressed industries.

Further, to cover a wider universe of stakeholders, copies of the draft law were sent to more than 80 individuals for their views and suggestions on the draft law. Separate meetings were also held with representatives of Pakistan Banks Association to take them on board. While reviewing the draft law, the committee considered the current international best practices and models in insolvency systems and risk management.

The objective of the revised CRA is to introduce a comprehensive legal framework to address the rehabilitation issues of distressed industries and to develop an effective corporate rehabilitation regime. It is expected that law will modernize the current insolvency regime by striking a balance between creditor rights and the needs of debtors by providing workable options other than liquidation.

Technical Assistance for Implementation of draft CRA

The draft CRA was submitted to the Ministry of Finance on 16 November 2009. Government of Pakistan is fully cognizant of the fact that there is a legislative gap in the legal framework for rehabilitation, there is lack of institutional set up for reorganization and there is an absence of trained cadre of rehab experts to steer distressed companies through formal proceedings. SECP has been in dialogue with the World Bank since the formation of the Committee by the Ministry of Finance, for seeking financial assistance to effectively implement the CRA. Accordingly, SECP vide letter dated 7 May 2009 officially requested assistance from the World Bank.

The technical assistance from the World Bank is broadly required under the following areas:

A. Training of Judges – six to eight months

1. Familiarization of at least 10 judges of the superior judiciary of Pakistan with the international insolvency regimes (one month each).
2. Interactive sessions of lawyers/judiciary in different cities of Pakistan to apprise them about the new draft law and remove any ambiguities. These interactive sessions will be led by the team of lawyers who assisted in drafting the law and the cost be borne by the World Bank.

B. Capacity Building of SECP – one year

1. The draft CRA defines “Regulations” as regulations made by the Commission under Section 86 of the CRA. The draft law requires a series of subordinate legislation to be developed. For instance, regulations will be required for the following:
 - a. to develop fit and proper criteria for members of Technical Assistance Committee;
 - b. minimum requirements to be laid down for mediators;
 - c. compensation of administrators;
 - d. fit and proper for appointment of members of Corporate Rehabilitation Board (CRB);
 - e. incorporation of CRC, etc.

The Institute of Advanced Legal Studies at the University of London conducts a month long course on Legislative Drafting every year. This course will be extremely beneficial for the relevant SECP official(s) who will assist in drafting subordinate legislation under CRA as well as other legislations under the ambit of SECP. The course fee inclusive of accommodation, meals, per diem, travel, etc. is around £11,000 and the course is scheduled from June 7, 2010 to July 2, 2010.

2. Assist SECP in developing the subordinate legislation required under the CRA, by sharing and providing knowledge gathered from different jurisdictions.
3. Corporate Restructuring Companies (CRC) formed under the CRA shall be licensed and regulated by the SECP. Capacity building of SECP officials is therefore important to effectively and efficiently regulate the CRCs. This may include specific training programs on corporate financial restructuring, regulatory procedures, standards to assess quality of restructuring portfolio, requisite internal controls, enforcement techniques, international best practices, etc. as well as study tour to look at the models followed by different jurisdictions with regards to regulating CRCs/RTC (esp. those jurisdictions where Govt has stake in the CRC).
4. In March 2009, SECP became a member of International Association of Insolvency Regulators (IAIR). Given resource constraint SECP was unable to attend the IAIR workshops and annual conference held during the year. These workshops and conferences are extremely beneficial and would help SECP keep abreast with any changes in insolvency regimes world wide as well as about international best practices and any legal or regulatory changes taking place in other jurisdictions.

C. Capacity Building for CRB – three to four years

1. Initially a week or 10 day visit to Pakistan of Mr. Adolfo Rouillion or any other World Bank consultant to advise SECP on the modes and models of various corporate rehabilitation institutions, from which Pakistan may model its own.
2. Assist SECP in implementation of a regulatory environment for insolvency Administrators, including the development of modes of licensing, ethical guidelines, qualifying criteria, an examination system and implementing a code of conduct and discipline scheme for administrators.
3. Provision of indirect (e.g. training materials), and direct (e.g. capacity building advisory services) support for the institutions involved in the new rehab regime, particularly the experts on and serving the CRB and judiciary involved with insolvency cases.
4. Assist in developing future training needs assessment of CRB and seek funding for future sustained growth of the institution.

D. Seed capital for Technical Assistance Committee (TAC) and Corporate Rehabilitation Board

1. The TAC formed under the CRA shall establish a fund for financing and funding its affairs. The fund can be financed through different sources, including but not limited to, grants or assistance from domestic and international donor agencies.
2. A Rehabilitation Fund will be established by CRB which can be financed from different sources including grants or other assistance from domestic and international donor agencies.
3. World Bank's assistance will be required for injecting seed capital for setting up TAC fund and CRB fund.

Time frame

The total duration of the technical assistance should be minimum 4 years.

Attachment 3

CONCEPT NOTE

Task Managers: Eric Manes and Shabana Khawar (SASFP) Legal Team: Joint CIC/LEGPS Team:	Sector Managers: John Speakman (acting), (SASFP), Marialisa Motta (CICRA), Vijay Tata (LEGPS)
Activity Name: Supporting the Development of a Corporate Reorganization Regime	
SAR sectoral teams involved: SASFP in partnership with CICRA and LEGPS.	
Explanation of the activity concept, time and scope/scale:	
<p>Background: The current insolvency regime for Pakistan deals with the resolution of corporate insolvency by focusing in detail on liquidation. In stark contrast, there are only limited provisions of law (in the Companies Ordinance, 1984 – see sections 284 & 296) relating to the rehabilitation / reorganization of companies. Three aspects of this legal gap prevent effective reorganization in the face of corporate distress: (i) a legislative gap in the legal framework for bankruptcy (Companies Ordinance, 1984), (ii) the lack of an institutional set up for reorganization, and (iii) the absence of a trained cadre of insolvency experts to steer distressed companies through formal proceedings, to provide legal and business advice during such proceedings, and to provide judicial oversight of the process.</p> <p>Faced with considerable corporate distress, variously attributable to lack of competitiveness, poor management and external shocks, the Government is fast-tracking efforts to provide the missing dimensions of the insolvency regime, not least so as to facilitate the sorting of cases according to their underlying prospects for recovery. A draft of a proposed Corporate Rehabilitation Act (CRA, 2009) has been under discussion with a range of stakeholders, including the World Bank team which has provided two rounds of comments based on a desk review and is prepared to review the final draft during August, 2009.</p> <p>Against the background of an urgent need to build a part of the insolvency regime which has heretofore not existed in Pakistan, the Securities and Exchange Commission of Pakistan (SECP), in a letter dated May 7, 2009 to the World Bank, has officially requested assistance in (i) bringing to bear the Bank's global knowledge on insolvency regimes around the world, including Latin American jurisdictions on which parts of the draft CRA 2009 have been modeled, (ii) the provision of technical assistance with the development of the rules, regulations, codes of conduct, procedures, etc to put the CRA into immediate practice, and (iii) capacity building for institutions involved in corporate restructuring, including the Corporate Rehabilitation Board, judicial insolvency bench, insolvency practitioners, etc. Confirmation for the work is expected shortly from Pakistan's Economic Affairs Division.</p> <p>Objective and Scope of the Non-Lending Technical Assistance. The proposed Non Lending Technical Assistance (NLTA) will be based on a thorough understanding of the Pakistan context for the law, including the impact on other laws and sectors of the economy, the underlying reasons for the law, the interest of the various stakeholders and the likely impediments that need to be managed in the implementation. Following this understanding the technical assistance will be primarily geared toward (i) advice on modes and models of various insolvency related institutions, from which Pakistan may model its own, (ii) technical assistance to develop rules, regulations, procedures, codes, etc for any new legal dimensions of the insolvency regime (corporate restructuring), (iii) the provision of indirect (e.g. training materials), and direct (e.g. capacity building advisory services) support for the institutions involved in the new insolvency regime, particularly the experts on and serving the Corporate Rehabilitation Board (CRB), the judiciary involved with insolvency cases, and other practitioners and (iv) the development of a licensing scheme (including related regulation and enforcement) so that the CRB can fulfill one of the core functions assigned to it under the draft CRA. The technical assistance may also consider outreach and communication strategies for potential participants of the system. The work will evaluate the importance of reform of other aspects of the insolvency regime as next steps and propose a design for follow-on activities by the Government and the Bank. An assessment will also be made regarding the degree to which the proposed Resolution Trust Corporation (RTC) impacts the other parts of the insolvency systems proposed by the CRA and to the extent that the impact is deemed adverse, recommends mitigating measures for its implementation.</p> <p>Timeline: The work will be phased and be guided according to the legislative process for the draft CRA, including its finalization by cabinet and submission to Parliament. At that stage, the detailed design of the TA for the above noted areas will be prepared /completed and the capacity building be launched. The total duration of this technical assistance would be 2 years with this phase of work to be completed prior to end June 2011.</p>	

Explanation of expected outcomes & how it supports the PRSP, CAS, lending program: The expected outcome of the activity is a functioning corporate reorganization system with a number of professionals having undergone intensive training to manage distressed companies through insolvency proceedings, provide advice, and adjudicate disputes.

A sustained process of growth based on improved industrial competitiveness depends on the economy being able with reasonable efficiency to allocate scarce financial resources to positive net present value projects while encouraging proper risk-taking by entrepreneurs. Part of this process includes fluid processes of entry along with a well-organized exit system in order for resources to be put to their best use.

The SECP has taken a number of important steps on the entry side - notably process reengineering and automated filing with regard to corporate registration - and now seeks to introduce a new system of corporate restructuring as part of well-governed exit mechanism for corporate entities unable to meet credit obligations. In anticipation of a large amount of corporate restructuring in the coming years, the SECP is supporting a dual process of legal design on the one hand along with grass root development of a corporate reorganization system on the other as the two dimensions of a well governed ICR system.

If AAA, explain dissemination (to what audience, in what final form): At the early stages of the activity, the communication would largely be by SECP and MOF as sponsors of the bill directly with Government and Parliament. Widespread stakeholder consultation on the legal framework as sponsored by SECP has been taking place and is now completed. Once the legal framework is enacted and operational, the communication activity will include dissemination of the new system of corporate restructuring to potential participants of the system, including the large corporate and the banking community. Communication mechanisms would also be needed to include other stakeholders, including government at the federal, provincial and district level, suppliers, management and labor as well as stakeholders

Government Counterpart: The Securities and Exchange Commission of Pakistan is the counterpart agency, under the Ministry of Finance, which is the responsible Ministry in Government for the SECP under the Government's Rules of Business.

Who in Government has approved this work: Chairman, SECP requested the activity directly in the context of the ongoing PRESSO policy dialogue discussions as part of implementation of an IDF grant, and through letters to the World Bank on May 7, 2009 and the Ministry of Finance (MoF) on April 16, 2009. Confirmation to the Bank from the Economic Affairs Division is expected soon.

Role of other donors and team members: The various technical and policy related dimensions of the project, requires the joining together of different strengths of the World Bank group in different units across the Bank and IFC. The Region developed the dialogue with the client – The Ministry of Finance and the SECP on the need to improve the insolvency regime in the context of the PRESSO operation. Along with LEGPS, the Mission advised the SECP at their request, on the aspects of the legal drafting through two rounds of comments and a video conference. The Investment Climate Unit (CIC) was approached to support the technical assistance aspects of the project particularly as a joint LEGPS / CIC project was being developed which would have been timely and appropriate for the Pakistan context. The work in advising the CRB on improving its regulatory capacity will be carried out under the CIC Global Insolvency Technical Assistance Program (*iDesk Project ID 569649*) approved on May 15, 2009 under the PDS Approval document.

Fiduciary issues that should be flagged: To monitor and manage any perceived or actual conflict of interest issues raised by potential of IFC investment into a proposed Resolution Trust Corporation – a related initiative under the same CRA, the IFC Conflict of Interest (CoI) unit was first consulted. Initial advice is to inform government counterparts if World Bank Group plans both advisory services on insolvency and IFC investment in distressed assets, through a letter disclosing both fronts early in the project cycle.

Completion Date: June 30, 2011

Initial Budget: \$160,000 by SASFP and \$150,000 by CICRA for 2 years. In addition, each unit will contribute own staff and travel costs for design and scoping, including the October mission. Depending on final design, costing will be finalized at that time with additional funding sought from internal and external sources, as needed.

Date Submitted: July 31, 2009

Cleared in substance by Sector Manager: John Speakman (Acting, SASFP), Marialisa Motta (CICRA), Vijay Tata (LEGPS)

Attachment 4

The World Bank

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

Islamabad Office

20-A, Shahrah-e-Jamhuriat
Sector G-5/1, Islamabad, Pakistan

Telephone: (92 51) 2279641-6

Facsimile: (92 51) 2279648

March 18, 2009

Mr. Salman Ali Shaikh
Acting Chairman
Securities and Exchange Commission of Pakistan (SECP)
Islamabad

Mr. Asif Bajwa
Additional Secretary
Ministry of Finance
Islamabad

Dear Mr. Shaikh and Mr. Bajwa:

Corporate Rehabilitation Act (CRA) – Video Conference Meeting to discuss CRA and its Implementation, March 26, 2009

With reference to discussions held by the Bank team with SECP and Ministry of Finance officials during the week of March 2, 2009, please find attached detailed comments on the draft Corporate Rehabilitation Act (CRA). We hope you will find these comments useful as you finalize the CRA.

As agreed during our discussions, we are pleased to propose a video conference (VC) with the Bank's insolvency and private sector team on **March 26 2009, from 5:00 p.m to 7 p.m** at the World Bank Islamabad office, to further discuss the draft CRA and particular issues that the Government may wish to consider in the context of implementation. We suggest the following agenda for the meeting:

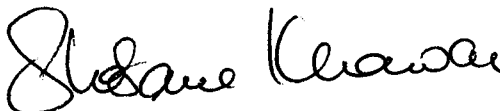
- Presentation of World Bank comments on Draft Corporate Rehabilitation Law (CRA)
- Experience from other countries, such as Mexico, on implementation of similar laws; and
- Technical Assistance programs to build capacity of various stakeholders, such as the administrators, Corporate Rehabilitation Board, etc.

The Bank team will comprise colleagues from Washington including: Mahesh Uttamchandani (Senior Counsel and Head of Insolvency & Creditor Rights team); Nagavalli Annamalai (Lead Counsel, Finance and Private Sector Development & Infrastructure), Eric David Manes (Senior Economist), Mr. Adolfo Rouillon (Consultant, Corporate Insolvency), Raha Shahidsaless (Consultant, Insolvency and Creditors Rights) and Ali Rahim (Operations Analyst). Colleagues from Islamabad office will include: Shabana Khawar (Senior Finance

Specialist), Anjum Ahmed (Senior Private Sector Development Specialist) and Kiran Afzal (Research Analyst).

We would appreciate receiving confirmation from your office for participation in the above VC, Mr. Samir Jan (Team Assistant, contact: 051-9090-218) will get in touch with your office.

Sincerely



Shabana Khawar
Senior Financial Sector Specialist

Attachments: a/s

cc: Mr. Sultan Mazher Sher, Director, Law, SECP, Islamabad
Mr. Rana Asad Amin, Joint Secretary, Ministry of Finance, Islamabad
Dr. Shujat Ali, Joint Secretary, Economic Reform Unit, Ministry of Finance, Islamabad
Mr. Muneeb Zia, Legal Advisor, Economic Reform Unit, Ministry of Finance, Islamabad

World Bank Insolvency and Creditor Rights Initiative
Overview of Pakistani Draft Corporate Rehabilitation Act (CRA)

Mahesh Uttamchandani, Sr. Counsel -Legal Private Sector, Finance and Infrastructure Practice
Group - and TTL of Insolvency ROSC Program

Introduction and General Comments

The purpose of this note is to provide an overview of the draft Corporate Rehabilitation Act (CRA) prepared by the Government of Pakistan (GOP). The GOP prepared this draft in 2004 and has recently convened a high-level committee to review and revise, as necessary, the draft law.

The CRA is a comprehensive restructuring law that contains most of the hallmarks of modern restructuring legislation. The law aims primarily to introduce a regime for corporate rehabilitation, rather than redesigning the entire insolvency system. Nevertheless, the draft law does include many of those elements habitually found in insolvency legislation such as avoidance provisions and details of the priority of payment of creditors' claims. From a legislative drafting perspective, it is clear and straightforward and the amount of cross-referencing is minimal, contributing to ease of readability.

As can be noted from the comments below, the CRA is an ambitious law in that it will require extremely effective implementation in a number of critical areas to function properly. Some of the implementation challenges can be mitigated by addressing specific sections above, but others will need to be dealt with more comprehensively. The World Bank's insolvency implementation technical assistance programs may be helpful in this regard and can be discussed in greater detail at the upcoming video-conference.

General Comments

We are advised that it is the intention of the GOP to leave provisions relating to the winding-up and liquidation of companies, currently in the Companies Act, largely untouched and to focus the CRA on rehabilitation. Many countries choose to bifurcate restructuring and liquidation legislation in this way, while others prefer a single, all-encompassing insolvency act that addresses both. This is largely a question of form and the choice between methods should be driven by a desire to ensure consistency with the broader approach to legislative drafting within the country. In this case, it is clear that the CRA would apply to the same entities that the Companies Act applies to and, as such, it is not clear why bifurcation was chosen. In the future, it may be useful to consider merging the two either into the Companies Act or into a single insolvency law. Nevertheless, the substantive issue to be addressed (and the CRA appears to have adequately addressed this) is the smooth movement between laws of a company that starts out trying to restructure but fails and must be liquidated. In that regard, great care should be taken to ensure that there is consistency between the avoidance provisions in both laws.

Somewhat uniquely, the law does not choose between a debtor-in-possession (DIP) model of restructuring and an administrator-led model. Rather, it allows the court to choose between systems in each case and, if a DIP model is used, allows the court to replace the DIP with an administrator if it so chooses. In principle, this allows for a great deal of flexibility and allows the court to determine the preferred approach for each case. In practice, however, there may be some difficulties implementing such provisions – which could be mitigated by some revisions to the CRA. Specifically, there seems to be very little guidance provided in the law for when a judge should remove the DIP and appoint an administrator. It is a truism that time is no friend of an insolvent company. The danger in allowing applications for any reason to be brought to remove the DIP is that the important early days of the restructuring will be mired in frivolous applications to appoint an administrator. Moreover, one of the principle arguments advanced in favor of the DIP approach is that it encourages debtors to seek protection under restructuring laws before it is too late for the company to be salvaged. If it turns out that debtors in possession are routinely replaced, there may be a dampening of this incentive. It may therefore be preferable to provide very strict and narrowly defined grounds under which the court can replace the DIP.

The law may also benefit from more clearly defining the boundaries between the many parties referenced in the law, including the mediator, technical advisory committee, Official administrator, inspector and the court, as many of these roles appear to overlap. Most importantly, the overlaps between the administrator and the mediator and between the mediator and the technical advisory committee seem to be significant and suggest the possibility of conflict.

The law provides, in a number of cases, a great deal of discretion to the courts to determine what is appropriate or ‘fair and equitable’ – with no specific guidance to the court on how to apply these provisions. This is not uncommon but is flagged here solely ensure that it is the drafters’ intention to provide such wide-ranging discretion to the judiciary in administering insolvency cases.

Finally, the law contains no provisions dealing with cross-border proceedings. It may be useful to consider such provisions in order to facilitate the efficient treatment of multi-national matters involving Pakistan.

Specific Comments on Individual Sections of the CRA

The discussion of sections below is limited to those sections which the drafters may consider amending for the reasons described below. A number of the articles in this draft law provide the essential framework for a modern restructuring law and are not discussed in detail herein.

Definitions

Definition 32 - It is not clear whether it is the ordinary practice to provide ‘examples’ of scenarios within the body of legislation. If it is not the usual practice in Pakistan, it may be advisable to remove these as they could lead to some confusion.

Definition 38 - One year may be too long a period required in order to classify a financial asset as 'non-performing'.

General provisions

Article 10 - It is consistent with international best practice to exclude financial institutions and insurance companies from the scope of this law. This section also precludes debtors who have reorganized within the preceding 5 years from reorganizing again unless it is in the best interests of 'justice'. It is not clear whether this is intended to mean the best interests of creditors (which is the concept used more commonly in this draft).

Article 17 - This article provides for the creation of Technical Assistance Committees. Such committees shall comprise three members for each province in Pakistan. This concept could prove extremely useful, but only if the appointed members have the requisite skill to deal with such cases. In absence of that, the technical assistance committee could in fact be a hindrance. Furthermore, bearing in mind the wide scope of duties of the technical assistance committee set out in the act, and at the limited period of 15 days within which the technical assistance committee is required to give its opinions to the court, it is quite possible that 3 members per province will be insufficient.

Case administration

Article 20 - This article provides for notice to the company to be given in the manner provided by the Financial Institutions and Recovery of Finances Ordinance. It is not clear what the relevance of this ordinance is to this draft bill.

Article 24 - The DIP option contemplates significant involvement of the technical advisory committees, again suggesting that the three persons per province may be too few.

Article 26 - This article provides for the court to prescribe time limitations to ensure that cases are handled expeditiously and economically. This includes the court setting numerous dates by which events must take place. There is no indication as to what appropriate timescales will be. While mandating 'fixed' timelines would not be advisable, it may be useful to respond to the inevitable concern of lenders that the law amounts to a 'blank cheque' to the court to permit endless delays. One option might be to provide interim timelines that may be extended by the Court if it is deemed 'in the best interest of stakeholders'.

Article 27 - This article provides for 'mediation' although the role of the mediator would seem to go far beyond the tasks normally associated with such a title including providing assistance to the debtor in the preparation of a plan of rehabilitation. Most importantly it is the task of the mediator to determine whether the plan is 'fair and equitable', although this term is never adequately defined.

Article 35 - This article provides that the appointment of an administrator is automatically terminated by the confirmation of a plan of rehabilitation. It is

frequently in the creditors' interests that there is a degree of supervision of a plan, which involves the administrator continuing, albeit in a diminished role.

Article 39 - This article provides for the powers and duties of an administrator. Some of the powers that are expressed as mandatory may better be expressed as discretionary.

Article 53 - This article provides for a diminishing remuneration for an administrator. This is a novel approach and a practical incentive to administrators to deal with matters expeditiously. There are many circumstances, however, under which such a provision may be unfair and could stimulate the wrong attitudes on the part of the administrator

Article 54 - This article provides that the administrators may only employ disinterested persons. This may be unduly restrictive and contrary to the creditors' interests where, for example, the company's solicitor was best placed to undertake legal conveyancing of property with which she was familiar.

Article 64 - This article includes some of the bill's most sensitive provisions. The secured creditor's security may be sold together with other assets and the secured creditor's lien is transferred to the proceeds of sale. The critical issue has to do with the allocation of value. A property sold as part of a loss-making business may be worth materially less than the same property is worth for alternative use. The view that the lender took when determining the amount that it was prudent to advance against the security of the property would not necessarily have assumed that the property was encumbered by a loss-making business. This is a universal problem and the proposed wording is in no way fundamentally flawed. The drafter's should simply bear in mind that it may produce unintended results for creditors.

Article 66 - This article restricts the ability of the administrator to reject certain contracts. It may be better for this restriction to be set aside where the contract is with a connected party.

Creditors debtors and the estate

Article 72 - This article may provide unduly onerous obligations for creditors to claim within a time limit set by court or to risk being deemed to have no claim against the estate. Such an approach is contrary to the obligations on the administrator to act in a fair and reasonable manner where the indebtedness to the creditor is admitted in the company's records and is not disputed. In such circumstances, there may be no valid reason why the creditor should lose its claim or why the creditor needs to seek the permission of the court to file out of time.

Article 80 - This article makes ample provision for preferential debts to be paid including, surprisingly, arrears of rent and compensation for the termination or rejection of any lease of real estate. Government claims rank as unsecured claims. Although this is entirely a matter of national priorities and has no link to 'best practice' per se, the drafters may wish to consider why real estate claims are being elevated to a status that they not normally are in most countries.

Submission and confirmation of a plan

Article 100 - This article introduces another novel concept. Namely, the obligation for the plan to 'contain information that would enable a hypothetical reasonable investor typical of holders of claims to make an informed judgment about the plan'. Save up for this, there are no other requirements for disclosure or for any other party to issue an independent opinion on the contents of any plan. It may be useful, given the multitude of parties involved in proceedings under the law, to provide for some independent evaluation of the plan.

Corporate Rehabilitation Board

This part of the act provides an infrastructure for administrators and mediators appointed under this act including roles for the board in the prescription of standards, examinations and licensing, disciplinary, training and general development of a profession, all of which is to be commended. This structure appears to be very similar to the Mexican IFECOM. The powers and functions of both mentioned bodies are essentially the same.

Mexico's IFECOM can be considered a successful model for insolvency regulatory bodies and has worked very well performing that function. The key to that success has been two factors: (1) the people in charge of IFECOM, who are highly respected and knowledgeable professionals; and, (2) the Mexican law organized IFECOM as an autonomous body but under the judicial branch of the federal government (this has ensured independence and protected it from political interference). These factors should be considered in the governance and staffing of the board.

The World Bank

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

Islamabad Office
20-A, Shahrah-e-Jamhuriat
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June 29, 2009

Mr. Salman Ali Sheikh
Chairman
Securities and Exchange Commission of Pakistan
Islamabad

Dear Mr. Sheikh,

***Re: Draft Corporate Rehabilitation Act
Comments # 2 and Proposed Technical Support for Implementation***

Thank you for your letter of May 7, 2009 providing an update on the progress toward finalization of the new Corporate Rehabilitation Act (CRA) and requesting support in its implementation. I also thank you for sharing the revised law with our team for their review and further comments.

We commend you and your team for the drafting and subsequent consultation on the draft CRA Act. The Bank's insolvency team has noted considerable advances since the previous version, including the incorporation of many of the earlier comments. While the detailed review and comments are provided in *Attachment-1*, I would like to highlight one key area for your attention and consideration. The revised law includes an additional chapter (Chapter 6) detailing the establishment of a Corporate Restructuring Company (CRC) as part of the CRA. This may involve complex issues and associated risks from a public policy perspective. Hence, you may wish to consider a separate and dedicated policy discussion and, possibly a separate legislative track.

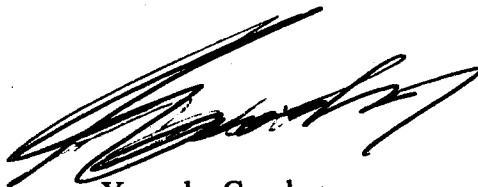
With regard to your request for technical assistance to support implementation of the new law, we would be pleased to support you, provided a formal request is made through Economic Affairs Division (EAD).

In terms of way forward, we suggest that our insolvency team work with you in September to carry out discussions on program design as well as specific issues such as setting up the CRB, specifying the necessary subordinate legislation and compiling international resources to assist SECP in the implementation of the CRA. Meanwhile, Mr. Eric Manes (Senior Economist) and Shabana Khawar (Senior Finance Specialist) will plan a meeting with your office in early July to discuss these details and consider with your team the appropriate next steps and timelines.

Finally, we are pleased to be able to provide any assistance to this important initiative. Please do not hesitate to contact Shabana Khawar in the Islamabad Office, should you have any questions or require any clarification.

Warm regards,

Yours sincerely,



Yusupha Crookes
Country Director
Pakistan

Attachment: WB Comments on Draft CRA

cc: Mr. Asif Bajwa, Additional Secretary, Ministry of Finance, Islamabad
Mr. Arif Azim, Additional Secretary, Economic Affairs Division, Islamabad
Ms. Nazrat Bashir, Senior Joint Secretary, Ministry of Finance, Islamabad
Mr. Muneeb Zia, Legal Advisor, Economic Reform Unit, Ministry of Finance, Islamabad

**Draft Corporate Restructuring Act
World Bank Comments and Suggestions
June 16, 2009**

In general, this is a much improved version of the already strong previous draft, on which we sent comments on March 18, 2009. We are pleased to note that most of our previous comments were taken on board. We also note that this draft is much more concise and clearly worded than the previous one, with many potentially dangerous ambiguities removed.

I. General Comments;

Separate Act for Corporate Restructuring. The first is to reiterate a fundamental point made in our earlier comments. Having a separate law on corporate restructuring while the rest of the 'insolvency' provisions remain in the Companies Act may be necessary for pragmatic reasons. Implementation on the other hand, should ensure that the bankruptcy process – whether liquidation or reorganization – be viewed as one system and be built up together so that the path toward enforcement of creditor rights is made on the basis merits and not capacity. Safeguards to build in at this stage to ensure this intended development path takes place may be considered.

The Corporate Restructuring Company. The second general point refers to Chapter 6, which contemplates the formation of an SECP licensed asset management company (AMC) called a Corporate Restructuring Company (CRC) whose purpose is to acquire, restructure and resolve non-performing assets of financial institutions designated by the government formation.

While there is nothing in the apparent design of this framework that is inherently antithetical to the rest of the CRA, it is not typical to find provisions such as these in a restructuring statute. Indeed, it may be that a high concentration of NPLs in a 'professional' organization results in a greater usage of the new CRA provisions. Still, three particular reasons call for a more comprehensive understanding and discourse regarding AMCs in Pakistan and therefore may support a separate policy and legislative track for the AMC dimension of the system.

- From a policy perspective, there is risk of allocating scarce resources to low performing entities which perhaps should pursue the liquidation thereby forgoing good investment and creating moral hazard in the process. While on the face of it, provisions in Chapter 6 do not necessarily themselves create the risk, the establishment of a framework with the background and operationalization plan of the RTCs in the world may justify some concern.

It would be important to have a more full discussion regarding (i) the underlying reasoning for an state sponsored AMC formed under law, (ii) since, in other countries the reasons stemmed from the risk of a collapse or a near collapse of the banking system, what is the NPL situation in Pakistan, (iii) what would the governance structure be – both in terms of how the RTC is run as well as how the haircut is determined and the assets get priced.

- Legislatively, for all the complications and detailed provisions entailing a good AMC law, it may be advisable for SECP to hive off Chapter 6 as a separate law and beef it up. For example, a specific point questions whether the provisions in Chapter 6 are sufficient to minimize legal challenges from obstructing the operation of RTCs. The provisions are an

abbreviated form of the AMC law (Malaysia) and are also short of legal protection for 3rd parties affected by the assignment of the debt- this is especially an issue with real estate.

- Organizationally, an AMC type of institution would typically be empowered under its own, stand alone legislation. Indeed, it may be that the concentration of NPLs in a 'professional' organization results in a greater usage of the new CRA provisions, but a separate legislation would enable process Conversely, if the CRC is not properly and adequately staffed, the concentration of NPLs in what becomes a dysfunctional institution may result in the under-utility of the CRA.

II. Specific Comments.

Definition (w): In the prior draft, we commented that the definition required the debt to be overdue for 12 months before being classified as 'non-performing'. This revised draft suggests that a debt be overdue for 1 day is classified as non-performing. While the former may have been too long a period, the latter may be too short. It might be useful to use a definition of overdue debt which is consistent with the definitions found in the State Bank of Pakistan's prudential regulations related to bank provisioning.

Article 10: The requirement for specific skills within the Technical Assistance Committee is a welcome amendment.

Article 13: The article suggests that a debtor can be involuntarily petitioned into bankruptcy if it has a single debt, of a certain amount, that is overdue by one day (*please confirm, if this is an erroneous understanding*) –If so, it creates opportunities for fraudulent or abusive bankruptcy petitions. Commonly, tests incorporate the underlying requirement that the debtor is indebted for the specified amount that the specified debt is overdue for a certain number of days and more generally, is generally unable to meet its liabilities as they come due -suggesting not just the lack of performance on a single debt but a general state of insolvency.

Article 24: We reiterate our concern expressed earlier that the grounds for terminating the debtor-in-possession arrangement in favor of an administrator need to be much clearer.

Article 26(n): We might suggest a slightly more precise standard – for example, "any loss or damages caused by any act or omission, other than those constituting gross negligence or fraud". This would expand the scope of the liability to include actions taken in good faith, but that were grossly negligent. It is also worth noting that, given the expansive role of the administrator, there may be need for extensive secondary legislation setting out how the administrator carries out its role.

Article 32: This article also suggests and reinforces the earlier point about the urgent need for detailed secondary legislation.

Article 40(3): We suggest adding the word 'sufficient' between 'obtain' and 'unsecured'.

Article 84: This article empowers the Federal Government to make any provision 'necessary for the purpose of removing [a difficulty arising in the application of the Act]. If this is a Pakistani drafting convention, it should not be altered, but it is unusually vague for such a broad power.

PAKISTAN
DRAFT CORPORATE REHABILITATION ACT

DRAFT COMMENTS FROM THE WORLD BANK

(transmitted informally, in preparation for March 3, VC discussion)

I. Background

1. In the context of the policy discussions between the World Bank and the Government of Pakistan on strengthening of policy and institutional frameworks for private sector-led growth and responsible access to finance arising out of the current PRSP and CAS meetings, and in connection with a recent request for assistance in modernizing legal frameworks in Pakistan for addressing corporate distress and insolvency, we have had the opportunity to review the current draft (provided to us on 24 November 2009) of the proposed Corporate Rehabilitation Act ('**CRA**'). The current draft of the CRA introduces a number of changes that, taken together, give rise to several policy concerns. Our reading suggests that the CRA as now structured appears unlikely to provide a mechanism designed to enable the preservation and rehabilitation of economically viable enterprises while strengthening the incentives for responsible access to credit. The degree of discretion left to courts (subject to the advice of a Technical Assistance Committee ('**TAC**') of experts over whose appointment and operations the government may be expected to exercise influence), without built-in checks and balances to ensure market-based valuation and other mechanisms to ensure objective and independent assessments of asset value and enterprise sustainability, is not consistent with the international 'best practice' guidance as reflected in the *United Nations International Trade Commission's Legislative Guide on Insolvency ('Guide')* and the *World Bank Principles on Effective Insolvency Systems ('Principles')*.

2. This note identifies the mechanisms in the draft CRA that give rise to concern, and sketches out the likely cumulative effects of the operation of those mechanisms. It then expands upon the main issues created by the CRA and highlights the specific provisions underlying these issues.

II. Summary of Concerns

A. Mechanisms

3. For a small group of the largest distressed companies in the economy, the CRA would create a mechanism that could allow the write down, write off or subordination of creditor claims; the suspension and subsequent discharge of third party guarantees held by such creditors; the maintenance of existing shareholders as the company's owners even though their equity had been extinguished by the company's financial state; and the retention of a management team that may have lost the creditors' confidence. Each of these mechanisms could operate without reference to any market-based test for the viability of the affected company and without an adequate valuation mechanism, and could override even the unanimous objections of the company's creditors, who by virtue of the company's financial state would have a direct economic stake in the company's assets and business. These mechanisms would operate by decision of the courts on the advice of a TAC, a quasi non-governmental organisation over the appointment and operations of which, absent appropriate checks and balances, state authorities could exercise significant influence. Further, the CRA would provide a framework within which a Corporate Restructuring Company ('**CRC**') with significant state ownership is envisaged as drawing on public (and other) funds to buy non-performing loans from banks and distressed assets from companies.

B. Cumulative Effect

4. In the result, the mechanisms that would become available under the draft CRA may call into question the governance and integrity of the corporate insolvency mechanism as a whole. By eliminating fundamental checks and balances and by centralising decision-making powers in state (or quasi non-state) bodies, it may hamper rather than assist stakeholders in finding sustainable, economically effective solutions for corporate distress. Further, the operation of the CRA could raise critical issues of financial stability (because banks would be forcibly required to absorb the loss of significant levels of non-performing loans), and/or could give rise to significant concern about fiscal discipline (because of the contemplated use of public funds to purchase claims but also assets with no clear market value).

C. Centralised Restructuring

5. By virtue of the role of the TAC and the elimination of any requirement for creditor consent in the confirmation of a plan, the CRA establishes a system for centralised restructuring. The members of the TAC would be appointed jointly by the Chair of the Securities and Exchange Commission of Pakistan and the Governor of the State Bank of Pakistan.¹ The Court would be required to seek the TAC's advice on all key questions concerning the plan, including whether a secured creditor had "adequate protection"; whether a proposed plan or an amendment thereto was "fair and equitable"; which creditor classes were underwater; and it seems, even the overall acceptability of the plan.²

6. The Court could "forcibly confirm" a plan at the TAC's advice³ even if all creditors had rejected it.⁴ While an aggrieved party could object before the Court,⁵ the Court would be able to decide against it – indeed, would possess jurisdiction to accept the entire plan – without any reference to the market value of the debtor's assets.⁶ The overall result of the law would be an insolvency system based on centralized decisions, isolated from market forces, and possibly influenced by non-economic factors.

D. Wealth Effects of the Proposed Legislation

7. The operation of the CRA could result in a substantial transfer of wealth from creditors – notably, financial institutions – to large corporate debtors, and even more so, to their controlling shareholders. The primary mechanism for this is the CRA provision allowing for "forcible confirmation" of expropriatory plans even in the face of unanimous creditor opposition.⁷ There is no restriction on any such plan seeking to maintain the company in the ownership of shareholders whose equity stake in it had been entirely extinguished by virtue of the company's financial state.⁸

8. The second mechanism for potential wealth transfers from creditors to debtors and shareholders is the extension of the benefit of the 'automatic stay' to the third-party guarantors of the company's liabilities.⁹ This is a highly unusual provision, since the stay in insolvency proceedings is generally intended to protect the going concern of the debtor company, not the financial position of

¹ CRA, Article 10(2).

² "The Court *shall* refer all plans..." (CRA, Article 10(9), emphasis added).

³ CRA, Article 10(9).

⁴ CRA, Article 57. By way of contrast and as an indication of international best practice, see *Guide*, Chapter IV, Recommendation 150; and *Principles*, Principle C.14.3.

⁵ CRA, Article 10(12).

⁶ CRA, Article 57, for example, paragraph 2(a).

⁷ CRA, Article 57.

⁸ By way of contrast and as an indication of international best practice, see *Principles*, Principle C.12.5.

⁹ CRA, Article 37(2).

owners or other third-party guarantors. In a restructuring system in which the consent of at least some affected creditors was required, such extension of the stay would be regarded as objectionable because it would make the proposed plan less likely to attract creditor consent.

9. Third, even a “forcible” confirmation of a plan would prima facie result in the extinguishment of all relevant natural-person third-party guarantees.¹⁰ Again, this provision is highly unusual, disincentivises creditor acceptance of the proposed plan, and may be constitutionally suspect, since it purports to affect the position of persons not party to the proceedings before the court, and correspondingly, also to affect the rights against such persons of the debtor company’s creditors.

10. In any case, the net result of these provisions would be a loss for creditors and a corresponding gain for large corporate debtors and shareholders, an outcome rendered particularly problematic since financial institutions would presumably have granted credit in reliance on the enforceability and (where appropriate) the priority of their claims and guarantees.

E. Management Entrenchment and Claim Subordination

11. The CRA potentially enables managers to retain control of the insolvent company even if they had lost the confidence of the creditors, whose money would actually be at stake in the company’s undertaking. A CRA procedure could be initiated by the company itself,¹¹ which could then continue to operate substantially as before.¹² The draft CRA would enable the company to defeat pre-existing creditors by obtaining new secured or unsecured loans enjoying priority over pre-existing claims.¹³ Pre-existing secured creditors would be accorded only notional protection that would not relate to any actual market valuation of the collateral.¹⁴ There is no requirement in the draft CRA that the new loans be necessary for the continued operation of the company or for the preservation of the value of its business.¹⁵

12. A crucial role of restructuring proceedings is to move productive assets out of the control of a failing management into the hands of a new, perhaps more competent one. Under the draft CRA, this need not happen, and indeed, the old management would be able to continue to operate the company even if it reduced (or extinguished) the value of legitimate claims of pre-existing creditors without bringing any corresponding benefit to the company’s business (as opposed to the position of its shareholders).

F. Risks to Financial Stability and/or to Fiscal Discipline

13. The CRA significantly impacts the position of banks as creditors. From the perspective of financial stability, given the relatively weak protection of creditor rights under the CRA and the potential for large loans to be written down, written off, or *de facto* extinguished by subordination, banks in Pakistan may find themselves saddled with significant NPLs that may weaken their balance sheets as a result of CRA-driven restructurings. Although the law would only apply to a minimal number of Pakistani companies¹⁶ (approximately, less than 0.33% of the corporate enterprise

¹⁰ CRA, Article 58(3).

¹¹ CRA, Article 12.

¹² CRA, Article 13(4), dealing with involuntary cases; and Article 22, dealing with both types of cases.

¹³ CRA, Articles 40, read together with Article 22.

¹⁴ CRA, Articles 40(4)(b) and 45(2), and point 2, above. By way of contrast and as an indication of international best practice, see *Guide*, Chapter IV, paragraph 38, and Recommendations 66-67; and *Principles*, Principle C.12.2.

¹⁵ By way of contrast and as an indication of international best practice, see *Guide*, Recommendation 63.

¹⁶ CRA, Article 7(2)(c).

population¹⁷), these may represent a disproportionately important part of the Pakistani economy, and banks' inability to obtain repayment from these companies could have systemic effects.

14. The envisaged operation of a (partly) state-funded CRC¹⁸ poses risks of another kind. Such an entity could bid for and take into the public sector assets that would more effectively have been utilised in the private one. Its operations could distort nascent distressed asset markets in the private sector by confounding price signals and by impeding private sector players' ability to learn to price assets properly and to develop skills to turn around distressed businesses. And even more problematically, it could buy claims from financial institutions in circumstances where the debtor had invoked or was likely to invoke the CRA procedure and the claims were at risk of being reduced or extinguished in the way described above. This could create a net loss to the public purse and pose a risk to fiscal discipline.

G. The Position of Employees and of Non-viable Distressed Companies

15. It is important to consider two roles that the CRA does not appear to be designed to play. Take first the position of employees. The CRA does not provide a framework for employment preservation in the context of corporate distress. Comparative restructuring law provides, as examples of employment preservation mechanisms, the obligation on those managing restructuring proceedings to consult with employee (or state) representatives before making redundancies; and the obligation on buyers of certain of the distressed company's assets to assume the burden of relevant employment contracts. The CRA contains no such mechanism. Further, restructuring laws often accord distributive priority to accrued wage and other employee claims. The CRA does not provide any such priority. Indeed, if a company were to be made subject to a CRA proceeding before being removed into winding-up, the employee claims given statutory priority in winding-up¹⁹ would apparently be subordinated to all CRA administrative costs and claims.²⁰ The absence from the CRA of any mechanism for the protection of employee interests provides a strong contrast with the unusually comprehensive protection it accords to the interests of the company's shareholders.

16. Second, the CRA is not a suitable vehicle for the pursuit of any social policy favoring the preservation of non-viable distressed enterprises.²¹ A government might be minded to pursue such a policy, for example, because some such enterprises were regarded as systemically significant, or for some other reason as possessing a value exceeding that of their economic product. It would be important, however, for any such policy to be pursued openly, with appropriate public scrutiny of its underlying rationale and justifications, and with due consideration of any alternatives. It would also be crucial openly to determine which public or private group ought to bear the costs of keeping distressed non-viable companies in operation. The CRA does not currently contain any of these safeguards. Firstly, it appears designed not so much to preserve distressed businesses as going concerns as it is to protect the position of the company's shareholders (see in particular paragraphs 8 and 9, above). Second, the effect of its distinctive features is to shift the primary costs of corporate distress from shareholders – the parties usually regarded as having responsibility for these costs – to creditors (see paragraphs 7 to 13, above). And third, these costs may then be shifted through the CRC mechanism to another group, perhaps including the taxpayer (see paragraph 14, above). The CRA

¹⁷ Compare the figures at http://www.statpak.gov.pk/depts/fbs/publications/ec_2005/appendix-x.pdf and http://www.statpak.gov.pk/depts/fbs/publications/ec_2005/appendix-xv.pdf. The figure in the text may be an underestimate: http://www.statpak.gov.pk/depts/fbs/publications/ec_2005/summary_findings.pdf; http://www.statpak.gov.pk/depts/fbs/publications/ec_2005/ch2.pdf, at page 7.

¹⁸ CRA, Chapter 6.

¹⁹ Pursuant to Section 405 of the Companies Ordinance 1984.

²⁰ CRA, Article 21(5).

²¹ In this context, a non-viable enterprise is defined as one the present value of the sum of whose current and future cash-flows is exceeded by the market value of its constituent assets; such an enterprise is distressed when it is unable to fully meet its obligations as they come due.

procedures serve to obscure rather than illuminate the rationale and justifications for each of these steps, and provide no guidance either on why the shareholders are not the appropriate cost-bearers, or on whether in any case the creditors, taxpayers, or some other group would be best placed to bear these costs.

H. Limited Scope of Proposed Legislation

17. As noted, the current draft of the law restricts its application to a very small number of corporate debtors; however, the scope may be expanded by administrative action. If the possible risks of the law enumerated above were not mitigated by changes to the CRA as currently drafted, strictly limiting the applicability of this proposed legislation would be important. Clearly, however, consideration should be given to the development of a different, comprehensive corporate rehabilitation statute, such that the resulting law would offer a balanced system allowing for the restructuring of all distressed companies in a sustainable, economically sound manner.

Corporate Rehabilitation Act (CRA)
VC Meeting to discuss Technical Assistance for Implementation
December 3rd 2009 at 8:00 AM (Washington, D.C. time); MC 11-849

A G E N D A

Introductions - 15 mins

- Introduction of Bank team and Opening Remarks - Eric Manes - 5 mins
- Introduction of SECP / MOF Guests and Opening Remarks - 5 mins

Brief overview on the Status of the CRA

- Comments by SECP Chairman and MOF Additional Secretary
- Questions and Answers

Brief Overview of Technical Assistance

- Part I – Riz Mokal
- Part II – Mahesh Uttamchandani
- Questions and Answers

Open Floor and Wrap Up

- Bank Team Wrap Up
- SECP / MOF Wrap Up
- Agreed Next Steps - Eric Manes, Shabana Khawar

Confirmed Participants

Securities and Exchange Commission of Pakistan (SECP):

- Mr. Salman Ali Shaikh, Acting Chairman
- Mr. Akif Saeed, Executive Director
- Mr. Ashraf Tiwana, Director
- Mr. Sultan Mazhar Sher, Director
- Ms. Sarwat Aftab, Director
- Mr. Saud Mukhtar, Joint Director

Ministry of Finance (MoF):

- Ms. Nazrat Bashir, Senior Joint Secretary (Investment Wing)
- Mr. Muneeb Zia, Legal Adviser, Economic Reform Unit

The World Bank Country Office, Islamabad, Pakistan

- Shabana Khawar, Sr. Finance and Private Sector Specialist
- Kiran Afzal, Research Analyst

The World Bank, Washington, D.C.

- Satu Kristiina Kahkonen, Country Lead Economist
- Eric Manes, Senior Economist
- Riz Mokal, Senior Counsel
- Jose M. Garrido, Senior Counsel
- Mahesh Uttamchandani, Senior Counsel
- Ina Hoxha, Consultant

Corporate Rehabilitation Act (CRA)
VC Meeting to discuss CRA's Implementation
March 26, 2009 at 8:00 AM (Washington, D.C. time); MC 4-N300

A G E N D A

Introductions - 15 mins

- Introduction of Bank team and Opening Remarks - Eric Manes from Washington - 5 mins
- Introduction of Bank team and Opening Remarks - Shabana Khawar from Islamabad - 5 mins
- Introduction of SECP / MOF Guests - 5 mins

Discussion on draft Corporate Restructuring Act - 45 mins

- Opening Remarks Regarding the Structure and Institutions of New Law - SECP from Islamabad 10-15 mins
- Presentation of WB Comments on Law - Mahesh Uttamchandani from Washington 10-15 mins
- Questions and Clarifications Requested by SECP / MOF Islamabad - 15 minutes

Discussion on Potential Implementation Support - 45 mins

- Presentation of Mexican Experience with Corporate Rehabilitation Board - Adolfo from Buenos Aires. 10-15 minutes
- Potential implementation challenges and areas where support is needed - SECP / MOF - 15 minutes
- Presentation of Areas where Bank sponsored TA can be of assistance - (e.g. Capacity Building for Insolvency Administrators, Accreditation process for Oversight Board, Judicial Training, etc) - Mahesh Uttamchandani - 15 minutes

Open Floor and Wrap Up - 15 minutes

- Bank Team Wrap Up - Mahesh Uttamchandani
- SECP / MOF Wrap Up
- Agreed Next Steps - Eric Manes, Shabana Khawar

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PAKISTAN DRAFT CORPORATE REHABILITATION ACT
POLICY AND RATIONALE OF KEY PROVISIONS

Agenda for SECP/WB Video/Audio Conference
(26 January 2010, 6 PM PST)

1. **Background: What is the Draft CRA intended to achieve?**
 - a. Threshold criteria: Article 7(2)(c)
 - b. Rationale
2. **Creditor consent to plan confirmation**
 - a. Origins of Draft CRA creditor consent and “forcible confirmation” provisions: Articles 56-57
 - b. “Forcible confirmation” and “fair and equitable” treatment of secured and unsecured creditors: Article 57(2) and (3), and also Article 57(3)
 - c. Valuation mechanisms (cf. *UNCITRAL Legislative Guide on Insolvency*, Chapter IV, Para. 38)
 - d. Final decision – Creditors, Court, and TAC: *ibid*, and Article 10(9)-(11)
 - e. Judicial vs. administrative discretion: appointment of TAC: Article 10(2)
 - f. International practice: *World Bank Principles for Effective Insolvency Systems*, Principle C.14; *UNCITRAL Legislative Guide on Insolvency*, Recommendation 150
3. **Treatment of guarantors: Rationale and Incentives**
 - a. Automatic stay: Article 37(2)
 - b. Discharge of guarantees: Article 58(3)
4. **Subordination/*de fact* extinguishment of pre-plan claims**
 - a. New credit as a ‘super-‘administrative expense: Article 40(3)(a)
 - b. Subordination of pre-plan secured creditors requires “adequate protection”: Article 40(4)(b)
 - c. Crucial check in such systems: whether new financing would facilitate reorganisation, including whether the plan would obtain creditor approval
 - d. Contrast with Draft CRA: Point 2, above
 - e. Valuation mechanisms (cf. *UNCITRAL Legislative Guide on Insolvency*, Chapter IV, Para. 38)

- f. International practice: *World Bank Principles for Effective Insolvency Systems*, Principle C.12; *UNCITRAL Legislative Guide on Insolvency*, Recommendations 63, 66 and 67

5. Corporate Restructuring Companies

- a. Rationale for Chapter 6: why can proposed activities not be carried out by 'ordinary' companies?
- b. Envisaged state-sector participation

Attachment 5



CRA

**SECURITIES AND EXCHANGE COMMISSION
OF PAKISTAN**

NIC Building, 63-Jinnah Avenue, Islamabad

Salman Ali Shaikh
Chairman

No. M&C(03)/MIN/04
27 April 2010

Mr. Salman Siddique
Secretary
Finance Division
Islamabad

Subject: DRAFT CORPORATE REHABILITATION ACT (CRA)

Dear Salman Sb.,

This is with reference to the Finance Division's letter No. 3(19)/Inv-V/2007-Pt dated March 17, 2010 on the captioned subject. SECP was asked to give its views on the comments received from the World Bank on draft CRA.

The Committee constituted by the Government of Pakistan in January 2009 (chaired by me) to review and amend the draft CRA completed its task in November 2009. The draft CRA was formally handed over to the Ministry of Finance in November, 2009. Subsequently, the draft law was presented to the Cabinet and "in principle" approval was obtained. Thereafter, in February 2010, the World Bank sent its detailed comments on the draft law. These comments were reviewed by the legal team who amended the draft CRA (2004) in light of stakeholder consultations. The World Bank's comments were reviewed by the legal team comprising of Mr. Sultan Mazhar Sher, Director Law, SECP; Mr. Muneeb Zia, Legal Expert (ERU), Finance Division; and Mr. Feisal Naqvi, Advocate, Bhandari Naqvi and Riaz. They have given their detailed response to the arguments raised by the World Bank team. Their comments are attached as Annexure A. We would appreciate if the Ministry of Finance could forward these comments to the World Bank.

Kind regards,

Very truly yours,

(Salman Ali Shaikh)
Chairman

c.c.

1. Ms. Nazrat Bashir, Additional Secretary Finance
2. Mr. Muneeb Zia, Legal Expert, Finance Division

Introductory Comments

1. These comments are being submitted on behalf of the Securities and Exchange Commission of Pakistan (“SECP”) in response to the comments (the “Comments”) received from the World Bank (the “World Bank”) through its letter dated [] March 2010, which Comments had been provided by the World Bank in relation to the draft Corporate Rehabilitation Act (“CRA”).
2. Before providing a detailed response to the Comments, it would be appropriate if certain basic considerations were kept in mind, particularly as these considerations appear to have been ignored by the World Bank.
 - a. We note first that the CRA has been analysed by the World Bank exclusively with reference to the UNCITRAL Legislative Guide on Insolvency and the World Bank Principles on Effective Insolvency Systems. We note further that the Comments contain absolutely no reference whatsoever to the actual legal conditions prevailing in Pakistan and to the manner in which corporate insolvency is currently handled by Pakistani law.
 - b. In our view, approaching the CRA from the enlightened perspective of a well appointed ivory tower is neither helpful nor desirable. The UNCITRAL Guide and the World Bank Principles reflect “a distillation of international best practice” but neither the Guide nor the Principles purport to be an inflexible one-size-fits-all legislative remedy. Instead, as explicitly noted in the Principles, “Adapting international best practices to the realities of developing countries [] requires an understanding of the market environments in which these systems operate.” The Comments, however, contain no reference whatsoever to the prevailing market environment in Pakistan or to the various legal and factual constraints within which insolvency law must operate within Pakistan. We would therefore submit that the World Bank would be better served by reading its own Guidelines more thoroughly before cherry-picking isolated quotes from them.
 - c. By comparison, it is our opinion that no examination of the CRA can (or rather, should) be carried out without taking into account the following aspects of the legal environment in Pakistan.
 - i. Firstly, despite decades of attempts by various governments to make laws increasingly creditor friendly, actual recovery of loan amount by creditors in Pakistan remains both time-consuming and difficult. The primary reason for this situation is that it is very difficult to execute a judgment against real property submitted as collateral, partly because of the complexities of the land titling system (or lack thereof) in Pakistan, and partly because of judicial oversight (and interference) in relation to the execution of decrees. Since neither of these underlying factors are realistically likely to be addressed in the near future, any design of any corporate insolvency system in Pakistan needs to take into account these basic factors.

- ii. Secondly, the vast majority of Pakistani companies are family-owned and run. The distinction between ownership and management, while certainly present in theory, is therefore normally not present in practice. Furthermore, practically all corporate loans in Pakistan are backed up by the personal guarantees of the directors. For all practical purposes therefore, most Pakistani companies are not limited liability companies but companies whose owners/managers are personally liable for the debts of the company in much the same way as partners of a partnership. This in turn means that debtors adopt a scorched earth approach to dealing with recovery lawsuits because quite often their own houses and personal assets are at stake.
 - iii. Thirdly, the courts in Pakistan are overwhelmed by litigation. Delays are therefore endemic and any process which is dependent upon the judicial determination of contested facts is therefore likely to take a considerable period of time. It is also unfortunately true that while the superior judiciary in Pakistan certainly consists of people with considerable legal talent, many judges have very limited exposure to corporate issues. At the same time, for constitutional reasons, it is not possible to take bankruptcy related disputes out of the judicial sphere and into the realm of a specialised tribunal with a more limited ambit.
- d. All of these factors were indeed taken into account while determining the initial concept of the CRA. It was therefore agreed, prior to any detailed drafting, that a new corporate insolvency law would have to be designed keeping in view the following:
- i. Given the failure of previous committee-driven efforts (as well as the lack of transparency associated with such efforts), any insolvency system would have to be driven primarily by the parties but subject to judicial oversight.
 - ii. Given the already present multiple demands on the judiciary, judges should not be called upon to make complex factual determinations but should rather be presented, to the maximum extent possible, with simple up or down decisions.
 - iii. For the same reasons, judges should be provided with sufficient technical support so as to minimise demands on their time and to provide them with a substantive basis for adjudication.
 - iv. Given the failure of creditor-friendly laws to have any real effect, it would be necessary to entice debtors into insolvency proceedings and in particular, offer the option of existing management remaining in possession of insolvent companies pending a final resolution of insolvency proceedings.
 - v. At the same time, offer a reasonable blend of incentives and punishment so as to preserve a “balance of terror” between creditors and debtors.

- vi. Establish the liquidation value of assets as the benchmark for assessing the viability of reorganization plans.
- e. The final point to note in this regard is that the CRA is not simply an off-the-shelf product but a document which has been finalised after many years of study and after multiple rounds of stakeholder consultation. The initial draft of the CRA was prepared in 2004 by the Banking Law Review Committee which had been set up by the State Bank of Pakistan and tasked with the job of reviewing all bank related legislation. That Committee was made up of a number of high-ranking experts, including the then deputy governor of the State Bank of Pakistan, the then chairman of the Securities Exchange Commission of Pakistan and the then adviser to the then Ministry of Finance along with a number of other prominent and well known authorities. This initial draft was then placed by the State Bank of Pakistan on its website and comments were invited from all stakeholders as well as multilateral institutions. The draft CRA was also presented at a number of international conferences dealing with insolvency issues. Nonetheless, given the economic climate at that time, the government of the day did not feel the need to introduce this law.
- f. In 2008, it was once again felt that instead of an ad hoc solution it was necessary to reach a comprehensive solution to the problem of corporate insolvency. For this purpose, yet another high-level Committee was formed to review the draft CRA and to provide recommendations in this regard. This Committee reviewed the CRA in great detail and invited comments from various sectors of industry as well as the general public. A number of meetings were held in this regard and all comments were discussed and debated. More specifically, the Pakistan Banks Association (“PBA”) held a series of meetings with the members of the Committee in order to apprise them of its concerns, which concerns were then taken into account through amendments to the draft CRA.
- g. The point of the foregoing is to simply note that the CRA is not just an academic exercise but the fruit of many years of effort. It has been discussed and debated at great length and the experience of a very large number of people, including specifically people from the banking sector, has been brought to bear upon the CRA. At the end of the day, it was the consensus of all these persons and parties that the CRA represented the best hope of moving towards a modern and functional corporate insolvency system in Pakistan. In our opinion, the World Bank should have given greater weight to this expertise and this process than is revealed by the Comments.

Detailed Comments

3. Rather than provide a paragraph by paragraph rebuttal of the points made in the Comments, we have instead tried to respond thematically to the various criticisms contained therein.
 - A. Mechanisms and Cumulative Effect
4. The concerns raised in the Comments relating to “Mechanisms” can be summarised as follows:

- a. The CRA is applicable only to a very small group of companies;
- b. The CRA allows for the write-down, write-off or subordination of creditor claims;
- c. The CRA allows the suspension and discharge of third-party guarantees;
- d. The CRA allows the maintenance of existing shareholders as owners even though the equity may have been extinguished and the retention of a management team that may have lost the confidence of creditors;
- e. There is no market-based test of the viability of the data company and no adequate evaluation mechanism;
- f. A reorganisation plan can be approved even if all of the creditors of the company are unanimously opposed to it;
- g. State authorities will be able to exercise significant influence over the process since the courts will operate on the advice of a quasi non-governmental organisation and because State or corporate restructuring companies will be able to draw on public funds to buy non-performing loans.

5. In response to the above noted concerns, the following may be noted:

- a. It is correct that the CRA as currently drafted will be applicable only to a very small group of companies. However, this limited scope is by design. It is evident that the CRA will call for a significant amount of judicial oversight as well as administrative regulation. The CRA is also an entirely new legislation which will require some degree of familiarisation on the part of the judiciary to be properly operated. Given these facts, it was decided that the operation of the CRA should initially be confined to larger debtors both so that the courts can gain some initial expertise with the process and also so that the eventual benefits of reorganisation are commensurate with the administrative costs. The one thing which was sought to be avoided was a law which would be unworkable because it would place too great a burden on the judiciary or other administrative structures. Once there is a greater familiarity with the law, the CRA provides that the threshold for its applicability can be changed by the Federal Government.
- b. It is obviously correct that the CRA provides for the write-down of debts and the retention of existing management. However, these are hardly revolutionary concepts in relation to corporate insolvencies. In fact, the whole point of the CRA is to allow those companies which can be saved from liquidation to be saved, so long as the benefits (and return to creditors) from reorganisation are greater than the benefits of liquidation. It is therefore completely incorrect for the Comments to state that there is no market-based test. That test is built into the provisions of Section 57 of the CRA which is explicitly modeled on the "cramdown" provisions of 11 USC 1129 of the United States Bankruptcy Code. Indeed, the reason why that language has been adopted is specifically so that judicial authorities in Pakistan have a

reservoir of precedent to rely upon rather than being left with complete discretion in the matter.

- c. The simple reason why the CRA provides for the discharge of third person guarantees is because it would be entirely unworkable otherwise. As already noted above, practically all corporate debt in Pakistan is secured by the personal guarantees of the directors (who, in most cases, are also the major shareholders of the company). The discharge of corporate debt without the corresponding discharge of personal guarantees would therefore still leave the management/shareholders vulnerable and liable to lose all of their personal assets. To put it mildly, not many directors of a company are so altruistic as to sacrifice their personal wealth for the sake of the company.
- d. It may further be noted that the automatic discharge of personal guarantees is hardly a major sacrifice for creditors because recovery on the basis of personal guarantees has always been very limited. According to a survey conducted by the State Bank of Pakistan, the actual recovery of dues on the basis of personal guarantees has historically been less than one per cent of the secured amount. In stakeholder meetings relating to the CRA, the most important factor identified by potential debtors was the discharge of personal guarantees. It is for this reason, that the CRA provides that the confirmation of a plan operates so as to discharge the guarantees of natural persons.
- e. The final point to note in this regard is that the discharge of personal guarantees only occurs if a plan is confirmed. If a plan is not confirmed, the debtor is wound up and the personal guarantees remain enforceable. The potential discharge of personal guarantees thus operates as a significant incentive for the debtor (and the guarantors) to enter into a mutually acceptable agreement with the creditors.
- f. It is not in dispute that the CRA allows for a plan to be confirmed without the consent of even a single creditor. However, it should also be noted that there are significant provisions in the CRA to ensure that this provision is not abused. In the first instance, all plans are referred to a Technical Advisory Committee ("TAC") for its expert opinion. These plans are then submitted to a court for approval. And in the event of any problem or dispute, a disgruntled party always has the option of filing an appeal. Self-evidently, the approval of a plan which does not enjoy the support of even a single creditor is likely to be an extremely unusual event. It is our opinion that the possibility of such an event should not be statutorily precluded in advance since there are sufficient mechanisms in the CRA to ensure that these provisions are not abused.
- g. With reference to the possible involvement of the State sector, it appears as if the author of the Comments is unnecessarily apprehensive in relation to the use of State influence.
 - i. In the first instance, the characterisation of the TAC and its members as State-controlled is uncalled for. Both the SECP and the State Bank of Pakistan are autonomous bodies which are relatively well insulated from direct governmental influence. In any event, they are the single

most respected bodies available to play a role with respect to the appointment of the members of the TAC.

- ii. The second point is that some sort of expert assistance is necessary for the CRA to operate because Pakistani courts simply do not have the expertise and experience necessary to deal with complicated financial matters. This expertise can either be provided by the parties through counsel, but judges will, at least initially, lack the ability to sort through competing opinions. It is for this reason that the TAC was provided in the CRA, so that the courts would have a neutral source of expertise available to them so as to “pre-digest” the information being submitted by the parties.
- iii. It may further be noted that the creditor community in Pakistan has welcomed the concept of the TAC and has, in fact, sought to make its role stronger than what is already provided in the CRA. The role of the TAC, however, cannot be expanded any further (i.e. made binding on the courts) because that would run into constitutional issues. In any event, if the decision of the TAC was made binding, the system would devolve into another committee-driven mechanism of which many variants have already been unsuccessfully tried in Pakistan.
- iv. The last point to note is that the opinion of the TAC is not binding on the courts. There is thus an independent check on the operations of the TAC. Furthermore, since the decisions of the courts are appealable, there is a second independent check present in the system. The availability of an appeal is particularly important because the yardstick which will invariably be applied by the courts is one of value to the creditors. Thus, if a particular plan has not been confirmed even though it offers more value to the creditors, those creditors always have the option of filing an appeal and challenging the decision of the court.
- h. In light of the above, the apprehension in the Comments that the system provided under the CRA will be open to abuse by well-connected parties appears exaggerated. In any event, the CRA needs to be contrasted not against some hypothetical ideal but against what happened the last time there was an NPL crisis in Pakistan (and which will happen again unless the CRA is enacted).
- i. To be more precise, the last NPL crisis in Pakistan was handled through the promulgation in 2002 of BCD Circular 29 by the State Bank of Pakistan. Under this Circular, defaulters were allowed to settle their overdue amounts by making payment of the “fire sale value” of their assets over 3 years. The payment of this amount also discharged all personal and other guarantees. In terms of implementation, the procedure was extremely opaque because the “fire sale value” of the assets was determined by an assessor who was often encouraged to give an artificially low value. Furthermore, the creditors did not have the option of taking over the assets in exchange for the loans nor did the creditors have the ability to put forward competing buyers (i.e. those willing to pay more than the fire sale price). The CRA has been drafted precisely to avoid a repeat of the Circular 29 fiasco because unless and until

there is some mechanism to deal with NPLs on a continuous basis the end result will inevitably be another crisis followed by politically unanswerable demands for a fresh bailout.

B. Wealth Effects

6. According to the Comments, the CRA could result in a “substantial transfer of wealth from creditors . . . to large corporate debtors” because:
 - a. The CRA allows for the forcible confirmation of plans even in the face of unanimous creditor opposition;
 - b. There is no restriction on the forcible confirmation of plans seeking to maintain the ownership of shareholders whose equity has otherwise been wiped out; and,
 - c. The CRA provides for the extension of the automatic stay to third-party guarantors of liabilities and the discharge of personal guarantees upon the confirmation of a plan.
7. In response to these observations, it may first be noted that they are – in effect – the same comments already made under the headings of “Mechanisms” and “Cumulative Effect.” The detailed replies already given hereinabove may therefore be re-examined in this context. More specifically:
 - a. As already conceded, the CRA does allow for the forcible confirmation of plans even in the face of unanimous creditor opposition. However, this is self-evidently an extreme situation and one which would be examined very carefully both by the court as well as by the TAC. To extrapolate from the fact that it is, in theory, possible for a plan to be confirmed even if all creditor classes are opposed to it to the conclusion that such confirmations are likely to be the norm is entirely unjustifiable.
 - b. The further query which arises in this context is why such an extreme situation needs to be catered for in the law. The reason for this lies in Pakistan’s particular history and the nationalization of banks in the 1970s. The next decade and a half was an era in which public sector control over the financial sector was grossly abused by well-connected parties, first to get loans and then to have them written off. The abuse of the process was predictably followed by public outrage and a regulatory tightening by the State Bank which made it extremely difficult for loans to be written off. This hostility towards any sort of loan write-offs then reached its peak with the enactment of the National Accountability Bureau Ordinance, 2001 in which allowing write-offs (and defaulting on loans) was criminalized.
 - c. The point being made here is that the financial sector community in Pakistan has good reason to be economically irrational in the context of bad loans. Bankers are well aware of the fact that their approval of loan resettlements may be used against them in the future. This attitude is changing with the privatisation of the banking sector and the entry of foreign banks but it remains nonetheless a very serious issue. The consequence of this is that the normal assumption that banks will act in their economic self-interest and

approve reorganization plans when such plans offer better returns than liquidation is not completely justified in Pakistan. The further consequence of this is that unless the CRA provides the “nuclear option” of a cramdown even in the absence of any creditor approval, the operation of the law could be severely handicapped.

- d. So far as the observations regarding third-person guarantees are concerned, it may again be noted that the normal distinctions between shareholders, management and corporate bodies often do not exist in Pakistan in practice. The assumption in the Comments that guarantors will be persons or entities distinct from the debtors, is therefore completely unjustified and yet another illustration on how the Comments appear to have been formulated without any regard for the ground realities prevailing in Pakistan. In any event, the consequence of this situation is companies will have no interest in being rescued unless their management/shareholding is also rescued at the same time. The discharge of personal guarantees is therefore a vital and necessary part of the CRA.
8. The broader point to consider is that the current draft of the CRA has been finalised with the concurrence of the Pakistan Banks Association. The reason why the PBA has agreed to the CRA is because current recovery procedures and laws have failed to make any real difference in the reduction of NPLs, notwithstanding the fact that various governments have tried from time to time to make these laws as creditor friendly as possible. The PBA has also agreed to the CRA because the CRA provides creditors with a range of substantive tools that they can use to enhance their recovery. For example, under the current recovery laws, it is very easy for debtors to delay the execution of decrees because of various lacunae in Pakistan's property laws (and more specifically, the fact that we do not have a system of recorded title) as well as a general hostility in the judiciary with respect to even minor shortcomings in the sale of mortgaged property. By comparison, the CRA allows creditors to come up with a plan which provides for the sale of secured property to a third-party buyer free and clear of all liens and encumbrances. There is no equivalent provision anywhere in Pakistani law. If the provision works as anticipated, it will benefit both creditors and debtors by allowing the value of secured property to be maximised. However, in order for this process to work, some benefits also need to be offered to the debtor. And, the discharge of personal guarantees seems a reasonable price to pay for the successful transfer of secured property (particularly when it is a well established fact that the actual benefit of personal guarantees in financial terms is minimal).
9. The final point to consider in this context is that the CRA is not a means by which creditors can be robbed of their rights. As already stated, the fundamental decision point while considering the forcible confirmation of plans is whether a proposed plan offers more than liquidation to creditors. A plan can therefore only be confirmed over the opposition of creditors if the net recovery from that plan is more than what would be received by creditors to liquidation. Not only is this standard entrenched in the CRA itself, but it has been repeated ad nauseam in the caselaw interpreting the United States Bankruptcy Code which, as already noted, will be available to Pakistani courts. The repeated observation in the Comments that the CRA allows for the confirmation of a plan without any reference to the market value of underlying assets is therefore completely incorrect.

10. It is conceded that given this decision point, the determination of liquidation values will be extremely important. However, it is for this reason that the CRA makes provision for a TAC and also provides for an institution to be in charge of regulating property evaluators. In any event, further protection against the abuse of this provision (as happened earlier in the case of Circular 29) is provided by the ability of creditors and debtors to submit competing plans. Thus the process of plan approval is intended not to be dependent upon judicial or expert revaluation of property valuations but rather dependent upon competition between debtors and creditors to come up with the highest possible value for secured assets. Such competition may not arise in every single instance which is why, again, some sort of neutral and expert assistance to the court will be necessary (hence the TAC).

C. Management entrenchment and claim subordination

11. According to the Comments, the CRA:

- a. potentially enables managers to retain control of the insolvent company even if they have lost the confidence of the creditors;
- b. enables the company to initiate reorganisation itself which would allow it to continue to operate substantially as before;
- c. enables the company to defeat the existing creditors by getting superpriority loans without any requirement that such loans be necessary for the continued operation of the company for the preservation of the value of its business.

12. In response to the foregoing it may kindly be noted as follows:

- a. It is not denied that the CRA potentially enables managers to retain control of an insolvent company even if they have lost the confidence of the creditors. However, it may first be noted that this is hardly a revolutionary concept. The United States Bankruptcy Code also provides that debtors may remain in possession of their companies and that insolvency proceedings may be initiated by the company itself. As such, it is difficult to see why the Comments regard these possibilities with such apprehension.
- b. The further point to note is that the initiation of rehabilitation proceedings renders the management and the shareholding of the company vulnerable to a far greater degree than before. Once a company enters rehabilitation proceedings, its management can be removed by the court upon the application of the creditors. Similarly, the management of a company in rehabilitation proceedings is required to account for its actions to a far greater degree than a company outside such proceedings. By focusing only on the potential for mischief, the Comments seemed to deliberately exaggerate the negative possibilities contained in the CRA rather than taking a holistic view of the matter.
- c. The final point to note is that any insolvency system other than a debtor in possession system will never work in Pakistan for the simple reason, as repeatedly noted above, that there is no distinction between management and shareholding so far as the vast majority of companies in Pakistan are concerned. Unless and until the possibility of the management staying in

possession of their companies is provided for by law, companies will simply choose to not enter into rehabilitation proceedings. This factor seems to have been completely ignored by the Comments.

- d. So far as the potential to allow superpriority loans is concerned, it may be noted that the relevant language is directly copied from the United States Bankruptcy Code. Such loans are therefore only available to debtors if no other loans are available and if a debtor is able to ensure that the interests of pre-existing secured creditors will be given sufficient protection. It should also be noted that such superpriority loans can only be approved by the court with notice to creditors. The apprehension contained in the Comments that such loans will be given out freely and without protection to the existing creditors is therefore unjustified and seems to ignore the language of the CRA. In fact, the very purpose of duplicating the language of the Bankruptcy Code was to ensure that the relevant precedents would also continue to be applicable.

D. Risks to financial stability and/or to fiscal discipline

13. According to the Comments, the CRA significantly weakens the position of banks as creditors and that as a consequence, banks may find themselves saddled with significant NPLs that may weaken their balance sheets. The Comments also express an apprehension that the risk of rising NPLs will be exacerbated by the operation of State-funded CRCs.
14. So far as the position of banks is concerned, it has already been noted that the CRA has been finalised after discussion and debate with the PBA. It may further be noted that the banks in Pakistan are already faced with a situation in which there is a rising amount of NPLs. However, the unanimous conclusion of all stakeholders is that the current legal framework cannot handle such situations and that the State-centric solution adopted the last time there was an NPL crisis (i.e. Circular 29) should not be repeated.
15. So far as the operation of CRCs is concerned, it appears as if the author of the Comments has not fully appreciated the manner in which such entities will operate. To begin with, there is no requirement – legal or otherwise – that CRCs be owned by the State. Instead, the idea behind the provisions relating to CRCs is that there should be a secondary market for debt (vulture capital) so that the parties which operate within the legal ambit of the CRA should be those which are familiar with its workings and know how to maximise its potential. To the extent that there are State owned CRCs, they will have to compete with private sector CRCs and no special benefit will be extended to the State sector entities. In any event, there is no privileged role for CRCs. Instead, CRCs can only acquire debt through an arms length transaction. Thus, CRCs cannot force banks to sell them distressed assets.

E. The Position of Employees and of Non-Viable Distressed Companies

16. The Comments note that the CRA does not provide a framework for employment preservation in the context of corporate distress and that comparative restructuring law provides, in India, an obligation on those managing restructuring proceedings to consult with the employee representatives before making redundancies. The Comments further note that the CRA is not a suitable vehicle for the pursuit of any

social policy favouring the preservation of non-viable distressed enterprises. Both observations are fundamentally misguided.

17. So far as the first observation is concerned, it needs to be understood that the CRA differs radically from the process envisaged by Chapter 11 of the United States Bankruptcy Code in that it is severely time bound. As such, the CRA provides for an initial period of 120 days in which parties can submit a plan, followed by a single possible extension of 60 days. The conversation during this period obviously had to focus on the debate between creditors and debtors. This period is not intended to be an extended period of reorganisation. Instead it is intended to serve as a mechanism to force a negotiated agreement, to the extent possible, between creditors and debtors and further to allow a transition into liquidation if negotiations fail.
18. It should further be noted that the requirement that employees be consulted in relation to the confirmation of a plan is not prohibited by the current provisions of the CRA. Instead, if a plan being submitted to confirmation negatively affects existing employees in a way which they feel is unfair; then obviously the employees will have a right to appear before the court and be heard. However, amending the CRA so as to provide the employees with a formal seat at the negotiating table seems to be highly unrealistic.
19. The final point to note in this regard is that the CRA is not intended to be the vehicle of a social policy favouring the preservation of non-viable distressed enterprises. However, to the extent the CRA is used in such a manner, it is a far better mechanism than what is currently available. More specifically, if the Government currently wants to subsidise a loss-making State enterprise it can do so without bringing the issue to public notice. On the other hand, if a State owned CRC wants to invest in a loss-making company for social reasons, that investment will have to be made in a public manner and subject to competition from other enterprises.

Conclusion

20. The current draft of the CRA has been more than eight years in the making. During that period it has been submitted on numerous occasions for comments to various multilateral agencies, none of which have ever on any previous occasion reacted with the alarm contained in the Comments. In addition, the concepts contained in the CRA have been repeatedly refined over years of discussion and negotiation with stakeholder bodies, including specifically, the banking sector in Pakistan. In our view, the indigenous origins of the CRA as well as the unusually lengthy period of scrutiny it has undergone are sufficient guarantees of its workability, far more so than its resemblance to a hypothetically ideal product.
21. It is not in dispute that the current corporate insolvency system in Pakistan is utterly inadequate and does not serve the purposes of either creditors or debtors. It may, in theory, be possible to craft a better solution than the CRA. However, the point is that the CRA is ready and available now whereas the hypothetically superior solution is nowhere to be seen. In any event, the CRA is open to subsequent amendment and improvement if and when practice shows that there are problems in its implementation. However, Pakistan does not have the luxury of waiting indefinitely for a supposedly superior draft law to be realized. At present, this is the best available option. And if the World Bank does not agree, it is welcome not to assist in the implementation of the CRA.



MOST IMMEDIATE

Government of Pakistan
Finance Division
Investment Wing

No. 3(19)Inv-V/2007

Islamabad the 15th June, 2010

To: The Country Director,
World Bank,
Islamabad Office,
Islamabad, Pakistan.

From: Muhammad Arshad
Assistant Economic Adviser (Inv-V)



Subject: **COMMENTS OF WORLD BANK ON DRAFT CORPORATE REHABILITATION ACT**

Sir,

I am writing with reference to the comments received from World Bank on draft Corporate Rehabilitation Act (CRA). The Finance Division appreciates World Bank's comments which have been thoroughly reviewed by this Division in consultation with Securities and Exchange Commission of Pakistan.

2. One of the comments of WB is that the CRA is applicable only to a small group of companies. CRA as currently drafted will indeed be applicable only to a small group of high-value companies. This aspect was thoroughly deliberated by the stakeholders and it was found that the CRA will call for a significant amount of judicial oversight as well as administrative regulation and therefore, initially a reasonable limit on the companies entering CRA was essential. It was further found that the CRA will be an entirely new legislation requiring familiarization on the part of the judiciary to be properly operated. Given these facts, it was decided that the operation of the CRA should initially be confined to larger debtors both so that the courts can gain some initial expertise with the process and so that the eventual benefits of reorganization are commensurate with the administrative costs. The one thing which was sought to be avoided was a law which would be unworkable because it would place too great a burden on the judiciary or other administrative structures. Once there is a greater familiarity with the law, the CRA provides that the threshold for its applicability can be changed by the Federal Government Through executive

notification. Thus, limit on CRA threshold is flexible and can be altered according to the need and circumstances.

3. WB further commented that the CRA provides for the write-down of debts and the retention of existing management. However, experts of insolvency are aware that these are hardly revolutionary concepts in relation to corporate insolvencies. In fact, the whole point of the CRA is to allow viable companies to be saved from liquidation, so long as the benefits (and return to creditors) from reorganisation are greater than the benefits of liquidation.

4. As regards the WB comments on automatic discharge of personal guarantees, it may be explained that it is hardly a major sacrifice for creditors because recovery on the basis of personal guarantees has always been negligible in Pakistan. According to a survey conducted by the State Bank of Pakistan, the actual recovery of dues on the basis of personal guarantees has historically been less than one per cent of the secured amount. Further, the discharge of personal guarantees only occurs if a plan is confirmed. If a plan is not confirmed, the debtor is wound up and the personal guarantees remain enforceable. The potential discharge of personal guarantees thus operates as a significant incentive for the debtor (and the guarantors) to enter into a mutually acceptable agreement with the creditors.

5. We do not find WB's comment about absence of a market-based test as correct. That test is built into the provisions of Section 57 of the CRA which is explicitly modeled on the "cramdown" provisions of 11 USC 1129 of the United States Bankruptcy Code. Indeed, the reason why that language has been adopted is specifically so that judicial authorities in Pakistan have a reservoir of precedent to rely upon rather than being left with complete discretion in the matter.

6. As per sub-section (2) of section 10 of the draft Act, the appointment of members of Technical Advisory Committee (TAC) shall be made by Chairman, Securities & Exchange Commission of Pakistan (SECP) and Governor, State Bank of Pakistan (SBP). Both the SECP and the SBP are autonomous bodies which are relatively well insulated from direct governmental influence. In any event, they are the single most respected bodies available to play a role with respect to the appointment of the members of the TAC. Further, the creditor community in Pakistan has welcomed the concept of the TAC and has, in fact, sought to make its role stronger than what is already provided in the CRA. The role of the TAC, however, cannot be expanded any further (i.e. made binding on the courts) because that would run into constitutional issues. In any event, if the decision of the TAC was made binding, the system would devolve into another

committee-driven mechanism of which many variants have already been unsuccessfully tried in Pakistan. Furthermore, the opinion of the TAC is not binding on the courts. There is thus an independent check on the operations of the TAC.

7. CRA differs from the process envisaged by Chapter 11 of the United States Bankruptcy Code in that it is severely time-bound. As such, the CRA provides for an initial period of 120 days in which parties can submit a plan, followed by a single possible extension of 60 days. The process during this period obviously had to focus on the debate between creditors and debtors. This period is not intended to be an extended period of reorganization. Instead it is intended to serve as a mechanism to arrive at a negotiated agreement, to the extent possible, between creditors and debtors and further to allow a transition into liquidation if negotiations fail. It may further be noted that the requirement that employees be consulted in relation to the confirmation of a plan is not prohibited by the current provisions of the CRA. Instead, if a plan being submitted to confirmation negatively affects existing employees in a way which they feel is unfair; then obviously the employees will have a right to appear before the court and be heard. However, amending the CRA so as to provide the employees with a formal seat at the negotiating table seems to be unrealistic and a non-starter.

8. CRA is not intended to be purely the vehicle of a social policy favoring the preservation of non-viable distressed enterprises. However, to the extent the CRA is used in such a manner, it is a far better mechanism than what is currently available. More specifically, if the Government currently wants to subsidise a loss-making state enterprise it is free to do so. On the other hand, if a state owned Corporate Restructuring Company (CRC) wants to invest in a loss-making company for social reasons that investment will have to be made in a public manner and subject to competition from other enterprises.

9. Finally, the World Bank's other comments, such as a reorganization plan can be approved even if all of the creditors of the company are unanimously opposed to it and that it potentially enables managers to retain control of the insolvent company even if they have lost the confidence of the creditors; and that it enables the company to defeat the existing creditors by getting superpriority loans without any requirement that such loans were necessary for the continued operation of the company for the preservation of the value of its business are not well placed given the whole scheme of CRA. It appears that exceptions in CRA have largely been generalized and, perhaps, due appreciation is wanting on checks and balances annexed to the concepts commented upon by WB. For further, clarity, it may be noted that CRA is the product of

hectic and extensive consultation, involving almost all the different segments of business community, regulator and government. Each of these areas has been thoroughly deliberated by the stakeholders at the end of SECP and thereby final position is determined. Ministry of Finance understands that it is a consensual document that takes into accounts the indigenous needs and international standards. However, we shall be pleased to assist the WB team in further clarifying any matter for its better understanding, if so required..


10. Hope the above reply will dully address the World Bank's comments on CRA.

Yours faithfully,



(Muhammad Arshad)

Assistant Economic Adviser (Inv-V)

 051-9209774

Attachment 6

Draft Corporate Rehabilitation Act

Technical Assistance Mission

Wrap Up Meeting

July 23, 2010

Agreed Principles

1. Two possibilities for defaulting borrowers: Liquidation or Reorganization as two outcomes of the same process.
2. Liquidation should be fast, unencumbered and cost effective to preserve and recycle valuable assets of non-viable borrowers.
3. The causes of distress for otherwise viable enterprises are either managerial or external to the firm (temporary shocks).
4. Viable plan should recognize and address first and foremost the causes of distress by relating the restructuring plan to the cause.
5. The acceptability of a restructuring plan should be determined by parties who stand to gain or lose from its implementation.
6. To minimize moral hazard, those who take on risk should bear the losses when the risk materializes.
7. The Court is the guarantor of the integrity of the process but should not be required to make technical judgments.
8. Creditors would rather that the debtor service its obligations than causing liquidation, owning corporations or chasing defaulters.

CRA Seeks to Apply These Principals

- Principle 1 –
 - Creates a legal framework for corporate reorganizing
 - Incentivizes debtors to initiate proceedings by leaving the debtor in possession
- Principle 2 – Admission of Insolvency and admission of liability have potential of speeding up winding up process
- Principles 3&4 – Through the focus on a restructuring plan, causes of firm distress may be identified and redressed [*]
- Principle 5 – The CRA introduces a party-led process encouraging debtors and creditors to propose plans and leads creditors to assess the viability of the plan through voting [*]
- Principle 7 – There is a mechanism to feed technical content into the courts decision making [*]

Issues of Concern

- Plan Confirmation
- Technical Assistance Committee
- Treatment of Personal Guarantees
- Effective Winding Up Mechanism
- Corporate Restructuring Company
- Way Forward

Plan Confirmation

- Art. 56: Provides for an exquisite creditor consultation and voting mechanism
- Art. 57. – Overrides this mechanism in favor of court forcibly confirming plan based on advice by the TAC.
- *Violates Principle Number 5* - In doing so, undermines financial discipline & enhances moral hazard for everyone.
- Alternatively, with full decision making power, creditors end up with the most accumulated knowledge of the sector, the firm and its management and have a direct financial stake in getting it right

Technical Assistance Committee

- Rationale For TAC is Understandable
 - Court requires technical knowledge it does not possess.
 - Process of Debtor – Creditor Negotiation will be messy and reliable and trusted source of advice facilitates negotiations.
- But the Mechanism Is Flawed
 - Mode of appointment makes the system vulnerable to considerations of politics, prestige and perks.
 - TAC members are beholden to their appointers rather than the courts, the parties or the market.
 - TAC mechanism suppresses incentive for insolvency practitioners to invest in skill development and market reputation.
- Better Alternative is Present within the System
 - CRB Model – Properly developed, CRB is first best mechanism to meeting the rationale, creating a profession whose members are accountable to the market, the parties and the court

Personal Guarantees

- Personal Guarantees are normal part of prudent bank lending around the world.
- To meet Principle 6, those who have offered personal guarantees should be made to stand by them.
- CRA proposes
 - moratorium on guarantee enforcement and
 - extinguishment of guarantee (unless the plan otherwise provides)
- Moratorium weakens incentive to make debtor cooperate in timely completion of the process
- Extinguishment by default in forcibly confirmed plans fundamentally - *Violates Principle 6*

Winding Up Provisions

- The potent catalytic force for corporate reorganization is the credible threat of speedy winding up. (P 1&2)
- Evidence suggests winding up is dysfunctional and does not provide a credible catalyst for reorganization
- CRA provides some improvements in accelerating the process,
- But absence of modern, winding up system, puts CRA effectiveness at risk
- Due to lack of credible threat, CRA seeks to attract debtors into the reorganization process by offering inducements which violate Principle 6,

Corporate Restructuring Company (RTC)

- Rationale, Design and Ownership for RTC is Unclear in Policy and Law
- Is it Part of Textile Policy or a means for developing second market for distressed assets?
- Public RTC is Typically a Response to Systemic Banking Crises, Privatization or Sector Wide Industrial Distress
- Fiscal impact of public RTC may be significant
- International and Pakistan experience with RTC type of approach has been detrimental for financial discipline

Way Forward

- Small Revisions to the Text Which Are Systematically Fundamental
- Rules and Regulations Covering Institutional and Procedural Matters
- Enhancement of Winding Up Procedures in the Companies Ordinance
- Review of Recovery Laws
- Program of Institution Building for CRB
- Professional Development for Insolvency Practitioners
- Program of Capacity Building for Judiciary
- Review of Associated Laws –eg land title registration
- Plan for 3 year Reviews to Adjust Based on Practice – e.g. entry criteria

Attachment 7

October 18, 2010

Mr. Salman Siddique
Secretary
Ministry of Finance
Government of Pakistan
Islamabad

Dear Secretary Siddique:

Draft Corporate Rehabilitation Act

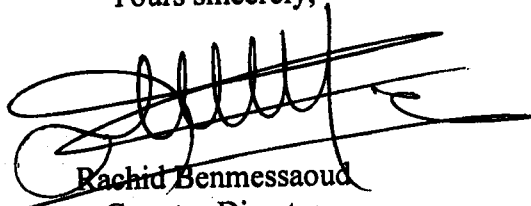
I am writing to follow up on your request to review the draft Corporate Rehabilitation Act (CRA), covering the principles and mechanisms incorporated into the framework. I understand that the Mission had a constructive exchange of views with the drafting committee in late July, 2010. We would like to express our sincere appreciation to you and all members of the committee for the considerable time spent with the Mission and the courtesies extended.

As we understand it, the draft law has been submitted to the Parliament for debate and legislative attention and the opportunity to consider further revisions to the draft law remains. It is in this context that the Mission has prepared a summary of the issues discussed, including possible alternatives that the Government might wish to consider in its debate on the draft CRA. Also attached is a copy of the power point presentation from the July 23 wrap up meeting.

If you would like to follow up on Mission's comments on the CRA, two of the Mission members, Mr. Eric Manes and Mr. Rizwan Mokal, would be available to visit you on Wednesday October 27, in advance of the Final PSD Task Force Meeting. Please let me know if this would be useful to you.

With warm regards.

Yours sincerely,



Rachid Benmessaoud
Country Director
Pakistan

Attachments: a/s

cc: Mr. Sibtain Fazal Halim, Secretary, Economic Affairs Division, Islamabad
Mr. Salman A. Shaikh, Chairman, Securities and Exchange Commission of Pakistan,
Islamabad

Drafted by: Eric David Manes & Riz Mokal

Cleared by: Vijay Srinivas & Asif Faiz through emails dated Oct 8, 2010

Bcc: Pakistan CMU, Ivan Rossignol, Eric David Manes, Riz Mokal, Vijay Srinivas, Satu Kristina Kahkonen, Shabana Khawar, Mudassir Khan, Marjorie Espiritu, SASPF Files; IRIS

PAKISTAN DRAFT CORPORATE REHABILITATION ACT
DRAFT COMMENTS FROM THE WORLD BANK

October 2010

EXECUTIVE SUMMARY

If appropriately amended, the draft Corporate Rehabilitation Act has the potential to plug an important lacuna in the legal governance of the market. It would do so by introducing, for the first time in the jurisdiction, a set of mechanisms by which distressed but viable enterprises may be rehabilitated and their causes of distress remedied.

As currently structured, however, the draft legislation is unlikely to realise these benefits. Instead, there is considerable risk that it may cause harm. It may enable non-viable enterprises to be continued, contrary to their creditors' wishes and in a socially value-destructive manner. It may permit debtors and their erstwhile owners to rid themselves without justification of legal obligations that they had freely accepted, obligations on the strength of which they would have raised money for the business. By the same token, it may prevent lenders from recovering what they are owed, thereby weakening their own viability, and in the process, could generate significant moral hazard. The proposed draft vests key technical decisions in the restructuring process in a proposed 'Technical Assistance Committee' whose members would be appointed in a non-transparent manner, without checks against the risk of political influence, and would not be meaningfully accountable to either the parties or the courts. This could cast doubt both on the suitability of their appointment and on the validity of their decisions. And finally, the legislation as currently drafted raises concern that public funds could be used to acquire distressed claims and businesses in a way that may undermine both the effective functioning of the market and fiscal discipline.

These potential problems with the draft legislation are fundamental and go to its heart, but they could be mitigated through relatively minor textual changes. Drawing on extensive discussions with the drafters of the legislation and other key stakeholder representatives, the World Bank team has formulated recommendations for improving the expected dynamics of the proposed framework, which have been discussed with Pakistani authorities, including the Secretary, Ministry of Finance. These are as follows: (1) The Court should not be given jurisdiction to forcibly confirm any plan which has not received support from at least a majority of creditors; (2) The draft legislation should dispense with the Technical Assistance Committee; instead, insolvency professionals licensed by the proposed 'Corporate Rehabilitation Board' should be appointed on a case by case basis at the parties' behest to advise them and the court; (3) The provisions suspending and extinguishing guarantees for the company's debt should be eliminated; (4) The government should be explicitly precluded from investing in any of the proposed 'Corporate Restructuring Companies'; and (5) At the next stage in the legislative reform process, efforts should be directed at creating a modern, streamlined liquidation system that could be functionally integrated with an appropriately amended corporate rehabilitation framework, and which, in addition to dealing with distressed non-viable businesses, would also provide the correct incentives for parties to corporate rehabilitation proceedings.

For the reasons explained in this document, implementation of the proposed legislation in an unmodified form may risk doing considerably more harm than good. By contrast, implementation of the proposed legislation incorporating the textually minor amendments proposed here could constitute a most significant first step in the creation of a world-class corporate rehabilitation system. It could also pave the way for international donors to assist Pakistan in developing the institutions and building the capacity required to effectively implement the legislation.

CONTEXT

1. An appropriate legal and institutional treatment of distressed enterprises is a key element in the effective governance of the market. A legal system equipped to distinguish distressed but nevertheless viable firms from non-viable ones can aid growth and development by (i) cost-effectively liquidating non-viable distressed enterprises and transferring their assets to new, more productive uses; (ii) enabling the rehabilitation of viable distressed enterprises which are more valuable when kept as going concerns than they would be if disposed of piecemeal; and in both these circumstances, (iii) protecting to the maximum extent the rights of the creditors of the enterprise, thereby minimising moral hazard for borrowers and incentivising potential creditors to lend in the first place.

BACKGROUND

2. The Government of Pakistan (**GoP**) is in the process of preparing a new Corporate Rehabilitation Act (**CRA**), the current draft of which is presently in the initial stages of the legislative process. At GoP's invitation and with a view to meeting the particular economic and social needs of Pakistan consistently with international best practice, the World Bank has provided comments on several drafts of the CRA. The Comments in this paper encapsulate the results of a mission by the Bank team to Pakistan from 19 to 23 July 2010, and are informed by extensive discussions in person and by phone and video conference between the Bank team and the Chair and legal team of the Securities and Exchange Commission of Pakistan (**SECP**) which has drafted the proposed CRA; interviews with representatives of lender and borrower communities in Karachi, Lahore, and Islamabad, the acting Chief Justice of the Sindh High Court, and relevant Ministries; and detailed dialogue with the Secretary, Ministry of Finance. The Comments build on those provided to GoP by the Bank team on 1 February 2010, and take into account responses from the SECP legal team received by email on 21 June 2010 and in person on 21 July (though dated 27 April 2010). The Comments also draw on the international 'best practice' guidance as reflected in the *United Nations International Trade Commission's Legislative Guide on Insolvency* (**'Guide'**) and the *World Bank Principles on Effective Insolvency Systems* (**'the Principles'**).

THE AGREED PRINCIPLES

3. The analysis of the draft CRA in these Comments proceeds by reference to a set of axioms or 'principles' (**'the Agreed Principles'**). These axioms were formulated by the Bank team as a result of its preparatory work (cf. paragraph 2, above), and presented during an Opening Meeting with the Secretary, Ministry of Finance, on 21 July 2010, which was also attended, among others, by the Chair and legal team of the SECP. Agreement was reached at the meeting that, in principle, these axioms accurately capture the rationale underlying both, GoP's objectives in introducing the draft CRA, and relevant international best practice in enterprise rehabilitation law and policy. Table I provides statements of these Agreed Principles.

Table I: AGREED PRINCIPLES

<p>An effective legal system would respond to distress in one of two closely inter-related ways: it would liquidate non-viable distressed enterprises, and would rehabilitate viable though distressed ones.</p>
<p>In order to preserve and recycle the valuable assets of non-viable distressed enterprises, liquidation should be fast, relatively unhindered, and cost effective.</p>
<p>In relation to viable distressed enterprises, distress may, broadly, be caused by either managerial failings or reasons independent of any such failings.</p>
<p>Restructuring plans should, first and foremost, recognize and address the causes of distress by relating the steps to be taken in the restructuring process to the causes.</p>
<p>The acceptability of a restructuring plan should be determined by the very parties who stand to gain or lose from its implementation, and who have the most knowledge about the debtor's business and prospects and about the competence of its management.</p>
<p>To minimise moral hazard, those who take on risk should bear the losses when the risk materializes.</p>
<p>The Court is the guarantor of the integrity of the distress resolution process but should not be required to make technical non-legal judgments.</p>
<p>A creditor would rather that the debtor services its obligations than that it be in need of being chased for repayment, or liquidated, or that its business have to be run by the creditor.</p>

SUMMARY OF CONCERNS

4. The Bank team's analysis of the proposed CRA by reference to the Agreed Principles gives rise to very significant concern. For a small group of the largest distressed companies in the economy, the CRA would create a mechanism that could allow the write down, write off or subordination of creditor claims; the suspension and subsequent discharge of third party guarantees held by such creditors; the maintenance of existing shareholders as the company's owners even though their equity had been extinguished by the company's financial state; and the retention of a management team that may have lost the creditors' confidence. Each of these mechanisms could operate without reference to any market-based test for the viability of the affected company and without an adequate valuation mechanism, and could override even the unanimous objections of the company's creditors, who by virtue of the company's financial state would have a direct economic stake in the company's assets and business. These mechanisms would operate by decision of the Court on the advice of a Technical Assistance Committee ("TAC"), a quasi non-governmental organisation over the appointment and operations of which, absent appropriate checks and balances, state authorities could exercise significant influence. Further, the CRA would provide a framework within which a Corporate Restructuring Company ("CRC") with significant state

ownership is envisaged as drawing on public (and other) funds to buy non-performing loans from banks and distressed assets from companies.

5. In the result, the mechanisms that would become available under the draft CRA would call into question the governance and integrity of the corporate rehabilitation mechanism as a whole. By eliminating fundamental checks and balances and by centralising decision-making powers in state (or quasi-state) bodies, it would hamper rather than assist stakeholders in finding sustainable, economically effective solutions for corporate distress. Further, the operation of the CRA could raise critical issues of financial stability (because banks would be forcibly required to absorb the loss of significant levels of non-performing loans), and/or could give rise to significant concern about fiscal discipline (because of the contemplated use of public funds to purchase claims but also assets with no clear market value).

PARTIAL COMPLIANCE WITH THE AGREED PRINCIPLES

6. Before addressing the reasons for these concerns, it is important to note that the draft CRA goes some way towards meeting the requirements of the Agreed Principles. Most notably:
 - a. It introduces, for the first time in the jurisdiction, a legal framework within which large corporations in distress may be rehabilitated; further, it incentivises the debtor's managers to initiate CRA proceedings by leaving them in control of the debtor's business notwithstanding the initiation of these proceedings (**Agreed Principle 1**);
 - b. It has the potential for speeding up the (distinct) liquidation process by requiring the debtor wishing to avail itself of the CRA process to admit insolvency and the fact of its liability (**Agreed Principle 2**);
 - c. It creates mechanisms by which a restructuring plan may be formulated which can identify and address the causes of distress (**Agreed Principles 3* and 4***);
 - d. It introduces a party-led process that encourages debtors and creditors to propose plans, and which enables creditors to assess the viability of these plans through voting (**Agreed Principle 5***); and
 - e. It creates a mechanism to feed non-legal technical content into the Court's decision-making (**Agreed Principle 7***).
7. Unfortunately, however, other key elements of the draft CRA fundamentally violate several of the Agreed Principles. The harm brought about by these aspects of the proposed legislation would, among other things, also negate or severely dilute the benefits that would otherwise have resulted from the draft CRA's compliance with Principles 3, 4, 5 and 7 (cf. paragraphs 6 (c), (d), and 3, above), a fact indicated in the previous paragraph by the asterisks (*).

FORCIBLE CONFIRMATION OF PLANS REJECTED BY CREDITOR MAJORITY

8. The central and fundamental problem with the draft CRA resides in this issue. Borrowing from Chapter 11 of the US Bankruptcy Code, the CRA introduces an exquisite and extensive framework for dividing the creditors into classes, and of ascertaining their views about any or all proposed rehabilitation plans.¹ The CRA then, however, proceeds to negate the utility of this framework by providing that the Court, at the advice of the TAC, may forcibly confirm a plan even if the creditors had unanimously rejected it.²
9. This structure poses serious risk to the likely efficacy of the rehabilitation framework proposed by the draft CRA, and it is crucial to understand why. To simplify, four important considerations are at play:
 - a. **Is the business viable?** Voting on proposed rehabilitation plans in relation to a distressed business is an inherently difficult process. The fundamental issue for decision is whether the business, even though distressed, nevertheless remains viable. Empirical evidence and experience in other jurisdictions suggest that most distressed enterprises are not viable. Such non-viable distressed businesses ought to be liquidated quickly and cost-effectively so that their constitutive assets would be put to more socially valuable uses. A minority of distressed businesses may indeed be viable. A crucial task for a rehabilitation framework, then, is to identify this minority of cases. (**Agreed Principles 1 to 3**) Creditors can be expected to have developed considerable knowledge of the debtor business by virtue of having lent money to, and then attempting to recover it from, it; or by having supplied it with goods and services. They would thereby be in a better position, compared with any other party outside the debtor business, to determine the causes of the distress, to ascertain whether it resulted from managerial incompetence or other factors, and to judge whether the business is still viable.
 - b. **How best to identify and remedy causes of distress?** If a distressed business is duly identified as capable of being rescued, the rehabilitation plan should be structured so as to maximise the likelihood of the rehabilitation of the business. This means it should identify and remedy the underlying causes of the distress. (**Agreed Principles 4 and 5**) Better than any other party outside the business, creditors are able to and ought to be enabled to use their knowledge of the causes of the debtor's distress to assess whether the proposed plan would be likely to give the business the best chance of being rehabilitated, and since their own money is at stake, they have a strong incentive to get this decision right. No other party can be expected to be in a better position to make such decisions, and no other party has the same incentives.

¹ CRA, Article 56.

² CRA, Article 57.

- c. **Is modification of creditor rights legitimate?** Any rehabilitation plan would modify the legal rights of the creditors of the business. In virtually all plans, they would be required to delay, reduce, or even to write off their claims in whole or part. (**Agreed Principle 5**) That it is some majority of creditors themselves who may vote to confirm a plan requiring the modification of creditor rights is evidently the best guarantee that any such modifications would be legitimate.
- d. **Would rehabilitation create moral hazard?** By the same token, the rehabilitation process allows the debtor company to walk away from some of its legal obligations. This intensifies financial agency costs and creates moral hazard. The owners and managers of the debtor company may be tempted *ex ante* to invest in excessively risky projects, in effect gambling the value received by the business from its creditors in the expectation that they would capture any increased returns (the lenders are restricted to their principal and interest), but that any losses would be also be shared by the creditors. A rehabilitation process increases the probability that even if such excessively risky strategies resulted in disaster, at least some part of the business would continue to be owned and run by at least some of its pre-distressed owners/managers, which in turn intensifies this socially harmful incentive. (**Agreed Principles 5 and 6**) Since it is the creditors' money at stake in the decision whether, and if so, how to attempt a rehabilitation of the distressed debtor, they have an incentive to assent to the rehabilitation only if they believe the business became distressed because of factors unrelated to managerial incompetence or excessive risk-taking. Owners and managers would anticipate that, in their business's distress, creditors would either vote to liquidate rather than rehabilitate; or else, approve a rehabilitation plan only on the condition that incompetent managers would be replaced and excessively risk-preferring owners deprived of equity stakes. This controls moral hazard.
10. It is in consideration of these and other factors that international best practice has converged on vesting important decision-making powers in the rehabilitation process in a majority or super-majority of creditors.³
11. Against this background, the present wording of Article 57 of the draft CRA creates the most serious risk to the efficacy of the proposed legislation. Pursuant to its current wording, the Court could "forcibly confirm" a plan at the TAC's advice⁴ even if all creditors had rejected it.⁵ While an aggrieved party could object before the Court,⁶ the Court would be able to decide against it – indeed, would possess jurisdiction to accept the entire plan – without any reference to the market value of the debtor's assets.⁷ This despite the fact that neither the Court nor the TAC can be expected to possess requisite knowledge of the

³ As an indication of international best practice, see *Principles*, Principle C.12.5.

⁴ CRA, Article 10(9).

⁵ CRA, Article 57. By way of contrast and as an indication of international best practice, see *Guide*, Chapter IV, Recommendation 150; and *Principles*, Principle C.14.3.

⁶ CRA, Article 10(12).

⁷ CRA, Article 57, for example, paragraph 2(a).

business, its managers, and its industry; neither the Court nor the TAC legitimately stand to gain from getting the reorganise/liquidate decision right or lose from getting it wrong; and neither the Court nor the TAC would be best placed to ensure that the rehabilitation plan would be best designed to address and remedy the causes of distress. The overall result of the law would be an insolvency system based on centralized decisions, isolated from market forces, and possibly influenced by non-economic factors. By the same token, the operation of this element of the CRA could result in a substantial transfer of wealth from creditors – notably, financial institutions – to large corporate debtors, and even more so, to their controlling shareholders. This would weaken – and in extreme cases, cast doubt on the viability of – the lender institutions themselves.

12. **Recommendation:** It would be a relatively easy matter to amend Article 57 to ensure that no plan could be forcibly confirmed by the Court unless it had attracted the support of an appropriate majority by value of the distressed company's creditors. Unless this were done, it is difficult to envisage that the CRA framework would be either efficacious or credible, and difficult to escape the conclusion that it would do more harm than good.

TECHNICAL ASSISTANCE COMMITTEE

13. This is the second troubling element of the draft CRA. The proposed legislation envisages that the Chair of the SECP and the Governor of the State Bank of Pakistan ("SBP") would jointly appoint the members of the TAC.⁸ The Court would be required to seek the TAC's advice on all key questions concerning the plan, including whether a secured creditor had "adequate protection"; whether a proposed plan or an amendment thereto was "fair and equitable"; which creditor classes were underwater; and it seems, even the overall acceptability of the plan.⁹
14. The rationale for a mechanism such as the TAC is understandable. The formulation and assessment of the rehabilitation plan requires possession of technical knowledge – most notably, that for the assessment of discounted cashflow projections – that the Court neither does nor should be expected to possess. This technical content is best derived from an independent expert source, on whose advice the Court and parties alike may rely. (**Agreed Principle 7**)
15. However, the structure of the TAC and the mode of appointment of its members is open to misuse and risks being corrosive to the establishment of a proper rehabilitation system. This is for two main reasons:
 - a. **Appointment:** The TAC is based on what may be called a 'closed list' system, i.e. it will consist of a small, fixed number of members (currently 15) to be appointed by the SECP and SBP heads, each of whom is themselves a government appointee. There is

⁸ CRA, Article 10(2).

⁹ "The Court *shall* refer all plans..." (CRA, Article 10(9), emphasis added).

considerable risk that appointments to this body – which the Bank team understands are intended to be prestigious, and on a case by case basis, well remunerated – would be, and be perceived to be, tainted by the politics of patronage and perks.

- b. **Operation, accountability, reputation:** Relatedly, TAC members would be fully accountable neither to the parties in rehabilitation proceedings nor the Court. Parties to rehabilitation proceedings would have little control over who serves in their case; could not veto a member's nomination; would have no control over their fees; and would not be able to effectively hold them accountable in Court. Correspondingly, TAC members would have no incentive to develop a credible reputation in the market so as to attract appointments in future rehabilitation proceedings. If anything, their incentive would be to please their two joint appointors and their appointors' political masters. This bodes well neither for the actual nor the perceived integrity of the proposed system.

16. **Recommendation:** While it is possible to envisage improving on this aspect of the proposed legislation in one of several ways, the Bank team commends the alternative enshrined in the draft CRA itself. The proposed legislation envisages that the Corporate Rehabilitation Board ('CRB') would train, license and accredit professionals to perform various roles within the rehabilitation process. With relatively minor amendments, the CRA could provide for the CRB to licence Insolvency Professionals ('IPs') on the lines of the various licensing bodies in medicine, engineering, architecture, auditing, law, etc. In any given rehabilitation proceeding, the parties could nominate and the Court could appoint a licensed IP to assist the Court through the non-legal technical aspects of the rehabilitation process. If the parties (debtor and creditors) failed to reach consensus on the identity of the IP, each could be entitled to nominate one IP, and the two nominees would together select a third member of the panel to serve in that case. Subject to appropriate guidance in subordinate legislation, the IPs' fees would have to be approved by the creditors (whose money would be at stake in the proceedings), or in the alternative, by the Court. This would mitigate the danger of unsuitable and unaccountable appointees distorting the insolvency process through the TAC, and would instead encourage IPs to invest in building a credible reputation for expertise and impartiality in order to attract nominations by parties to future proceedings.

TREATMENT OF PERSONAL GUARANTEES

17. The third problematic element of the draft CRA is its treatment of personal guarantees. It should be noted at the outset that, firstly, the acquisition of personal guarantees from a company's owners/managers to secure corporate borrowing serves to reduce financial agency costs, and is thus an absolutely standard part of the armoury of prudent bank lending in every corner of the world. Secondly, such guarantees are doubly important in jurisdictions where corporate financial reporting practices are underdeveloped or otherwise unreliable, and where it is difficult to enforce the legal boundaries between corporate revenues and the

personal assets of the company's owners/managers. The Bank team understands that financial lenders in Pakistan consider practices in the country to fall into both these categories (unreliable corporate reporting; weak checks against misappropriation of corporate assets). And thirdly, it is important in order to minimise moral hazard for those who have undertaken personal guarantees to be required to stand by them when duly called upon to do so. (Agreed Principle 6)

18. Notwithstanding these factors, the draft CRA proposes the following:

a. **Suspension:** The imposition of the 'automatic stay' upon the initiation of CRA proceedings would also suspend enforcement action against the guarantors of the company's liabilities.¹⁰ This is a highly unusual provision, since the stay in insolvency proceedings is generally intended to protect the going concern of the debtor company, not the financial position of owners or other third-party guarantors. In a restructuring system in which the consent of at least some affected creditors was required, such extension of the ambit of the stay would be regarded as objectionable because it would make the proposed plan less likely to attract creditor consent. Correspondingly, it would weaken the incentives of the debtor's managers/owners to cooperate in the timely completion of the rehabilitation process.

b. **Extinguishment:** Even more problematically, even a "forcible" confirmation of a plan would prima facie result in the extinguishment of all relevant natural-person guarantees.¹¹ Again, this provision is highly unusual, and taken together with the Court's jurisdiction to forcibly confirm a plan which has not attracted majority creditor support, is fundamentally objectionable because it enables the guarantors, who had freely accepted their liabilities and benefited from doing so, to walk away from them, thus loading unbargained-for losses on to creditors. This would create moral hazard, and would tend to undermine the viability of the lenders themselves. (Agreed Principle 6)

19. **Recommendation:** This problem could most simply be addressed by deleting the provision that suspends guarantees during the rehabilitation process (Articles 37(2)), and that which prima facie extinguishes them at the culmination of this process (Article 58(3)). Suspension of guarantees is on balance not justified by the rationale of corporate rehabilitation; and if the creditors, whose money is at stake in the process, are persuaded of the business case for extinguishing guarantees (for example, because they can thereby persuade guarantors to provide new money for the rehabilitated business), then they would vote of their own accord for a plan which would bring about this extinguishment.

CORPORATE RESTRUCTURING COMPANIES

¹⁰ CRA, Article 37(2).

¹¹ CRA, Article 58(3).

20. Chapter 6 of the draft CRA proposes to create a framework for the creation and operation of 'Corporate Restructuring Companies' ('CRCs') whose role would be to trade in distressed assets. The Bank team's discussions with various stakeholder representatives confirm, however, that there is neither clarity nor agreement amongst stakeholders as to the rationale, design, or ownership of these companies.
21. In principle, the legal system may usefully stimulate the creation of a secondary market in distressed assets by, among other things, enabling private sector market participants to set up in the business of buying assets from and/or claims against distressed enterprises. Some stakeholder representatives informed the Bank team that this is indeed what Chapter 6 of the draft CRA is intended to accomplish.
22. More troubling is the suggestion, made to the Bank team by more than one stakeholder representative, that the government is intended to have a significant equity stake in at least one CRC set up pursuant to Chapter 6, which would be utilised as a way of consolidating capacity in the textiles sector. It should be noted that international experience strongly suggests that there are at most three situations in which, *if* carefully structured and disciplined, publicly funded CRCs can play a useful role: (i) in resolving systemic banking crises; (ii) in resolving sector-wide industrial distress; and (iii) in transferring businesses from the public to the private sector. Outside of these limited domains, experience with publicly funded CRCs has been invariably negative. None of these three sets of circumstances currently prevails in Pakistan.
23. In the Pakistani context, a publicly funded CRC could bid for and take into the public sector assets that would more effectively have been utilised in the private one. Its operations could distort nascent distressed asset markets in the private sector by confounding price signals and by impeding private sector players' ability to learn to price assets properly and to develop skills to turn around distressed businesses. And even more problematically, it could buy claims from financial institutions in circumstances where the debtor had invoked or was likely to invoke the CRA procedure and the claims were at risk of being reduced or extinguished in the way described above. This risks a loss to the public purse and to fiscal responsibility.
24. **Recommendation:** This problem could most simply be addressed through the insertion of a provision in Chapter 6 of the CRA requiring that companies set up under that framework should be funded solely through private sector resources.

AN EFFECTIVE LIQUIDATION FRAMEWORK

25. In a well-functioning legal system, an effective liquidation framework is, as it were, the conjoined twin of an effective rehabilitation process. As noted in paragraph 1, above, most distressed companies are distressed because their business proposition is no longer viable, and a well functioning legal system would cost-effectively recycle their assets to more promising uses. Additionally, the credible threat of speedy liquidation can be a potent

catalyst for distressed debtors to initiate rehabilitation proceedings. (**Agreed Principles 1 and 2**)

26. Evidence available to the Bank team suggests that the Pakistani corporate winding-up framework is dysfunctional: it is procedurally cumbersome, involves unnecessarily lengthy delays, and can be costly. For these reasons, the threat of its invocation against them does not constitute an effective inducement for debtors to initiate rehabilitation proceedings.
27. The absence of a credible threat of liquidation may have had a distortive effect on the design of the CRA. As if to compensate for its absence, the CRA seeks to provide inducements for debtors to initiate rehabilitation proceedings – for example, in relation to personal guarantees (paragraphs 17-19, above) – that in fact are corrosive to its rehabilitative efficacy.
28. **Recommendation:** Instead of creating self-defeating inducements for debtors to initiate CRA proceedings, stakeholders should be encouraged at the next stage of the legislative reform process to design a modern and effective liquidation regime that would properly integrate with the CRA, and which would create incentives for the parties to initiate and cooperate in the successful conclusion of CRA proceedings.

CONCLUSION AND NEXT STEPS

29. The current draft of the CRA goes some way towards creating a modern corporate rehabilitation framework. Because of the features discussed above, however, it presently risks doing more harm than good. The changes recommended in these Comments are textually minor, yet could fundamentally alter the dynamics of the proposed system. Thus amended, the CRA could constitute the first and significant step towards plugging this important lacuna in the governance of the market. The Bank team is ready to assist at each stage of the process.
30. Enactment of a suitably amended CRA would enable international donors to assist GoP with many of the expertise- and resource-intensive steps in the implementation of the corporate rehabilitation framework. These include, among others:
 - a. Formulation of secondary rules and regulations for detailed implementation of the CRA;
 - b. Programme of capacity-building for the CRB;
 - c. Programme for the training and licensing of IPs;
 - d. Programme of capacity-building for the judiciary;
 - e. Review of associated laws, including those governing non-bankruptcy claim enforcement and land title registration; and
 - f. Plan for three-yearly reviews of the implementation and functioning of the CRA to incorporate lessons from experience.

Slide 1

Draft Corporate Rehabilitation Act

Technical Assistance Mission
Wrap Up Meeting
July 23, 2010

Slide 2

Agreed Principles

1. Two possibilities for defaulting borrowers: Liquidation or Reorganization as two outcomes of the same process.
2. Liquidation should be fast, unencumbered and cost effective to preserve and recycle valuable assets of non-viable borrowers.
3. The causes of distress for otherwise viable enterprises are either managerial or external to the firm (temporary shocks).
4. Viable plan should recognize and address first and foremost the causes of distress by relating the restructuring plan to the cause.
5. The acceptability of a restructuring plan should be determined by parties who stand to gain or lose from its implementation.
6. To minimize moral hazard, those who take on risk should bear the losses when the risk materializes.
7. The Court is the guarantor of the integrity of the process but should not be required to make technical judgments.
8. Creditors would rather that the debtor service its obligations than causing liquidation, owning corporations or chasing defaulters.

Slide 3

CRA Seeks to Apply These Principals

- Principle 1 –
 - Creates a legal framework for corporate reorganizing
 - Incentivizes debtors to initiate proceedings by leaving the debtor in possession
- Principle 2 – Admission of Insolvency and admission of liability have potential of speeding up winding up process
- Principles 3&4 – Through the focus on a restructuring plan, causes of firm distress may be identified and redressed [*]
- Principle 5 – The CRA introduces a party-led process encouraging debtors and creditors to propose plans and leads creditors to assess the viability of the plan through voting [*]
- Principle 7 – There is a mechanism to feed technical content into the courts decision making [*]

Slide 4

Issues of Concern

- Plan Confirmation
- Technical Assistance Committee
- Treatment of Personal Guarantees
- Effective Winding Up Mechanism
- Corporate Restructuring Company
- Way Forward

Slide 5

Plan Confirmation

- Art. 56: Provides for an exquisite creditor consultation and voting mechanism
- Art. 57. – Overrides this mechanism in favor of court forcibly confirming plan based on advice by the TAC.
- *Violates Principle Number 5* - In doing so, undermines financial discipline & enhances moral hazard for everyone.
- Alternatively, with full decision making power, creditors end up with the most accumulated knowledge of the sector, the firm and its management and have a direct financial stake in getting it right

Slide 6

Technical Assistance Committee

- Rationale For TAC is Understandable
 - Court requires technical knowledge it does not possess.
 - Process of Debtor – Creditor Negotiation will be messy and reliable and trusted source of advice facilitates negotiations.
- But the Mechanism Is Flawed
 - Mode of appointment makes the system vulnerable to considerations of politics, prestige and perks.
 - TAC members are beholden to their appointers rather than the courts, the parties or the market.
 - TAC mechanism suppresses incentive for insolvency practitioners to invest in skill development and market reputation.
- Better Alternative is Present within the System
 - CRB Model – Properly developed, CRB is first best mechanism to meeting the rationale, creating a profession whose members are accountable to the market, the parties and the court

Slide 7

Personal Guarantees

- Personal Guarantees are normal part of prudent bank lending around the world.
- To meet Principle 6, those who have offered personal guarantees should be made to stand by them.
- CRA proposes
 - moratorium on guarantee enforcement and
 - extinguishment of guarantee (unless the plan otherwise provides)
- Moratorium weakens incentive to make debtor cooperate in timely completion of the process
- Extinguishment by default in forcibly confirmed plans fundamentally - *Violates Principle 6*

Slide 8

Winding Up Provisions

- The potent catalytic force for corporate reorganization is the credible threat of speedy winding up. (P 1&2)
- Evidence suggests winding up is dysfunctional and does not provide a credible catalyst for reorganization
- CRA provides some improvements in accelerating the process,
- But absence of modern, winding up system, puts CRA effectiveness at risk
- Due to lack of credible threat, CRA seeks to attract debtors into the reorganization process by offering inducements which violate Principle 6,

Slide 9

Corporate Restructuring Company (RTC)

- Rationale, Design and Ownership for RTC is Unclear in Policy and Law
- Is it Part of Textile Policy or a means for developing second market for distressed assets?
- Public RTC is Typically a Response to Systemic Banking Crises, Privatization or Sector Wide Industrial Distress
- Fiscal impact of public RTC may be significant
- International and Pakistan experience with RTC type of approach has been detrimental for financial discipline

Slide 10

Way Forward

- Small Revisions to the Text Which Are Systematically Fundamental
- Rules and Regulations Covering Institutional and Procedural Matters
- Enhancement of Winding Up Procedures in the Companies Ordinance
- Review of Recovery Laws
- Program of Institution Building for CRB
- Professional Development for Insolvency Practitioners
- Program of Capacity Building for Judiciary
- Review of Associated Laws –eg land title registration
- Plan for 3 year Reviews to Adjust Based on Practice – e.g. entry criteria

CORPORATE REHABILITATION ACT

BACKGROUND NOTE

BACKGROUND: BANK INVOLVEMENT IN CRA

In the wake of the rise in corporate distress among manufacturing enterprises, Pakistan, like other jurisdictions, has given considerable attention to establishing a corporate restructuring mechanism to deal effectively with financial distress of business enterprises. The Bank's policy dialogue started with the PRESO and carried forward to the PRSC has included these issues. As a result, there has been an on-going dialogue on a proposed corporate restructuring mechanism with the SECP for almost a year.

In the context of this dialogue, the WB had been asked to review and comment on two versions of a draft corporate restructuring statute in March 2009 and again in July 2009. For those earlier versions, we registered our support for the effort and activity and offered technical assistance.

On November 24 2009, after reading in the newspaper that the law had been presented to the Ministry of Finance by the SECP, and after noting a significant deterioration in the application of good insolvency principals in the final draft, WB urgently requested the opportunity to review the law and followed up with 2 Video Conferences - December 3rd and January 27 - to fully understand the policy issues behind the new draft. Draft comments were provided to the technical team at SECP and MOF before providing them in the attached letter. No response has yet been received.

CITATION IN IMF THIRD REVIEW: Consultations on the new bankruptcy law (Corporate Rehabilitation Act) have reached a final stage. The new law will help both the corporate and financial sectors by strengthening the legal basis for rehabilitation of viable but struggling corporate borrowers and speeding up the process of liquidation of unviable entities. Submission of the draft law to parliament has been delayed in order to allay concerns raised by financial institutions regarding creditor protection. The revised law was submitted to the Minister of Finance on November 16, 2009 and submission to parliament is expected by end-March, 2010."

GENERAL POINTS

The current version of the CRA appears to create a centralized mechanism for the protection of existing shareholders of a small percentage of the largest Pakistani business enterprises and appears to allow the entrenchment of existing management at the expense of the interests of other stakeholders, without regard to the viability of the enterprise and without necessary checks and balances. This approach in current version of the CRA appears inconsistent with the expressed policy goals of the Government and the goal of creating a viable and economically sustainable mechanism for corporate restructuring. As the draft CRA now has gone to the Cabinet, it is important that the WB's views on the CRA be updated, lest the earlier expressed support be misconstrued as applying to the CRA in its current form.

Taken together, the provisions -- many of them highly unusual in their own right, and unique as a set -- create a very serious risk indeed that the CRA framework would be a vehicle for abuse, to defeat creditor rights and allow either the continuation of non-viable entities, or more likely, the continuing ownership and management of distressed businesses by incompetent people who no longer retained the confidence of creditors, the very group whose money (and not any longer the shareholders') would be directly at stake in the enterprise.

The very weak creditor rights regime would be highly likely to cause the banks to bear heavy losses in relation to loans made to companies invoking the CRA, which could have systemic effects. And the operations of the partly state-funded Corporate Restructuring Company would be highly likely to result in net losses to the public purse for little or no social welfare gain and would create a risk to fiscal discipline. Specifically,

- At the heart of the CRA is what appears to be a framework to restructure -- or indeed, simply to write down or write off -- the existing liabilities of a **handful of the largest companies** in the economy.
- The proposed procedure would allow this to be done through a restructuring plan **even if each and every creditor of a company had voted against this plan**, through order of the court **at the advice of members of a proposed Technical Assistance Committee, a quasi non-governmental organisation** appointed jointly by the Chairman of the Securities and Exchange Commission of Pakistan and the Governor of the State Bank of Pakistan.
- **At no point need there be anything like a proper market-referenced valuation of the collateral**, to determine whether the debtor company was in fact insolvent; or whether it had a going concern surplus and thus ought to be rescued rather than liquidated; or how badly insolvent it was, with a view to determining which claimant classes are underwater.
- The benefit of the enforcement moratorium would **extend to the debtor's guarantors**, which would usually be its owners. From the point of view of the policy of corporate restructuring, it is difficult to identify a legitimate rationale for this provision, since the enforcement moratorium is intended to protect the company's going concern, not the financial interests of third parties like shareholders.
- The procedure would allow for the **subordination -- to the point of *de facto* extinguishment -- of pre-existing claims** by new loans. *De facto* extinguishment would occur when the value of the new loans exceeded the value of the company's assets and/or the present value of its future cash-flows.
- The approval of a plan would ***prima facie* discharge the debtor's natural-person guarantors**. Again, this is a highly unusual provision, showing extraordinary concern not for the continuation of the company's going concern, the position of its employees, or indeed the rights of creditors, but with the interests of its owners, who would usually be the guarantors of its liabilities.
- A **Corporate Restructuring Company, which is envisaged as being funded partly by the state**, could distort the operations of the markets for NPLs and for distressed assets, and

could also retard their development. Even more problematically, it could -- indeed, would be designed to -- buy claims from financial institutions in circumstances where the debtor had invoked or was likely to invoke the CRA procedure and the claims were at risk of being reduced or extinguished in the way described above.

THREE SPECIFIC POINTS

Entry requirements: Who benefits? C companies are eligible to invoke the CRA process only if they have debts (nb. not turnover) of more than Rs 50m (or another Government specified sum),¹ i.e. approximately US\$ 0.6m. (By contrast, the median (nb. not minimum) debt of companies in US Bankruptcy Code Chapter 11 proceedings is something like US\$1.2m.²)

It follows that a significant number of companies benefiting from Chapter 11 would be ineligible to benefit from the CRA, even discounting economic differences like relative per capita GDPs, purchasing power, and so on, which would suggest that the average US company would have a significantly larger turnover than the average Pakistani company. .

The CRA will be open to a tiny proportion (perhaps less than a third of one percent, i.e. <0.33%) of Pakistani companies, and would have entry requirements very much more restrictive than, for example, those for US Chapter 11. What justifies this focus and the exclusion from the process of most companies in the economy? What proportion of NPLs reside in these few dozen companies?

Some further context:

- Total number of Pakistani corporate enterprises: **64,559**.³
- Number of Pakistani companies with sales revenue (nb. not debt) over Rs 30m: **216**.⁴
- Number of Pakistani companies employing more than 1,000 people: **32**.⁵

Technical Assistance Committee: Who decides whether to liquidate or reorganize a company?
The CRA provides for the reorganisation plan to be approved at the advice of an SECP/SBP-appointed quango without any market valuation of the debtor's assets (which the debtor may retain), and even if all creditors would rather have the company liquidated. Specifically,

- The members of the Committee would be appointed by the SECP Chair and SBP Governor.⁶
- Even if all creditors have rejected a proposed reorganisation plan, it may nevertheless be "forcibly confirmed" by the court⁷ on the advice of this Committee.⁸

¹ Article 7(2)(c).

² Lubben, Stephen J., Corporate Reorganization & Professional Fees. American Bankruptcy Law Journal, Vol. 82, p. 77, 2008, at page 90; Seton Hall Public Law Research Paper No. 1094032. Available at SSRN: <http://ssrn.com/abstract=1094032>.

³ http://www.statpak.gov.pk/depts/fbs/publications/ec_2005/appendix-x.pdf

⁴ http://www.statpak.gov.pk/depts/fbs/publications/ec_2005/appendix-xv.pdf. The figure may be an underestimate: http://www.statpak.gov.pk/depts/fbs/publications/ec_2005/summary_findings.pdf ; http://www.statpak.gov.pk/depts/fbs/publications/ec_2005/ch2.pdf, at page 7.

⁵ http://www.statpak.gov.pk/depts/fbs/publications/ec_2005/appendix-xvi.pdf

⁶ Article 10(2).

⁷ Article 57.

⁸ Article 10(9).

- The Committee would decide all key question concerning the plan, including whether a secured creditor has “adequate protection”; whether a proposed plan or an amendment thereto is “fair and equitable”; which creditor classes are underwater, and it seems, even the overall acceptability of the plan.⁹
- While an aggrieved party may object before the court,¹⁰ the court may decide against it – indeed, may decide to accept the entire plan – without any reference to the market value of the debtor’s assets.¹¹

Potential abuse: What the debtor company and its owners obtain from the CRA process. The legislation is ripe for abuse by both debtor and its owners. Specifically,

- A CRA procedure can be initiated by the company itself.¹²
- The company then continues to operate.¹³
- Its guarantors (i.e. its owners) get the benefit of the enforcement moratorium;¹⁴ this is highly unusual, since the moratorium is generally intended to protect the going concern of the debtor company, not the financial position of any other party.
- Similarly, the claims against the company cannot even be “assessed”;¹⁵ this also is highly unusual, for the same reason; enforcement against assets may break up the going concern, but assessment of creditor claims does not. The intention here appears to be to hamper all creditor efforts.
- The company can then defeat pre-existing creditors by obtaining new secured or unsecured loans enjoying priority over pre-existing claims.¹⁶ Pre-existing secured creditors are accorded only notional protection which does not relate to on any actual market valuation of the collateral.¹⁷
- Finally, the confirmation of the plan releases the debtor’s guarantors (i.e. owners).¹⁸

⁹ “The Court *shall* refer all plans...” (Article 10(9), emphasis added).

¹⁰ Article 10(12).

¹¹ Article 57, for example, paragraph 2(a).

¹² Article 12.

¹³ Article 13(4), dealing with involuntary cases; and Article 22, dealing with both types of cases.

¹⁴ Article 37(2).

¹⁵ Article 37(1)(f).

¹⁶ Articles 40, read together with Article 22.

¹⁷ Articles 40(4)(b) and 45(2), and point 2, above.

¹⁸ Article 58(3), focusing solely on guarantors who are natural persons.

Attachment 8

December 22, 2010

Dr. Waqar Masud
Secretary
Ministry of Finance
Government of Pakistan
Islamabad

Dear Dr. Masud:

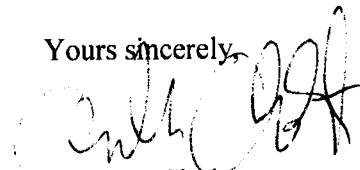
Proposed Corporate Rehabilitation Act 2010- Follow Up to October 26 Meeting

Following up on your predecessor Mr Salman Siddique's meeting on 26 October 2010 with Mr. Ernesto May, I am writing to provide the Bank's comments on the draft Corporate Rehabilitation Act 2010 ('CRA 2010') in annotated form, as requested

The annotations are intended to be read together with and in the light of our earlier comments provided to you in my letter of 18 October 2010 and appended to this document for reference. As you will see, our comments to the draft CRA 2010 cover only sections 10, 37, 57 and 58, along with some more general comments pertaining to Chapters 5 and 6.

If we can be of any further assistance in this matter, please let us know.

Yours sincerely,



Anthony Cholst
Acting Country Director for Pakistan

Attachments: World Bank Annotations: November 16, 2010
World Bank Comments: October 18, 2010

cc: Mr. Sibtain Fazal Halim, Secretary, Economic Affairs Division, Islamabad
Mr. Salman A. Shaikh, Chairman, Securities and Exchange Commission of
Pakistan, Islamabad

Drafted by: Eric David Manes/Riz Mokal

Cleared by: Uzma Ikram / Asif Faiz through email dated 12/20/2010.

bcc: Pakistan CMU, Ernesto May, Eric David Manes, Riz Mokal, Mudassir Khan, Shabana Khawar, Hanid Mukhtar, Project Files, IRIS

PAKISTAN DRAFT CORPORATE REHABILITATION ACT

WORLD BANK ANNOTATIONS – NOVEMBER 2010

The following annotations are provided by the World Bank at the request of the Secretary, Ministry of Finance, Government of Pakistan. They are provided with a view to assisting in the ongoing consultation and amendment process amongst Pakistani stakeholders to improve this draft legislation to best meet the economic and social needs of Pakistan, consistently with the country's legal and cultural traditions and with international best practice. The annotations should be read together with and in the light of the World Bank's October 2010 Comments on the Draft Corporate Rehabilitation Act, appended for reference to the end of this document. The annotations concern themselves solely with substantive issues, and are not intended to outline all the textual changes that would be required in order properly to incorporate the suggestions made in this document.

Corporate Rehabilitation Act

Bill

to provide for the rehabilitation of corporate entities

WHEREAS it is necessary to provide for the rehabilitation, reorganisation and restructuring of distressed corporate entities and their businesses so as to encourage economic growth and development.

It is hereby enacted as follows:

Chapter 1 – General Provisions

1. Short title, extent and commencement.- (1) This Act shall be called the Corporate Rehabilitation Act, 2009.

(2) It extends to the whole of Pakistan.

(3) This section shall come into force at once and the remaining provisions of this Act shall come into force within ninety days of the coming into force of this section or on such earlier date as the Federal Government may by notification in the Official Gazette appoint and different dates may be so appointed for different provisions within the aforesaid ninety days.

2. Definitions. (1) In this Act, unless there is anything repugnant in the subject or context:

(a) “administrator” means an administrator appointed under section 24;

(b) “Board” means the Corporate Rehabilitation Board established by section 62;

(c) “claim” means, –

(i) right to payment, whether or not such right is reduced to judgment, liquidated, un-liquidated, fixed, contingent, matured, disputed, undisputed, legal, equitable, secured or unsecured; or,

(ii) right to an equitable remedy for breach of performance if such breach gives rise to a right of payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, disputed, undisputed, secured or unsecured;

- (iii)(d) “charge” includes mortgage, lien, hypothecation, pledge, assignment or any other security interest whether legal or equitable, registered or unregistered;
- (e) “Collateral” includes any asset, property, right, claim, entitlement, share, undertaking, guarantee, agreement, instrument, charge or document used or meant as security for a financial asset;
- (f) “Commission” means the Securities and Exchange Commission of Pakistan; established under section 3 of the Securities and Exchange Commission of Pakistan Act, 1997 (XLII of 1997);
- (g) “Court” means the Court referred to in section 4;
- (h) “creditor” means an entity that has a claim against the debtor,—
- (i) that arose at the time of or before the order for relief concerning the debtor; or
- (ii) is deemed by this Act to have arisen at the time of or before the order for relief concerning the debtor;
- (i) “Creditors Committee” means the committee appointed by the Official Administrator under section 34;
- (j) “custodian” means, —
- (i) receiver or trustee of the property of the debtor appointed in a case or proceeding not initiated under this Act,
- (ii) authorised party under a general assignment for the benefit of the debtor’s creditors; or
- (iii) trustee, receiver or agent under applicable law or under a contract, appointed or authorized to take charge of property of the debtor for the purpose of enforcing a charge against such property or for the purpose of general administration of such property for the benefit of the debtor’s creditors;
- (k) “debtor” means a company specified under section 7 of this Act;
- (l) “debtor in possession” means a debtor against which a case has commenced under this Act but which has been allowed to continue in possession and control of the estate;
- (m) “entity” includes person, estate, trust, Government Agency and Official Administrator;
- (n) “estate” means the property stated under section 47;
- (o) “executory contract” means a contract pursuant to which the obligations of both parties are unperformed to the extent that the

failure of either party to complete performance will constitute a material breach of such contract;

- (p) “financial asset” includes any short, medium or long term interest and non-interest bearing loan, finance, advance, lease, installment, term finance certificate, participation term certificate, modaraba, musharaka, ijara, profit and loss sharing agreement, redeemable capital, guarantee or contractual right to receive payment of money in respect of sums advanced or committed to an obligor by a financial institution;
- (q) “Financial Institution” means financial institutions defined under clause (a) of section 2 of the Financial Institutions (Recovery of Finances) Ordinance, 2001;
- (r) “Government Agency” means the Federal and Provincial Governments or a Department, Agency or instrumentality of either the Federal or Provincial Government;
- (s) “insider” means such persons who by virtue of their association with the debtor have such material knowledge regarding the debtor which is not available to the general public and includes, –
 - (i) directors of the debtor;
 - (ii) senior salaried employees of the debtor occupying managerial positions;
 - (iii) any person who, directly, indirectly or through benamidars owns a majority of the voting security of the debtor;
 - (iv) relative of a director, officer or person in control of the debtor; and
 - (v) associated companies and associated undertakings of the debtor and their directors;
- (t) “insolvency clause” means a provision in a contract, lease or law that gives an option to effect a forfeiture, modification or termination of the debtor’s interest in property or is otherwise conditioned on or relates to, -
 - (i) the insolvency or financial condition of the debtor;
 - (ii) the commencement of a case under this Act;
 - (iii) the appointment of or taking possession by an administrator, in a case under this Act or a custodian before such commencement; or
 - (iv) the satisfaction of any penalty or provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under an executory contract or unexpired lease;

- (u) “insolvent” means financial condition where the entity’s debts are greater than all of such entity’s property, at a fair valuation, exclusive of property transferred, concealed or removed with intent to hinder, delay or defraud such entity’s creditors and a company shall also be deemed to be insolvent if, –
- (i) the debtor is not paying its debts as they become due, except to the extent such debts are the subject of a bona fide dispute; or
 - (ii) within one hundred and twenty days before the date of the filing of the petition, a custodian was appointed or took possession of substantially all property of the debtor for the purpose of enforcing a charge against such property:

Provided that in determining whether or not there is a bona fide dispute, the Court shall not take into account any claim or counterclaims that the debtor has filed or may file, against the holder of that claim and any such claim or counter-claims may be taken into consideration by the Court when examining a proposed plan of rehabilitation;

Illustrations:

- i. Bank A files a petition against Company B for failure to repay a loan. B disputes the claim on the basis that B suffered damages due to A’s failure to extend additional or other loans to B. There is no bona fide dispute with respect to A’s claim against B.
- ii. Bank A files a petition against Company B for failure to repay a loan. B disputes the claim only on the basis that Bank A has charged excessive mark-up. There is no bona fide dispute with respect to A’s claim to the extent that the principal amount of the loan remains unpaid as well as to the extent the Court determines that mark-up legitimately owed and charged has not been paid.
- iii. Bank A files a petition against Company B for failure to repay a loan. B disputes the claim on the basis that it has already repaid the entire amount due under the loan agreement. There is a bona fide dispute with respect to A’s claim against B.
- iv. Bank A files a petition against Company B for failure to repay a loan of Rs. 1,000,000. Company B claims that it has repaid Rs. 300,000. There is a bona fide dispute only with respect to the amount of Rs. 300,000.

- (v) “liquidation value” of a claim means the value likely to be received by a creditor if the debtor is wound up and in the case of a secured

creditor the liquidation value means the value likely to be received by a secured creditor for its claim through recovery proceedings;

- (w) “mediator” means a mediator appointed in accordance with section 18;
- (x) “non-performing asset” means a financial asset held on the books of a financial institution with respect to which the obligor has been in arrears for more than one year on any payment obligation and includes all security interests with respect to the collateral thereof;
- (y) “obligor” means any individual, proprietorship, partnership, trust, company or other entity that has, with respect to a financial asset, a contractual or legal obligation to make payment, effect performance, provide security or collateral, whether as principal, surety, guarantor or otherwise and whether such obligation is primary, secondary, matured or contingent;
- (y) “Official Administrator” means a natural person appointed to the office of the Official Administrator in accordance with section 9 and includes an acting Official Administrator;
- (z) “Ordinance” means the Companies Ordinance, 1984 (XLVII of 1984); (aa)

“order of relief” means an order of the Court that a debtor is insolvent;

- (bb) “person” includes an individual, partnership, firm and company but does not include a Government Agency;
- (cc) “plan” means a plan of rehabilitation filed in accordance with section 52;
- (dd) “prescribed” means prescribed by Rules or Regulations made under this Act;
- (ee) “relative” means husband, wife, ancestor, lineal descendant, brother or sister;
- (ff) “Regulations” means regulations made by the Commission under section 86;
- (gg) “Rules” means rules made under this Act in accordance with section 6 or section 88;
- (hh) “security” shall have the same meaning as assigned to the term security as under Section 2 (l) of the Securities and Exchange Ordinance, 1969 (XVII of 1969);
- (ii) “security interest” means a guarantee, charge, mortgage, lien, hypothecation, pledge, assignment or any other security interest in relation to collateral;
 - (ij) “transferor” means the financial institution which enters into the transfer and assignment agreement provided in clause (a), sub-section (1) of section 77;

(kk) “utility service” includes the following services, –

- (i) electricity;
- (ii) natural gas;
- (iii) water; or
- (iv) telephone and other communication services, such as internet access, mobile telephony, etc;

(ll) “vesting date” means the date of signing of the transfer and assignment agreement between a financial institution and a Corporate Restructuring Company as provided in clause (a), sub-section (1) of section 77.

(2) The words and expressions used but not defined in this Act shall have the same meaning as assigned in the Ordinance.

3. Act to override other laws, contracts, instruments, memorandum and articles. Save as otherwise expressly provided in this Act,-

- (a) the provisions of this Act shall have effect notwithstanding anything to the contrary contained in any other law, contract, instrument, memorandum or articles of a company or in any agreement executed by a company or in any resolution passed by the company in a general meeting or by its directors, whether the same is registered, executed or passed, before or after the commencement of this Act; and
- (b) any provision contained in any other law, contract, instrument, memorandum, articles, agreement or resolution aforesaid shall, to the extent to which it is inconsistent with the provisions of this Act, be ineffective.

4. Jurisdiction and Powers of High Court. (1) The Court having jurisdiction under this Act shall be the High Court having jurisdiction over the place at which the registered office of the debtor is situated or having jurisdiction over the principal place of business of the debtor.

(2) Subject to the provisions of this Act and except as provided otherwise by this Act or the Rules, the Court shall

- (a) in the exercise of its civil jurisdiction have all the powers vested in a Civil Court under the Code of Civil Procedure, 1908 (Act V of 1908); and

in the exercise of its criminal jurisdiction have all the powers vested in a court exercising jurisdiction under the Code of Criminal Procedure, 1898 (Act V of 1898).

(3) All proceedings before the Court shall be deemed to be judicial proceedings within the meaning of sections 193 and 228 of the Pakistan Penal Code (Act XLV of 1860).

(4) Subject to the provisions of this Act and of Rules made under section 6, a Judge of a Court exercising jurisdiction under this Act may exercise the whole or any part of his jurisdiction in chambers.

(5) The Chief Justice of a High Court may, from time to time, direct, in any matters in respect of which jurisdiction is given to the High Court by this Act, the Official Administrator for the said High Court shall have the following powers:-

- (a) to hold the public examination of the debtor and its officers;
- (b) subject to the Court's approval, hear and determine any application consented to by all parties; and
- (c) examine any person summoned by the Court:

Provided that the Official Administrator shall not have power to try for contempt of Court.

(6) The Court shall refer all plans to the Technical Assistance Committee for a report thereon and may refer any other matter it feels appropriate for an expert opinion.

(7) Notwithstanding anything contained in any other law, all matters coming before the Court under this Act shall be disposed of expeditiously and final judgment pronounced no later than ninety days from the date of the report of the Technical Assistance Committee on any plan(s) submitted in the case, except in extraordinary circumstances and on grounds to be recorded by the Court, in which instance the Court shall hear the case on day to day basis.

5. Appeal and review. (1) An appeal shall lie, at the instance of any person aggrieved by an order made by a Judge of the High Court in the exercise of the jurisdiction conferred by this Act, in the same way and subject to the same provisions as an appeal from an order made by a Judge in the exercise of the ordinary original jurisdiction of that Court.

(2) The Court may review, rescind or vary any order made by it under this Act.

6. High Court Rules.- The High Court may, in consultation with the Federal Government, by notification in the Official Gazette make Rules, concerning the

mode of proceedings for the rehabilitation of a company and generally for all applications to be made to the Court and all other proceedings or matters coming within the purview, powers or duties of the Courts under this Act.

7. Applicability of law.- (1) Subject to sub-section (2), a debtor shall be a company which commences or against which a case has commenced under this Act.

(2) A company shall not be a debtor under this Act if it is,-

- (a) a financial institution;
- (b) a company engaged in the business of insurance as defined in paragraph (xxvii) of section 2 of the Insurance Ordinance, 2000 ((XXXIX of 2000);
- (c) a company which has debts of less than Rupees fifty million or such other sum as the Federal Government may, by notification in the official Gazette, specify;
- (d) a company with respect to which a plan of rehabilitation has been confirmed under this Act and a period of ten years has not elapsed, unless the Court finds that it would be in the interest of justice for such company to be allowed to be a debtor under this Act;
- (e) a company against which a winding up order has already been passed;
- (f) a company which has resolved by special resolution that such company be wound up, voluntarily; or
- (g) a company that has availed relief under BPD Circular 29 of 2002 issued by the State Bank of Pakistan.

8. Limitation.- (1) Except as provided otherwise in this Act, the provisions of the Limitation Act, 1908, including sections 5 and 14 of the said Act, shall apply to this Act.

(2) Notwithstanding anything contained in the Limitation Act, 1908 (IX of 1908), in computing the time within which an administrator may file a suit under this Act for the recovery of any debt due to the debtor the period which elapses between the filing of a petition under this Act and the passing of an order for relief under this Act or a period of one year, whichever be greater, shall be excluded.

9. Office of the Official Administrator.- (1) The Federal Government shall in

consultation with the Chief Justice of the High Court, appoint a natural person to the office of Official Administrator for the said Court and may, in consultation with the Official Administrator, appoint a natural person or persons to the office of the Deputy or Assistant Official Administrator.

(2) The Official Administrator shall be a corporation sole by the name of the Official Administrator of the relevant High Court and shall have perpetual succession and an official seal and may sue and be sued in his corporate name and may do all such acts necessary or expedient to be done in the execution of his office.

(3) The terms and conditions upon which any person is appointed under sub-section (1) shall be prescribed by Rules and not altered to the person's detriment during their period of service.

(4) All appointments under sub-section (1) shall be for a period of five years and may be renewed upon the expiry of such period.

(5) Subject to the Rules, the Deputy Official Administrator shall have all the powers and discharge all the duties and in exercise of such powers and in the discharge of such duties shall be subject to all the liabilities of the Official Administrator under this Act.

(6) If any Official Administrator does not faithfully perform his duties and duly observe all the requirements imposed on him by any enactment, rules or otherwise, with respect to the performance of his duties or if any complaint is made to the Court by any creditors in regard thereto, the Court shall inquire into the matter and take such action thereon as may be deemed expedient.

(7) The Court may at any time require any Official Administrator to answer any inquiry made by it in relation to any proceedings in which he is engaged and may examine him or any other person on oath concerning the said proceedings.

(8) The Court may also direct an investigation to be made of the books and vouchers of the Official Administrator.

10. Technical Assistance Committee. (1) There shall be a Technical Assistance Committee comprising of 15 members, each member having a minimum experience of ten years and expertise in the field of accountancy, banking, economics, finance, insolvency, law or management.

(2) The members of the Technical Assistance Committee shall be appointed by the Chairman of the Commission and the Governor of the State Bank of Pakistan according to the fit and proper criteria prescribed through Regulations.

(3) The Technical Assistance Committee shall be headed by a Chairman appointed by the Chairman of the Commission and the Governor of the State Bank of Pakistan from amongst the members who shall be responsible for the administration of the affairs of the committee.

- (4) The members of the Technical Assistance Committee shall be entitled to such remuneration on a case to case basis and on such terms and conditions as may be determined by the Commission.
- (5) The Chairman of the Technical Assistance Committee shall be paid a fixed salary as determined by the Commission, in addition to any remuneration which he may receive as a member under subsection (4).
- (6) The members of the Technical Assistance Committee shall be appointed for a term of three years and not be removed except for physical or mental incapacity, insolvency or misconduct.
- (7) The Chairman of the Technical Assistance Committee shall cease to hold office as Chairman and member upon the completion of three years of his appointment as a member of the committee.
- (8) The Commission shall prescribe standards relating to conflict of interest to be observed by the Technical Assistance Committee and where necessary may co-opt additional members.
- (9) The Court shall refer all plans and may either on its own motion or on the request of an interested party refer any question to the Technical Assistance Committee for submitting report including, –
 - (a) whether for the purposes of section 36 the “adequate protection” being offered to the holder of a charge is in fact adequate;
 - (b) whether a proposed plan is “fair and equitable” for the purposes of section 57;
 - (c) what modifications are required to make a proposed plan “fair and equitable” for the purposes of section 57;
 - (d) determination of liability of secured creditors; or
 - (e) whether any particular claim or class of claims can be justified on the basis of generally accepted accounting principles.
- (10) Whenever a matter is referred to the Technical Assistance Committee, the Chairman of the committee will constitute a three member sub-committee to examine the matter.
- (11) The sub-committee of the Technical Assistance Committee shall file its report to the Court, –
 - (a) after giving a hearing in person to all interested parties or their representatives in accordance with the Regulations; and
 - (b) within thirty days of the referral of a plan or a question to it by the Court.
- (12) Any party aggrieved by a report of the sub-committee of the Technical Assistance Committee may file objections before the Court, against the report, within 15 days of the filing of the report.
- (13) The Technical Assistance Committee shall establish a fund for financing and funding the affairs of the Technical Assistance Committee.
- (14) The fund established under sub-section (13) of this section shall be financed from the following sources,-
 - (a) grants or other assistance from domestic and international donor agencies;
 - (b) fees charge from the parties at the time of filing of a plan in Court;
 - (c) grants from the Federal Government; and
 - (d) income and earnings on account of its operations and investments;
- (15) The fund established under sub-section (13) shall be expended for the purpose of paying any expenditure lawfully incurred by the Technical

Assistance Committee including all remuneration, pays and allowances, fees and costs, purchasing or hiring equipment, acquiring or leasing property, repaying any financial accommodation or money borrowed along with profit and return thereupon and generally all costs and expenses in relation to the performance of its functions or the exercise of its powers under this Act.

(16) The accounts of the Technical Assistance Committee shall be,-

- (a) maintained in such form and manner as the Commission may determine; and
- (b) audited by an auditor duly licensed by the Institute of Chartered Accountants of Pakistan.

(17) The Technical Assistance Committee shall, after the end of every financial year, submit to the Commission the audited annual statement of accounts of the Technical Assistance Committee.

WORLD BANK ANNOTATION

Description: Article 10 provides for the Chair of the SECP and the Governor of the State Bank of Pakistan (“SBP”) to jointly appoint the members of the Technical Assistance Committee (“TAC”). The Court would be required to seek the TAC’s advice on all key questions concerning the plan, including whether a secured creditor had “adequate protection”; whether a proposed plan or an amendment thereto was “fair and equitable”; which creditor classes were underwater; and it seems, even the overall acceptability of the plan.¹

Rationale: The rationale for a mechanism such as the TAC is understandable. The formulation and assessment of the rehabilitation plan requires possession of technical knowledge – most notably, that for the assessment of discounted cashflow projections – that the Court neither does nor should be expected to possess. This technical content is best derived from an independent expert source, on whose advice the Court and parties alike may rely.

Concern: The structure of the TAC and the mode of appointment of its members is open to misuse and risks being corrosive to the establishment of a proper rehabilitation system. This is for two main reasons:

Appointment: The TAC is based on what may be called a ‘closed list’ system, i.e. it will consist of a small, fixed number of members (currently 15) to be appointed by the SECP and SBP heads, each of whom is themselves a government appointee. There is considerable risk that appointments to this body – which the Bank team understands are intended to be prestigious, and on a case by case basis, well remunerated – would be, and be perceived to be, tainted by the politics of patronage and perks.

Operation, accountability, reputation: Relatedly, TAC members would be fully accountable neither to the parties in rehabilitation proceedings nor the Court. Parties to rehabilitation proceedings would have little control over who serves in their case; could not veto a member’s nomination; would have no control over their fees; and would not be able to effectively hold them accountable in Court. Correspondingly, TAC members would have no incentive to develop a credible reputation in the market so as to attract appointments in future rehabilitation proceedings. If anything, their incentive would be to please their two joint appointors and their appointors’ political masters. This bodes well neither for the actual nor the perceived integrity of the proposed system.

Recommendation: Consideration should be given to deleting the present Article 10, and for all or virtually all of the functions allocated pursuant to it to the Technical Assistance Committee to be entrusted instead to an ‘Insolvency Professional’ licensed pursuant to amended Chapter 5. Even as currently drafted, the CRA envisages that the Corporate Rehabilitation Board (“CRB”) would train, license and accredit professionals to perform various roles within the rehabilitation process. With relatively minor amendments, the CRA could provide for the CRB to licence Insolvency Professionals (“IPs”) on the lines of the various licensing bodies in medicine, engineering, architecture, auditing, law, etc. In any given rehabilitation proceeding, the parties could nominate and the Court could appoint a licensed IP to assist the Court through the non-legal technical

¹ “The Court *shall* refer all plans...” (CRA, Article 10(9), emphasis added).

aspects of the rehabilitation process. If the parties (debtor and creditors) failed to reach consensus on the identity of the IP, each could be entitled to nominate one IP, and the two nominees would together select a third member of the panel to serve in that case. Subject to appropriate guidance in subordinate legislation, the IPs' fees would have to be approved by the creditors (whose money would be at stake in the proceedings), or in the alternative, by the Court. This would mitigate the danger of unsuitable and unaccountable appointees distorting the insolvency process through the TAC, and would instead encourage IPs to invest in building a credible reputation for expertise and impartiality in order to attract nominations by parties to future proceedings.

See discussion at Paragraphs 13 to 16 of the World Bank's October 2010 Comments, at Appendix, below.

Chapter 2 – Case Administration

11. COMMENCEMENT OF A CASE.- (1) A case under this Act is deemed to have commenced the moment a petition seeking an order of relief is filed with the Court under this Act.

(2) A case under this Act may be either a voluntary case or an involuntary case. No petition seeking an order of relief shall be competently filed unless a copy of such petition has also been filed in advance with the office of the relevant Official Administrator.

(3) The Federal Government may by publication in the Official Gazette prescribe charges and fees for the filing of a petition under this Act which may be revised after previous publication of the proposed revision in the Official Gazette.

12. Voluntary Cases.- (1) A voluntary case is commenced when a debtor files a petition before the Court seeking an order of relief against itself.

(2) A company shall not file a petition seeking an order of relief against itself unless the decision to file such a petition has been approved in advance by a special resolution of such company declaring the company insolvent according to the provisions of this Act.

(3) Subject to section 14 and the requirements contained in sub-section (2), the filing of a petition seeking an order of relief shall be deemed by the Court to be conclusive proof that the debtor is insolvent and thereby entitled to relief in accordance with the provisions of this Act.

13. Involuntary Cases.- (1) An involuntary case may only be commenced against a debtor by one or more entities by filing a petition seeking an order of relief before the Court, so long as, –

(a) each entity is the holder of an unpaid claim against the debtor that is not, –

(i) contingent as to liability; or

(ii) the subject of a bona fide dispute; and

(b) the unpaid claim or claims of such entities aggregate Rupees fifty million or such higher sum as the Federal Government may, by notification in the official Gazette, specify.

(2) Upon the commencement of an involuntary case, the Court shall issue notice to the company in the manner provided by section 9(5) of the Financial Institutions (Recovery of Finances) Ordinance, 2001 to show cause as to why an order for relief should not be passed against it.

(3) The notice to be issued to the company against which the petition has been filed shall specify a date, not later than two weeks after the completion of service in accordance with sub-section (2) on the said company, on which date that company shall be heard if it wants to defend the petition.

(4) Any written reply filed by the company against which the petition has been filed shall only be considered by the Court if such reply has been,—

(a) filed with the Court at least two days prior to the date of hearing; and

(b) copies of the reply have been supplied simultaneously therewith to all entities which had filed the petition against that company.

(5) Except to the extent that the Court orders otherwise and until an order for relief has been passed in the case, a company against which a petition for an order of relief has been filed may continue to operate and may continue to use, acquire or dispose of property as if an involuntary case concerning it had not been commenced.

14. Dismissal of a case.- (1) Notwithstanding anything to the contrary under this Act the Court may on the application of an entity or on its own accord dismiss a case under this Act or may suspend all proceedings in a case under this Act at any time, if the Court determines that allowing proceedings to continue would amount to an abuse of the judicial process.

(2) If the Court dismisses a case under subsection (1), the entity filing that case shall be liable to pay the costs of the case incurred by all other interested parties and shall also be liable to pay a fine which may extend to ten million rupees or both.

15. Effect of dismissal.- (1) Unless the Court for cause orders otherwise, the dismissal of a case under section 14 does not bar the discharge, in a later case under this Act of debts that were dischargeable in the case dismissed nor does the dismissal of a case under this Act prejudice the debtor with regard to the filing of a subsequent petition under this Act.

(2) Unless the Court for cause orders otherwise and except as otherwise provided, the dismissal of a case does not affect the validity of any action taken during the pendency of a case.

(3) Unless the Court for cause orders otherwise, the dismissal of a case, —

- (a) reinstates,
 - (i) any proceeding or custodianship superseded under this Act;
 - (ii) any transfer avoided under this Act; and
 - (iii) any charge voided under this Act;
- (b) vacates any order or transfer ordered under this Act; and reverts the property of the estate in the entity in which such property was vested immediately before the commencement of the case under this Act.

16. Order of relief.- (1) In a voluntary case, the Court shall pass an order of relief on the first date of hearing.

(2) In an involuntary case, the Court may pass an order of relief only after notice and a hearing.

(3) After passing an order of relief, the Court shall, –

- (a) refer the case to mediation in accordance with the Regulations; and
- (b) issue notice of the order of relief to be given in accordance with section 17.

17. Notice of an order of relief.- (1) Notice of an order of relief shall be provided by the debtor in possession or the administrator, if one has been appointed, to all interested parties within three days of the order of relief, through:

- (a) registered post, acknowledgement due;
- (b) courier service; and
- (c) publication in one English language and one Urdu language daily newspaper of wide circulation in the country;

and service duly effected in any one of the aforesaid modes shall be deemed to be valid service for the purposes of this Act.

(2) If the debtor's business is such that persons in remote or rural areas are likely to be affected, the Court shall also order that notice of an order of relief be provided through such other methods as it deems necessary to provide effective notice to all interested parties.

(3) The notice of an order of relief shall, -

- (a) specify the date and the place where, the Official Administrator (or the administrator, if one has been appointed) shall hold a creditors meeting; and
 - (b) specify the name of the mediator appointed in the case and the date and place where the mediator shall hold his first meeting with the interested parties.
- (4) If the debtor in possession or the administrator, if one has been appointed, does not comply with the provisions of this section the Court may impose a fine not exceeding Rupees five hundred thousand.

18. Mediation.- (1) A mediator shall, –

- (a) meet the requirements prescribed through Regulations for administrators in accordance with this Act and the by-laws made under section 74;
 - (b) be paid for his services, in accordance with such rates as prescribed through Regulations, by the party which has initiated proceedings under this Act; and
 - (c) not be entitled to be appointed as an administrator or as a liquidator with respect to that debtor.
- (2) The mediator shall assist all interested parties in trying to reach consensus on a plan of rehabilitation which meets the requirements of this Act.
- (3) If within the time period allowed by the Court for filing of a plan the debtor and its creditors do not file a consensual plan, the mediator shall file a report within two weeks of the expiration of the time period allowed for filing of a plan before the Court in which he shall,-
- (a) summarise the relevant facts leading up to the commencement of the case and identify broadly the various claims against the debtor;
 - (b) summarise the features of the proposed plan(s) of rehabilitation; and
 - (c) list the basis on which the interested parties have refused to accept the proposed plan(s) of rehabilitation.

19. Power to require delivery of property.- Without prejudice to the obligation imposed under any other provision, the Court may at any time after passing an order of relief under this Act require any trustee, receiver, banker, agent, officer or employee or past officer or employee or auditor of the debtor to pay, deliver, convey, surrender or transfer forthwith or within such time as the Court directs,

to the administrator if one has been appointed, any money, property or books and papers including documents in his hands to which the debtor is prima facie entitled, which is not subject to any charge.

20. Conversion of a case.- (1) A case under this Act shall be converted by the Court into winding up if, –(an application to such effect is made by a debtor in possession and such decision to convert has been approved in advance by a special resolution of that company;

- (a) the Court finds that a petition under this Act by the debtor was filed fraudulently;
- (b) no plan is filed within the period under section 52;
- (c) no plan is confirmed by the Court; or
- (d) an order of revocation is passed under section 60.

(2) If after notice and a hearing, the Court determines that a petition has been fraudulently filed under this Act, the entity filing such petition, shall be liable for, –

- (a) the costs and fees reasonably incurred by all other parties with regard to such fraudulently filed petitions; and
- (b) a fine of not less than Rupees five hundred thousand or such other higher amount, as the Court may determine.

(3) The Court may convert a case under this Act into winding up proceedings by the Court for cause, including, –

- (a) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation;
- (b) unreasonable delay by the debtor that is prejudicial to creditors;
- (c) failure to propose a plan under this Act within any time fixed by the Court;
- (d) denial of confirmation of every proposed plan and denial of a request made for additional time for filing another plan or a modification of a plan;
- (e) revocation of an order of confirmation under section 60.

(4) The order of conversion shall also provide for the appointment of a liquidator and the Court shall for such purpose exercise necessary jurisdiction under the Ordinance.

(5) An administrator appointed in a case shall not be appointed as a liquidator in that case.

(6) An application for conversion under this section shall not be filed by any party except, –

- (a) the debtor;
- (b) the Creditors Committee;
- (c) the Official Administrator; or
- (d) the administrator appointed in the case.

21. Consequences of conversion.- (1) Notwithstanding the provisions of the Ordinance, an order of conversion under section 20 shall be deemed to be a winding up order by the Court under section 305 of the Ordinance and the winding up shall be deemed to have commenced on the date of commencement of the case under this Act.

(2) Except as provided in sub-section (3), all proceedings subsequent to an order of conversion under section 20 shall be carried out in accordance with the provisions of the Ordinance, including the filing of appeal against such order and other remedies provided therein.

(3) Following an order of conversion, a financial institution may initiate or continue with proceedings under the Financial Institutions (Recovery of Finances) Ordinance, 2001 without seeking permission from the Court under Section 316 of the Ordinance.

(4) An admission of liability by the debtor for the purposes of its plan or during the course of proceedings under this Act or determination of liability under the provisions of this Act shall, at the option of the creditors, be deemed to constitute an admission of liability of the debtor for the purposes of a recovery suit, if such a suit is proceeded with after an order of conversion.

(5) All administrative expenses incurred or accrued during proceedings under this Act shall, following the conversion of proceedings under this Act into winding up proceedings under the Ordinance by the Court, be paid in priority to all other debts including those provided in section 405 of the Ordinance.

22. Powers and duties of a debtor in possession.- (1) If no administrator has been appointed, except to the extent property of the estate is in the control of a receiver, the debtor in possession shall, –

- (a) continue in possession and control of the property of the estate and may use, sell or lease property of the estate in the same manner as before;
- (b) exercise all the rights and powers of an administrator including in relation to the operation of the debtor's business other than the right provided under section 48; and

(c) perform all the functions and duties of the administrator.

(2) The Court may upon the application of any interested party restrict the rights and duties of a debtor in possession, as it deems appropriate.(3) A debtor in possession shall not be entitled to any compensation under section 32.

23. Duties of debtors .- (1) If an administrator is appointed, the debtor shall, –

- (a) cooperate with the administrator to enable the administrator to perform the administrator’s duties under this Act;
- (b) surrender to the administrator all property of the estate and any recorded information including books, documents, records and papers relating to property of the estate; and
- (c) appear at any hearings at which its presence is required by either the administrator or a committee appointed under section 34.

(2) The duty of the debtor to co-operate with the administrator contained in subsection (1) of this section extends to all directors and employees of the debtor.

24. Appointment of administrator.- (1) In a voluntary case, the Court may after notice and hearing appoint an administrator at any time after an order of relief but before confirmation of a plan on request of an interested party or the Official Administrator, –

- (a) for cause including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management either before or after the commencement of the case or similar cause; or
- (b) if such appointment is in the interest of creditors, any shareholders and other interests of the estate.

(2) In an involuntary case, the Court shall appoint an administrator at the time of passing of the order of relief.

(3) No person shall be appointed by the Court as an administrator under this Act unless he has a minimum experience of 10 years in banking, law, accountancy or management and has been duly authorized to practice as an administrator by the Corporate Rehabilitation Board in accordance with the criteria specified by the Corporate Rehabilitation Board.

(4) The appointment of an administrator is automatically terminated by the confirmation of a plan of rehabilitation under section 56 or section 57 as well as by the conversion of a case under this Act into winding up proceedings.

(5) If an administrator dies or resigns during the pendency of a case or is removed, then a replacement administrator shall be appointed within three working days of receiving notice of such death or resignation.

(6) Notice of the appointment of an administrator in every case shall be given by the appointed administrator to the Commission within two working days of his appointment.

25. Removal and termination of administrator.- (1) The Court may at any time before confirmation of a plan, on request of an interested party or the Official Administrator and after notice and a hearing terminate the administrator's appointment and restore the debtor to possession and management of the property of the estate and of the operation of the debtor's business.

(2) The Court, after notice and a hearing, may remove an administrator other than the Official Administrator for cause and appoint another administrator.

(3) Whenever the Court removes an administrator under sub-section (2), such administrator shall also thereby stand automatically removed in all other cases under this Act in which such administrator is then serving unless the Court orders otherwise.

(4) A vacancy in the office of the administrator during a case does not abate any pending action or proceeding and the successor administrator shall be substituted as a party in such action or proceeding.

26. Power and duties of an administrator.- (1) An administrator shall, –

- (a) operate the debtor's business;
- (b) perform the duties of an administrator specified in this Act;
- (c) if the debtor has not done so, file the list, schedule and statement required under section 42;
- (d) except to the extent that the Court orders otherwise investigate the acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business and any matter relevant to the case or the formulation of a plan;
- (e) as soon as practicable, –
 - (i) file a statement of any investigation conducted under paragraph (d) including any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of the debtor or to a cause of action available to the estate; and

- (ii) transmit a copy or a summary of any such statement to any creditor's committee or shareholder's committee, mortgagee, receiver or charge holder and to such other entity as the Court designates;
- (f) either file a plan under this Act or recommend the winding up of the debtor under the Ordinance;
- (g) institute or defend any suit, action, prosecution or other legal proceeding, civil or criminal, in the name and on behalf of the debtor, to the extent necessary;
- (h) subject to Court approval, make any compromise or arrangement with creditors or persons claiming to be creditors or having or alleging themselves to have any claim, present or future, certain or contingent, ascertained or sounding only in damages against the debtor or whereby the debtor may be rendered liable;
- (i) be accountable for all property received in the manner specified;
- (j) examine proofs of claim and object to the allowance of any claim that is improper;
- (k) unless the Court orders otherwise, furnish such information concerning the estate and the estate's administration as is requested by an interested party;
- Ø make a final report and file a final account of the administration of the estate with the Court and with the Official Administrator;
- (m) have the power to, –
 - (i) do anything that is incidental to exercising a power set out in this section; and
 - (ii) do anything else that is necessary or convenient for the purpose of administering the affairs of the debtor; and
- (n) not be liable for any loss or damages caused by any act or omission undertaken in good faith.

27. Administrator's account. (1) Every administrator shall, at such times, as may be prescribed through Regulations during his tenure in office, present to the Court a comprehensive account of his receipts and payments and dealings as administrator together with such further information as may be prescribed through Regulations.

(2) The Court shall cause the account and the books and papers of the administrator to be audited in such manner as it thinks fit.

(3) The administrator shall cause a copy of the account when audited to be sent by post to the Commission as well as to every creditor.

28. Power to order payment into bank.- The Court may order any person from whom any money is due to the debtor to pay the same into the account of the administrator in a scheduled bank instead of to the administrator and any such order may be enforced in the same manner as if it had directed payment to the administrator.

29. Summary disposal of certain suits.- Notwithstanding anything contained in the Code of Civil Procedure, 1908 (Act V of 1908), an administrator desiring to recover any debt due to the debtor may apply to the Court in which the proceedings are pending that the same be determined summarily and the Court may determine it on affidavits but when the Court deems it just and expedient, either on an application made to it in this behalf or of its own motion, it may set down any issue or issues for hearing on other evidence also and pass such orders for discovery of particulars as it may do in a suit.

30. Information as to pending proceedings.- (1) After an order of relief is passed against a debtor the administrator shall, every month or at such periods as may be prescribed through Regulations, until proceedings are concluded, file in the Court a statement in the form prescribed through Regulations and containing the prescribed particulars.

(2) Any interested party shall be entitled, by himself or by his agent at all reasonable times, on payment of the fee prescribed through Regulations, to inspect the statement and to receive a copy thereof or extract therefrom.

(3) When the statement is filed in the Court, a copy shall simultaneously be filed by the administrator with the Commission and shall be kept by it along with the other records of the company.

31. Effect of appointment of administrator.- On the appointment of an administrator, -

- (a) all the powers of the directors, chief executive and other officers of the debtor shall cease, except as may be required under this Act and except so far as the Court may sanction the continuance thereof; and
- (b) all the powers of a receiver appointed prior to the commencement of a case shall cease in relation to the property of the estate.

32. Compensation of administrators.- After notice to the interested parties and the Official Administrator and a hearing, the Court may award to an administrator such fees and expenses as may be prescribed through Regulations.

33. Employment of professional persons.- (1) The administrator may employ
(2) In cases of emergency the administrator may appoint a person and submit the details of terms and conditions of such appointment along with due reasons thereof in the Court for approval.
(3) The Court may approve, modify or reject appointment under sub-section (2), if it is of the opinion that the terms and conditions of appointment exceed the reasonable value of the services.

34. Creditors' and shareholders' committees.- (1) The Official Administrator shall appoint a committee of creditors and may appoint an additional committee of shareholders if the Official Administrator deems appropriate.

(2) The committees shall have adequate representation of the different classes of creditors or shareholders of the debtor, as the case may be.

(3) The expenses of a committee appointed under this section shall be borne by the class represented by that committee.

(4) On request of an interested party, the Court may order the Official Administrator to appoint such additional members of a committee as the Court feels necessary to assure adequate representation of creditors or shareholders.

35. Powers and duties of committees.- (1) A committee appointed under section 34 may, –

- (a) consult the administrator or debtor in possession concerning the administration of the case;
- (b) review the acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business and any other matter relevant to the case or to the formation of a plan;
- (c) participate in the formulation of a plan, advise those represented by the committee of the committee's determination as to any plan formulated and collect and file with the Court acceptances or rejections of a plan; and
- (d) request the appointment of an administrator.

(2) As soon as practicable after the appointment of a committee under this Act, the administrator or debtor in possession shall meet with such committee to transact such business as may be necessary and proper.

(3) The powers of a committee appointed under section 34 terminate upon the confirmation of a plan or upon the conversion of a case into winding-up under the Ordinance.

36. Adequate protection.- When adequate protection is required under any section of this Act of an interest of an entity in property, the Court may order such adequate protection to be provided by, –

- (a) requiring the administrator to make a cash payment or periodic cash payments to such entity, to the extent that,
 - (i) the automatic stay under section 37;
 - (ii) the use, sale or lease under section 39; or
 - (iii) any grant of a charge under section 40;results in a decrease in the value of such entity's interest in such property;
- (b) requiring the administrator to provide such entity an additional or replacement charge to the extent that such stay, use, sale, lease or grant results in a decrease in the value of such entity's interest in such property; or
- (c) granting such other relief other than entitling such entity to compensation allowable under section 44 as an administrative expense, as will result in the realization by such entity of the equivalent of such entity's interest in such property.

37. Automatic Stay.- (1) The order of relief operates as a stay, applicable to all entities against,-

- (a) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this Act or to recover a claim against the debtor that arose before the commencement of the case under this Act;
- (b) the enforcement or execution of a judgment obtained before the commencement of the case under this Act against the debtor or against property of the estate;
- (c) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
- (d) any act to create, perfect or enforce any charge against property of the estate;

- (e) any act to create, perfect or enforce any charge against property of the debtor to the extent that such charge secures a claim that arose before the commencement of the case under this Act;
- (f) any act to collect, assess or recover a claim against the debtor that arose before the commencement of the case under this Act;
- (g) the setoff of any debt owing to the debtor that arose before the commencement of the case under this Act against any claim against the debtor;
- (h) except as provided by this Act, the commencement or continuation of any proceeding seeking the winding up of the debtor under the Ordinance;
- (i) revocation, suspension, cancellation or refusal to renew, a license, permit, charter, franchise or other similar grant in favor of a debtor intended to be made on or after the commencement of the case by the debtor; and
- (j) alteration, refusal or discontinuance of a utility service to the debtor except if the debtor fails to make payment for the utility service provided after the commencement of a case under this Act.

(2) For the purposes of this section,-

- (a) any action against any person who has guaranteed any liability of the debtor shall be deemed to be an action against the debtor, to the extent that such action relates to a claim against the debtor; and
- (b) any action against any person arising out of any liability originally incurred by the debtor shall be deemed to be an action against the debtor.

WORLD BANK ANNOTATION

Description: Pursuant to Article 37(2), the imposition of the ‘automatic stay’ upon the initiation of CRA proceedings would also suspend enforcement action against the guarantors of the company’s liabilities.

Rationale: This is a highly unusual provision, since the stay in insolvency proceedings is generally intended to protect the going concern of the debtor company, not the financial position of owners or other third-party guarantors.

The acquisition of personal guarantees from a company’s owners/managers to secure corporate borrowing serves to reduce financial agency costs, and is thus an absolutely standard part of the armoury of prudent bank lending in every corner of the world. Secondly, such guarantees are doubly important in jurisdictions where corporate financial reporting practices are underdeveloped or otherwise unreliable, and where it is difficult to enforce the legal boundaries between corporate revenues and the personal assets of the company’s owners/managers. The Bank team understands that financial lenders in Pakistan consider practices in the country to fall into both these categories (unreliable

corporate reporting; weak checks against misappropriation of corporate assets). And thirdly, it is important in order to minimise moral hazard for those who have undertaken personal guarantees to be required to stand by them when duly called upon to do so.

Concern: In a restructuring system in which the consent of at least some affected creditors was necessarily required (cf. discussion of Article 57(1), below), extension of the ambit of the stay provided by Article 37(2) would be regarded as objectionable because it would make the proposed plan less likely to attract creditor consent. Correspondingly, it would weaken the incentives of the debtor's managers/owners to cooperate in the timely completion of the rehabilitation process.

Recommendation: Consideration should be given to deleting Article 37(2), since it is on balance not justified by the rationale of corporate rehabilitation.

See discussion at Paragraphs 17 to 19 of the World Bank's October 2010 Comments, at Appendix, below.

(3) The stay of any act under subsection (1) shall expire upon, –

- (a) the confirmation of a plan;
- (b) the dismissal of the case; or
- (c) the conversion of the case into winding up proceedings under the Ordinance.

38. Relief from automatic stay.- (1) On the request of an interested party and after notice and a hearing the Court shall grant relief from the stay provided under subsection (1) of section 37, such as by vacating, discharging or modifying such stay, –

- (a) for cause, including the lack of adequate protection of an interest in property of such property in interest; or
- (b) with respect to a stay of an act against property under subsection (1) of section 37, if –
 - (i) the debtor does not have any equity in such property;
and
 - (ii) such property is not necessary to an effective re-organization;

(2) Upon request of an interested party, the Court, with or without a hearing, shall grant such relief from the stay provided under subsection (1) of section 37 as is necessary to prevent irreparable harm or loss to the interest of an entity in property, if such interest will suffer such harm before there is an opportunity for notice and a hearing.

(3) In any hearing concerning relief from the stay of any act under subsection (1) of section 37,—

- (a) the party requesting such relief has the burden of proof on the issue of the debtor's equity in property; and
- (b) the party opposing such relief has the burden of proof on all other issues.

(4) On the request of an interested party and after notice and a hearing the Court shall grant relief from the stay provided under subsection (1) of section 37, such as by vacating, discharging or modifying such stay if a period of more than 180 days has expired since receipt by the Court of the report of the Technical Advisory Committee on the plan(s) submitted to it.

39. Use, sale or lease of property.- (1) Unless the Court orders otherwise, the administrator may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing and may use property of the estate in the ordinary course of business without notice and a hearing.

(2) The administrator may use, sell or lease property of the estate in a manner other than in the ordinary course of business only after notice and a hearing.

(3) The administrator may use, sell or lease property under subsections (1) or (2) only to the extent not inconsistent with any relief granted under section 37.

(4) Under subsections (1) and (2), the administrator may sell property of the estate free and clear of any interest in such property of an entity other than the estate, only if;

- (a) applicable law other than this Act permits the sale of such property free and clear of such interest;
- (b) such entity consents;
- (c) such interest is a charge and the price at which such property is to be sold is greater than the aggregate value of all charges on such property;
- (d) such interest is not in bona fide dispute; or
- (e) any charge that a secured creditor had with respect to the sold property is transferred to the proceeds of the sale, up to the extent of the value of such creditors allowed claim.

(5) At a sale under subsection (1) of property that is subject to a charge that secures an allowed claim, unless the Court for cause orders otherwise, the holder of such claim may bid at such sale and if the holder of such claim purchases

such property, such holder may offset such claim against the purchase price of such property.

(6) Notwithstanding any insolvency clause to the contrary but subject to the provisions of this Act, the administrator may use, sell or lease property under subsections (1) or (2) or a plan under this Act may provide for the use, sale or lease of property.

(7) The reversal or modification on appeal of an authorization under subsections (1) or (2) of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

(8) In any hearing under this section, –

- (a) the administrator has the burden of proof on the issue of adequate protection; and
- (b) the entity asserting an interest in property has the burden of proof on the issue of the validity, priority or extent of such interest.

40. Obtaining credit.- (1) Unless the Court orders otherwise, the administrator may to the extent allowed by applicable law obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable as an administrative expense.

(2) The Court, after notice and a hearing, may authorise the administrator on such terms and conditions as it deems appropriate to obtain unsecured credit to the extent allowed by applicable law other than in the ordinary course of business and allow such credit as an administrative expense.

(3) If the administrator is not able to obtain unsecured credit under subsections (1) and (2) above, the Court may on such terms and conditions as it deems appropriate, after notice and a hearing, authorise the obtaining of credit or the incurring of debt, –

- (a) with priority over all administrative expenses;
- (b) secured by a charge on property of the estate that is not otherwise subject to a charge; or
- (c) secured by a subordinate charge on property of the estate that is subject to a charge.

(4) The Court, after notice and a hearing, may authorise on such terms and conditions as it deems appropriate, the obtaining of credit or the incurring of debt

secured by a superior or equal charge on property of the estate that is subject to a charge, only if, –

- (a) the administrator is unable to obtain credit otherwise; and
- (b) there is adequate protection of the interest of the holder of the charge on the property of the estate on which such superior or equal charge is proposed to be granted.

(5) In any hearing under sub-section (4), the administrator has the burden of proof with respect to the issue of whether any protection being given to the holder of the charge on the property of the estate on which a superior or equal charge is proposed to be granted is actually “adequate protection” as provided by section 36.

(6) The reversal or modification on appeal of an authorisation under this section to obtain credit or incur debt or of a grant under this section of a priority or a charge does not affect the validity of any debt so incurred or any priority or charge so granted to an entity that extend such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorisation and such sale or lease were stayed pending appeal.

41. Assumption and rejection of executory contracts and unexpired leases.- (1)

Subject to the restrictions contained in this Act, the administrator, subject to the Court’s approval, may assume or reject any executory contract or unexpired lease of the debtor, including,-

- (a) any executory contract relating to the employment or services of any person; and
- (b) any unexpired lease of immovable property.

(2) The administrator shall timely perform all the obligations of the debtor arising from and after the order for relief under any unexpired lease until such lease is assumed or rejected.

(3) The administrator may not reject any executory contract or unexpired lease without giving notice of his intent to reject to all parties to such executory contracts or unexpired leases.

(4) Any party which is prejudiced by the debtor’s rejection of an executory contract or unexpired lease may file a claim for damages provided that such claim shall be deemed to be a breach of such contract or lease occurring immediately prior to the date of the filing of the petition.

(5) Where the debtor assumes any executory contract or unexpired lease, any damages arising out of any default by the debtor prior to the order of relief shall be payable as a debt occurring immediately prior to the date of the filing of the petition.

(6) After the commencement of the case, an executory contract or unexpired lease of the debtor may not be terminated or modified at any time by the parties other than the debtor solely because of an Insolvency Clause.

Chapter 3 – Creditors, Debtor and the Estate

42. Statement of Affairs.- (1) In every case there shall be made out and submitted to the Court and the Official Administrator a statement as to the affairs of the debtor in the form prescribed through Regulations, verified by an affidavit and containing the following particulars, namely,-

- (a) the assets of the debtor stating separately the cash balance in hand and at the bank, if any, and the negotiable securities, if any, held by the company;
- (b) the debts and liabilities (both direct and contingent) of the debtor;
- (c) the names, residences and occupations of the creditors of the debtor, stating separately the amount of secured debts and unsecured debts and in the case of secured debts, particulars of the securities given, their value and the dates when they were given;
- (d) the debts due to the debtor and the names, residences and occupations of the persons from whom they are due and the amount likely to be realised therefrom;
- (e) where any property of the debtor is not in its custody or possession, the place where and the person in whose custody or possession such property is;
- (f) full address of the places where the business of the debtor was conducted during six months preceding the relevant date and the names and particulars of the persons in charge of the same;
- (g) details of any pending suits or proceedings in which the debtor is a party;
- (h) latest publically disclosed accounts and the last audited accounts;
- and (i) such other particulars as may be prescribed through Regulations or as
the Court may require in writing.

(2) The statement of affairs shall be submitted within twenty-one days from the date of the order of relief.

(3) Notice of the statement of affairs shall be published in one English language and one Urdu language daily newspaper of wide national circulation and copies of the statement of affairs shall be given to all parties in interest within 3 days of the filing of the statement of affairs through;

- (a) Registered post, acknowledgement due; and
- (b) Courier service;

and service duly effected in any one of the aforesaid modes shall be deemed to be valid service for the purposes of this Act provided that the Court may specify any other mode for the service of the notice of the statement of affairs.

(4) The responsibility to file and provide copies of the statement of affairs and issue notice thereof shall be that of the debtor in possession or of the administrator, if an administrator has been appointed.

(5) If the statement of affairs is not timely filed, the Court shall, –

- (a) appoint an administrator if the responsibility to file the statement of affairs was of the debtor in possession; or
- (b) remove the administrator and appoint a replacement administrator, if the responsibility to file the statement of affairs was of the administrator.

(6) An administrator removed by the Court under this section shall not be entitled to any compensation for any work done by him.

(7) Any administrator appointed under sub-section (5) shall file the statement of affairs within 21 days of his appointment.

(8) Whoever intentionally files a statement of affairs which is false in material respects or falsely denies his signature on any document before the Court, shall be guilty of an offence punishable with imprisonment of either description for a term which may extend to three years, or with fine, or with both.

(9) Where the person accused of an offence under this Act is a company, the chief executive by whatever name called, as well as any director or officer involved, shall be deemed to be guilty of the offence and shall be liable to be prosecuted and punished accordingly.

43. Claims and interests.- (1) Within 21 days of the publication of the notice of the statement of affairs a proof of claim or interest shall be filed with the Official Administrator by the creditor, shareholder or interested party, as the case may be.

(2) Any claim or interest listed in the statement of affairs shall be deemed to have been timely filed with the Official Administrator except for a claim or interest that is classified therein as disputed, contingent or unliquidated.

(3) A creditor who does not timely file a claim will be deemed to have no claim against the estate unless the delay in filing the claim is condoned, after notice and a hearing, by the Court for substantial cause shown.

(4) A claim or interest, proof of which is timely filed, is deemed allowed unless an interested party objects within 14 days of the last day provided for filing of claims.

(5) If any objection to a claim is made, the Official Administrator, after notice and a hearing, shall determine the amount of such claim to be allowed.

(6) Any party aggrieved by a determination of the Official Administrator may file an appeal before the Court which shall determine the amount of the claim or interest.

44. Allowance of claims for administrative expenses.- (1) After notice and a hearing, there shall be allowed administrative expenses, from time to time, including,—

- (a) the actual, necessary costs and expenses of preserving the estate, including,
 - (i) any credit facility obtained by the debtor under section 40;
 - (ii) wages, salaries or commissions for services rendered after the commencement of the case;
 - (iii) payment for agricultural produce supplied to the debtor as raw material for the debtor's business; and
 - (iv) payment for goods supplied to the debtor in the ordinary course of the debtor's business;

provided that no claim may be allowed as an administrative expense if such claim relates to goods or agricultural produce supplied to the debtor more than six months prior to the commencement of the case; and

- (b) compensation and reimbursement awarded under section 32.

45. Priorities.- (1) Administrative expenses allowed under section 44 shall have priority over all other expenses and claims.

(2) If the administrator, under any provision of this Act, provides adequate protection of the interest of a creditor secured by a charge on property of the debtor and if, notwithstanding such protection, such creditor has a claim arising from the stay of action against such property under section 37, from the use, sale or lease of such property under section 39 or from the granting of a charge

under section 40, then such creditors claim under such subsection shall have priority over every other claim allowable under subsection (1).

46. Claims of Government Agency's.- All revenues, taxes, cesses, rates and amounts due from the debtor to a Government Agency or a utility service provider on the date the petition was filed shall be accorded the same priority as unsecured claims.

47. Property of the Estate.- (1) The estate shall include the following,-

- (a) all legal, equitable rights or interests of the debtor in any property upto the commencement of the case;
- (b) any interest in property that the administrator recovers for the benefit of the estate under this Act;
- (c) any interest in property ordered to be transferred to the estate under this Act;
- (d) proceeds, product, produce, offspring, rents or profits of or from property of the estate; and
- (e) any interest in property that the estate acquires after the commencement of the case.

(2) An interest of the debtor in property becomes property of the estate under this Act, notwithstanding any insolvency clause to the contrary or any provision in an agreement, transfer instrument or law that restricts or conditions transfer of such interest by the debtor.

48. Turnover of property to the estate to the Administrator.- (1) A custodian or an entity in possession, custody or control of a property that the administrator may use, sell or lease under this Act shall deliver such property to the administrator or account for the value of such property.

(2) An entity that owes a debt that is property of the estate and that is matured, payable on demand or payable on order shall pay such debt to or on the order of the administrator, except to the extent that such debt may be offset under this Act against a claim against the debtor as provided by section 50.

(3) After notice and hearing, the Court may excuse compliance with any provision of this section if the interests of creditors would be better served by

permitting a custodian to continue in possession, custody or control of such property.

49. Avoidance of transfers.- (1) Except as provided under sub-section (2), an administrator may avoid a transfer of an interest of the debtor in property in favour of a creditor where such transfer, –

- (a) is made on account of an antecedent debt owed by the debtor before such transfer;
- (b) is within,-
 - (i) 6 months before the date of the filing of the petition under this Act; or
 - (ii) if the creditor is an insider, on or within one year before the date of the filing of the petition under this Act; and
- (c) enables such creditor to receive more than what such creditor would have received otherwise.

(2) The administrator shall not avoid a transfer where such transfer is, –

- (a) intended by the debtor and the creditor to be a contemporaneous exchange for new value given to the debtor and is a substantially contemporaneous exchange;
- (b) made in payment of a debt incurred by the debtor in the ordinary course of business and according to ordinary business terms; or
- (c) for the benefit of a creditor to the extent that such creditor gives new value to or for the benefit of the debtor subsequent to the transfer.

(3) To the extent that a transfer is avoided under this section the Court may allow the administrator to recover for the benefit of the estate the property transferred or the value of such property from the initial transferee or subsequent transferee.

(4) For the purposes of this section, “new value” means money worth in goods, services or new credit or released by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the administrator under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation.

50. Setoff.- Except as otherwise provided in this section and in sections 37 and 39, nothing in this Act shall affect any right of a creditor to offset a debt owed by such creditor to the debtor which arose before the commencement of the case under this Act against a claim of such creditor against the debtor that also arose before the commencement of the case except to the extent that, –

- (a) the claim of such creditor against the debtor is disallowed;
- (b) such claim was transferred, by an entity other than the debtor, to such creditor, –
 - (i) after the commencement of the case; or
 - (ii) within 6 months before the commencement of the case, and
- (c) the debt owed to the debtor by such creditor was incurred by such creditor,
 - (i) within 6 months of the date of the filing of the petition; and
 - (ii) for the purpose of obtaining a right of setoff against the debtor.

51. Abandonment of property of the estate.- (1) After notice and a hearing the administrator may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.

(2) On request of an interested party and after notice and a hearing, the Court may order the administrator to abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.

Chapter 4 – Submission and Confirmation of a Plan

52. Who may file a plan and timing.- (1) In a voluntary case, the debtor shall file a plan with the petition and may freely amend such plan within one hundred and twenty days of the order of relief or an extension thereof granted under subsection (4).

(2) In an involuntary case, the administrator shall file a plan within one hundred and twenty days of the order of relief.

(3) Any interested party including the debtor, administrator, creditors committee, shareholder's committee, a creditor, a shareholder, any mortgagee or receiver may file a plan within one hundred and twenty days of the order of relief.

The period of one hundred and twenty days for filing a plan may be extended by the Court, for good cause shown, for an additional period of sixty days on an application made by the debtor or party in interest.

(4) No plan shall be valid for the purposes of this Act unless filed within a period of one hundred and twenty days from the order of relief or extension thereof under sub-section (4).

(5) All plans filed in the Court shall be accompanied by evidence of payment of fee prescribed through Regulations and such fee shall be paid in the account of the Technical Assistance Committee.

53. Contents of plan.- (1) Notwithstanding any provision of any law, a plan shall, –

- (a) designate, –
 - (i) classes of claims other than claims entitled to priority under section 45; and
 - (ii) classes of interests;
- (b) specify any class of claims or interests that is not impaired under the plan;
- (c) specify the treatment of any class of claims or interests that is impaired under the plan;
- (d) provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favourable treatment of such particular claim or interest;
- (e) provide adequate means for the plan's implementation; and
- (f) specify the consequences of default under the plan.

(2) Subject to subsection (1) a plan may, –

- (a) impair or leave unimpaired any class of claims, secured, unsecured or of interest;
- (b) provide for the assumption, rejection or assignment of any executory contract or unexpired lease of the debtor not previously rejected under such section;
- (c) provide for, –

- (i) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or
 - (ii) the retention and enforcement by the debtor, administrator or a representative of the estate appointed for such purpose, of any such claim or interest;
- (d) provide for the sale of all or substantially all of the property of the estate and the distribution of the proceeds of such sale among holders of claims or interests;
 - (e) modify the rights of holders of secured claims or leave unaffected the rights of holders of any class of claims; and
 - (f) include any other appropriate provisions not inconsistent with the applicable provisions of this Act.

54. Impairment of claims or interest.- (1) Except as provided in paragraph (d) of sub-section (1) of section 53, a class of claims or interests is impaired under a plan unless with respect to each claim or interest of such class the plan, –

- (a) leaves unaltered the legal, equitable and contractual rights to which such claim or interest entitles the holder of such claim or interest; or
- (b) notwithstanding any contractual provision or law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence,–
 - (i) cures any such default that occurred before or after the commencement of the case under this Act, other than a default arising out of an insolvency clause;
 - (ii) reinstates the maturity of such claim or interest as such maturity existed before such default; and
 - (iii) does not otherwise alter the legal, equitable or contractual rights to which such claim or interest entitles the holder of such claim or interest.

55. Acceptance of Plan.- (1) An acceptance or rejection of a plan may not be solicited from a holder of a claim or interest unless such holder is first provided with a copy of the plan.

(2) A class of claims shall be deemed to have accepted a plan if such plan is accepted by creditors holding at least two-thirds in value of the allowed claims of such class.

(4) A class of interests shall be deemed to have accepted a plan if such plan is accepted by holders of such interests holding at least two-thirds in value of the allowed interests of such class.

(5) class that is not impaired under a plan and each holder of a claim or interest of such class are conclusively presumed to have accepted the plan and solicitation of acceptances with respect to such class from the holders of claims or interests of such class is not required.

(6) Any holder of a claim or interest that has accepted or rejected a plan is deemed to have accepted or rejected, as the case may be, such plan as modified, unless, within the time fixed by the Court such holder changes such holder's previous acceptance or rejection.

56. Confirmation of a plan.- (1) After notice the Court shall hold a hearing regarding the confirmation of a plan.

(2) The Court shall confirm a plan if the plan is in accordance with the provisions of this Act and,-

- (a) with respect to each class of claims or interests, –
 - (i) such class has accepted the plan; or
 - (ii) such class is not impaired under the plan;
- (b) except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that with respect to claims for administrative expenses specified in section 44, on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim;
- (c) all fees payable under any law as determined by the Court at the hearing on confirmation of the plan have been paid or the plan provides for the payment of all such fees on the effective date of the plan.

(3) The Court may confirm only one plan and if the requirements of this Act are met with respect to more than one plan, the Court shall consider the preferences of creditors and shareholders in determining which plan to confirm.

(4) Notwithstanding any provision of this Act, on the request of a Government Agency which is an interested party the Court may refuse to confirm a plan if the principal purpose of the plan is the avoidance of taxes.

57. Forcible Confirmation.- (1) If all the applicable requirements of section 56

other than sub-section (2) of section 56 are met with respect to a plan the Court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if,-

- (a) the plan does not discriminate unfairly; and
- (b) is fair and equitable with respect to each class of claims or interests.

(2) For the purpose of this section “fair and equitable” includes the following requirements,-

(a) With respect to a class of secured creditors, the plan provides,-

(i) that,-

- (I) the holders of such claims retain the charges securing such claims, whether the property subject to such charges is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims;
- (II) each holder of a claim of such class receives on account of such claim deferred cash payments totalling at least the allowed amount of such claim; and
- (III) the net present value of such deferred cash payments calculated on the basis of such rate as may be notified from time to time by the State Bank of Pakistan, which on the effective date of the plan is at least the value of such holder’s interest in the estate’s interest in such property;

(ii) for the sale, subject to sub-section (5) of section 39, of any property that is subject to the charges securing such claims, free and clear of such charges, with such charges to attach to the proceeds of such sale, and the treatment of such charges on proceeds under sub-clause (a) of sub-section (1); and

(iii) for the realisation by such holders of the indubitable equivalent of such claims;

(b) With respect to a class of unsecured claims, -

- (i) the plan provides that each holder of a claim of such class receives or retain on account such claim property of a value, as of the effective date of the plan, equal to the allowed amount of each claim; or

(ii) the holder of any claim or interest that is subordinate to the claims of such class will not receive or retain under the plan on account of such subordinate claim or interest any property;

© With respect to a class of interest, –

(i) the plan provides either;

(I) that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled or the value of such interest; or

(II) or the holder of any interest that is subordinate to the interests of such class will not receive or retain under the plan on account of such subordinate interest any property; or

(ii) if no class of interest is subordinate to a particular class of interest, then that the plan provides that no superior class shall receive more than 100% of its allowed claims.

WORLD BANK ANNOTATION

Description: Borrowing from Chapter 11 of the US Bankruptcy Code, Article 56 creates an exquisite and extensive framework for dividing the creditors into classes, and for ascertaining their views about any or all proposed rehabilitation plans. Pursuant to Article 57(1), however, the Court could “forcibly confirm” a plan at the TAC’s advice² even if all creditors had rejected it.³ While an aggrieved party could object before the Court,⁴ the Court would be able to decide against it – indeed, would possess jurisdiction to accept the entire plan – without any reference to the market value of the debtor’s assets.⁵

Rationale: Article 57(1) as currently drafted constitutes the central and fundamental problem with the CRA. It poses serious risk to the likely efficacy of the proposed rehabilitation framework, and it is crucial to understand why. To simplify, four important considerations are at play:

Who decides whether the business is viable? Voting on proposed rehabilitation plans in relation to a distressed business is an inherently difficult process. The fundamental issue for decision is whether the business, even though distressed, nevertheless remains viable. Empirical evidence and experience in other jurisdictions suggest that most distressed enterprises are not viable. Such non-viable distressed businesses ought to be

² CRA, Article 10(9).

³ CRA, Article 57. By way of contrast and as an indication of international best practice, see *Guide*, Chapter IV, Recommendation 150; and *Principles*, Principle C.14.3.

⁴ CRA, Article 10(12).

⁵ CRA, Article 57, for example, paragraph 2(a).

liquidated quickly and cost-effectively so that their constitutive assets would be put to more socially valuable uses. A minority of distressed businesses may indeed be viable. A crucial task for a rehabilitation framework, then, is to identify this minority of cases. Creditors can be expected to have developed considerable knowledge of the debtor business by virtue of having lent money to, and then attempting to recover it from, it; or by having supplied it with goods and services. They would thereby be in a better position, compared with any other party outside the debtor business, to determine the causes of the distress, to ascertain whether it resulted from managerial incompetence or other factors, and to judge whether the business is still viable.

How best to identify and remedy the causes of distress? If a distressed business is duly identified as capable of being rescued, the rehabilitation plan should be structured so as to maximise the likelihood of the rehabilitation of the business. This means it should identify and remedy the underlying causes of the distress. Better than any other party outside the business, creditors are able to and ought to be enabled to use their knowledge of the causes of the debtor's distress to assess whether the proposed plan would be likely to give the business the best chance of being rehabilitated, and since their own money is at stake, they have a strong incentive to get this decision right. No other party can be expected to be in a better position to make such decisions, and no other party has the same incentives.

Is modification of creditor rights legitimate? Any rehabilitation plan would modify the legal rights of the creditors of the business. In virtually all plans, they would be required to delay, reduce, or even to write off their claims in whole or part. That it is some majority of creditors themselves who may vote to confirm a plan requiring the modification of creditor rights is evidently the best guarantee that any such modifications would be legitimate.

Would rehabilitation create moral hazard? By the same token, the rehabilitation process allows the debtor company to walk away from some of its legal obligations. This intensifies financial agency costs and creates moral hazard. The owners and managers of the debtor company may be tempted *ex ante* to invest in excessively risky projects, in effect gambling the value received by the business from its creditors in the expectation that they would capture any increased returns (the lenders are restricted to their principal and interest), but that any losses would also be shared by the creditors. A rehabilitation process increases the probability that even if such excessively risky strategies resulted in disaster, at least some part of the business would continue to be owned and run by at least some of its pre-distressed owners/managers, which in turn intensifies this socially harmful incentive. Since it is the creditors' money at stake in the decision whether, and if so, how to attempt a rehabilitation of the distressed debtor, they have an incentive to assent to the rehabilitation only if they believe the business became distressed because of factors unrelated to managerial incompetence or excessive risk-taking. Owners and managers would anticipate that, in their business's distress, creditors would either vote to liquidate rather than rehabilitate; or else, approve a rehabilitation plan only on the condition that incompetent managers would be replaced and excessively risk-preferring owners deprived of equity stakes. This controls moral hazard.

It is in consideration of these and other factors that international best practice has converged on vesting important decision-making powers in the rehabilitation process –

including, in particular, whether to approve a rehabilitation plan – in a majority or super-majority of creditors.⁶

Concern: Against this background, the present wording of Article 57(1) of the draft CRA creates the most serious risk to the efficacy of the proposed legislation. Neither the Court nor the TAC can be expected to possess requisite knowledge of the distressed business, its managers, or its industry to enable them to ascertain whether the debtor is viable and ought to be rehabilitated, or upon the causes of its distress. Neither the Court nor the TAC legitimately stand to gain from getting the reorganise/liquidate decision right or lose from getting it wrong. And neither the Court nor the TAC would be best placed to ensure that the rehabilitation plan would be best designed to address and remedy the causes of distress. The overall result of the law would be an insolvency system based on centralized decisions, isolated from market forces, and possibly influenced by non-economic factors. By the same token, the operation of this element of the CRA could result in a substantial transfer of wealth from creditors – notably, financial institutions – to large corporate debtors, and even more so, to their controlling shareholders. This would weaken – and in extreme cases, cast doubt on the viability of – the lender institutions themselves.

Recommendation: Consideration should be given for an additional clause to be added to Article 57(1) prohibiting the Court from confirming any plan that has not attracted the support of an appropriate majority by value of the distressed company's creditors. Unless this were done, it is difficult to envisage that the CRA framework would be either efficacious or credible, and difficult to escape the conclusion that it would do more harm than good.

See discussion at Paragraphs 8 to 12 of the World Bank's October 2010 Comments, at Appendix, below.

58. Effect of confirmation by the Court.- (1) The provisions of a plan confirmed by the Court bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan and any creditor or shareholder in the debtor, whether or not the claim or interest of such creditor or shareholder is impaired under the plan and whether or not such creditor or shareholder has accepted the plan.

(2) Except as otherwise provided in a plan confirmed by the Court,-

- (a) the property dealt with by such plan shall be free and clear of all claims and interests of creditors or shareholders in the debtor;
- (b) the debtor is discharged from any debt that arose before the date of such confirmation, as well as any debt deemed by this Act to have arisen before the date of such confirmation; and
- (c) all rights and interests of shareholders stand terminated.

⁶ As an indication of international best practice, see *Principles*, Principle C.12.5.

(3) Except as otherwise provided in a plan confirmed by the Court, the restructuring or rescheduling of a debt of the debtor shall discharge any guarantee given by any natural person for such debt.

WORLD BANK ANNOTATION

Description: Pursuant to Article 58(3), any plan confirmation – even a “forcible” confirmation under Article 57(1) – would prima facie result in the extinguishment of all relevant natural-person guarantees.

Rationale: This is again a highly unusual provision not supported by the rationale of corporate rehabilitation.

It bears repeating that, firstly, the acquisition of personal guarantees from a company’s owners/managers to secure corporate borrowing serves to reduce financial agency costs, and is thus an absolutely standard part of the armoury of prudent bank lending in every corner of the world. Secondly, such guarantees are doubly important in jurisdictions where corporate financial reporting practices are underdeveloped or otherwise unreliable, and where it is difficult to enforce the legal boundaries between corporate revenues and the personal assets of the company’s owners/managers. The Bank team understands that financial lenders in Pakistan consider practices in the country to fall into both these categories (unreliable corporate reporting; weak checks against misappropriation of corporate assets). And thirdly, it is important in order to minimise moral hazard for those who have undertaken personal guarantees to be required to stand by them when duly called upon to do so.

Concern: Taken together with the Court’s jurisdiction to forcibly confirm a plan that has not attracted majority creditor support (Article 57(1)), this provision is fundamentally objectionable because it enables the guarantors, who had freely accepted their liabilities and benefited from doing so, to walk away from them, thus loading unbargained-for losses on to creditors. This would create moral hazard, and would tend to undermine the viability of the lenders themselves.

Recommendation: Consideration should be given to deleting Article 58(3). If the creditors, whose money is at stake in the process, are persuaded of the business case for extinguishing guarantees (for example, because they can thereby persuade guarantors to provide new money for the rehabilitated business), then they would vote of their own accord for a plan which would bring about this extinguishment.

See discussion at Paragraphs 17 to 19 of the World Bank’s October 2010 Comments, at Appendix, below.

59. Implementation of the plan.- (1) The debtor or entity responsible for the purpose of carrying out the plan or any part thereof shall carry out the plan and shall comply with any orders of the Court.

(2) The Court may direct the debtor and any other necessary party to execute or deliver or to join in the execution or delivery of any instrument required to effect a transfer of property dealt with by a confirmed plan and to perform any other act, including the satisfaction of any charge, that is necessary for the consummation of the charge.

60. Revocation of an order of confirmation or order of dissolution.- (1) Where an order of confirmation has been passed, the Court may at any time within one year of the date of confirmation of the plan, on request of an interested party and after notice and a hearing, make an order, upon such terms as the Court thinks fit, declaring the confirmation to have been void.

(2) The Court may pass an order under subsection (1) if the order of confirmation to be declared void was procured by fraud.

(3) An order under this section revoking an order of confirmation shall provide for all such measures as are necessary to protect any entity which has acquired rights in good faith reliance on the order of confirmation.

61. Special tax provisions.- (1) The creation, issuance, transfer or exchange of a security or the making or delivery of an instrument of transfer under a confirmed plan, shall not be taxed under any law.

(2) An amount which is written off under a confirmed plan shall not be taxable under any law which provides for such amount being treated as a taxable gain to the debtor.

Chapter 5 – Corporate Rehabilitation Board

WORLD BANK ANNOTATION

Recommendation: As discussed in relation to Article 10, above, consideration should be given to the addition of one or more Articles to Chapter 5 to authorise the Corporate Rehabilitation Board to licence duly qualified ‘Insolvency Professionals’, who would be appointed at the behest of the parties to rehabilitation proceedings on a case to case basis to perform all or virtually all of the functions currently allocated under Article 10 to the Technical Assistance Committee.

See discussion at Paragraphs 13 to 16 of the World Bank’s October 2010 Comments, at Appendix, below.

62. Establishment of the Board. (1) There shall be establish a Board to be known as the Corporate Rehabilitation Board.

(2) The Board shall be a body corporate with perpetual succession and a common seal and may sue or be sued in its own name and subject to and for the purposes of this Act, may enter into contracts and may acquire, purchase, take, hold and enjoy moveable and immovable property of every description and may convey, assign, surrender, yield up, charge, demise, reassign, transfer or otherwise dispose of or deal with any moveable and immovable property or any interest vested in it, upon which terms and conditions as it deems fit.

63. Head office. (1) The head office of the Board shall be at Lahore or such other place in Pakistan as the Federal Government may by order determine.

(2) The Board may establish and close down offices at such other places in Pakistan as it considers necessary.

64. Creation, composition and constitution of the Board. (1) The Board shall consist of not more than six members, including a Chairperson.

(2) The members shall be appointed by the Commission in consultation with the State Bank of Pakistan on such terms and condition as deemed proper.

(3) A member shall be a natural person who is known for his integrity, expertise and experience in the field of law, banking, accountancy, corporate insolvency, management, economics or finance.

(4) The members of the Board appointed under sub-section (2) shall hold office for a term of three years and retire on the expiration of that term and may be re-appointed for one further term of three years.

(5) Subject to the provisions of this Act, the Board shall, in the discharge of its functions and exercise of its powers, conduct its proceedings in accordance with its bye-laws approved by the Commission.

65. Powers and functions of the Board. (1) The Board shall have all such powers as may be necessary to perform its duties and functions under this Act.

(2) The Board may, having regard to its functions and to exercise its powers efficiently, organize itself into committees, divisions or other such sub-committees or sub-divisions as it considers expedient.

(3) The Board shall be responsible for the performance of the following functions,-

- (a) prescribing standards, criteria and codes of conduct for administrators and mediators under this Act;
- (b) admitting natural persons as administrators and mediators under this Act onto its rolls, conducting examinations for the purposes of

such admission, maintaining a roll of such administrators and mediators and removing administrators and mediators from such rolls;

- (c) conducting disciplinary proceedings against administrators and mediators and removing them from the rolls;
- (d) training administrators and mediators and certifying the training of such administrators and mediators;
- (e) training and certifying chartered accountants for the purposes of valuation and forensic examination of insolvent companies;
- (g) encouraging scholarship in corporate and commercial laws and particularly in the field of corporate insolvency;
- (h) periodically reviewing developments in international insolvency regimes and reviewing the laws of Pakistan to see whether they are in accordance with international best practices and publishing annual report with respect thereto;
- (i) employing and hiring employees of the Board and holding them accountable in accordance with the procedures laid down by it; and
- (j) performing all other functions conferred on it by or under this Act.

66. The Chairperson. (1) The Commission shall, in consultation with the State Bank of Pakistan, appoint from amongst the Members of the Board, a natural person as Chairperson of the Board on such terms and conditions as it may determine.

(2) The Chairperson shall be the chief executive officer of the Board and shall, together with the other members, be responsible for the day to day administration of the affairs of the Board and shall, subject to the bye-laws made by the Board, be assisted by the other members of the Board in carrying out the functions of the Board.

67. Resignation and filing of vacancies. (1) The Chairperson or any member of the Board may, by writing under his hand addressed to the Chairman of the Commission, resign from his office.

(2) Any vacancy occurring in the membership of the Board due to death, removal or resignation shall be filled in accordance with the provisions of this Act.

(3) In the case of a vacancy occurring in the office of the Chairperson, the Commission may nominate any member of the Board to act as the Chairperson for a maximum period of two months, during which period the Commission

shall fill in the vacancy by appointing a regular Chairperson in accordance with this Act.

(4) No act, proceeding, decision or order of the Board shall be invalid by reason of the existence of a vacancy or defect in the constitution of the Board.

(2) The decision to employ and the terms of employment of external advisers and consultants shall be made by the Board in accordance with such policy guidelines as the Board may determine from time to time.

69. Delegation of the Board's functions or powers. (1) The Board may, subject to such terms and conditions as it may deem fit to impose, delegate any of its functions or powers to one or more Members of the Board or any officer or employee of the Board.

(2) The delegation of any function or power under this section shall not prevent the concurrent performance or exercise by the Board of the functions or powers so delegated.

70. Fund, accounts and reports of the Board. (1) There shall be a Fund of the Board to be called the Rehabilitation Fund which shall be financed from the following sources,-

- (e) grants or other assistance from domestic and international donor agencies;
- (f) fees charged from administrators and mediators for their training, certification, examinations and admission on to the rolls;
- (g) income and earnings on account of its operations and investments; and
- (h) grants from the Federal Government.

(2) The Fund shall be expended for the purpose of paying any expenditure lawfully incurred by the Board including all remuneration, pays and allowances, fees and costs, purchasing or hiring equipment, acquiring or leasing property, repaying any financial accommodation or money borrowed along with profit and return thereupon and generally all costs and expenses in relation to the performance of its functions or the exercise of its powers by the Board under this Act.

(3) The accounts of the Board shall be,-

- (c) maintained in such form and manner as the Commission may determine; and
- (d) audited by an auditor duly licensed by the Institute of Chartered Accountants of Pakistan.

(4) The Board shall, after the end of every financial year, submit to the Commission the audited annual statement of accounts of the Board together with its auditor's report.

72. Authentication of decisions, etc. All decisions of the Board shall be authenticated by the signature of the Chairperson or of any other Member authorized by it in this behalf and all other orders or instruments issued or executed by or on behalf of the Board shall be authenticated by the signature of an officer of the Board authorized by it.

73. Chairperson, Members and officers etc. to be public servants.-

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Chairperson, Members, officers, employees, consultants and advisers of the Board shall be deemed to be public servants within the meaning of section 21 of the Pakistan Penal Code, 1860 (Act XLV of 1860).

74. Power to make bye-laws.- The Board may, from time to time, after the prior approval of the Commission and by notification in the Official Gazette, make bye-laws for purposes of exercising its powers and discharging its duties under this Act.

Chapter 6 - Corporate Restructuring Company

WORLD BANK ANNOTATION

Description: Chapter 6 of the draft CRA proposes to create a framework for the creation and operation of 'Corporate Restructuring Companies' ('CRCs') whose role would be to trade in distressed assets.

Rationale: The Bank team's discussions with various stakeholder representatives confirm that there is neither clarity nor agreement amongst stakeholders as to the rationale, design, or ownership of these companies.

In principle, the legal system may usefully stimulate the creation of a secondary market in distressed assets by, among other things, enabling private sector market participants to set up in the business of buying assets from and/or claims against distressed enterprises. Some stakeholder representatives informed the Bank team that this is indeed what Chapter 6 of the draft CRA is intended to accomplish.

More troubling is the suggestion, made to the Bank team by more than one stakeholder representative, that the government is intended to have a significant equity stake in at least one CRC set up pursuant to Chapter 6, which would be utilised as a way of consolidating capacity in the textiles sector. It should be noted that international experience strongly suggests that there are at most three situations in which, *if* carefully structured and disciplined, publicly funded CRCs can play a useful role: (i) in resolving

systemic banking crises; (ii) in resolving sector-wide industrial distress; and (iii) in transferring businesses from the public to the private sector. Outside of these limited domains, experience with publicly funded CRCs has been invariably negative. None of these three sets of circumstances currently prevails in Pakistan.

Concern: In the Pakistani context, a publicly funded CRC could bid for and take into the public sector assets that would more effectively have been utilised in the private one. Its operations could distort nascent distressed asset markets in the private sector by confounding price signals and by impeding private sector players' ability to learn to price assets properly and to develop skills to turn around distressed businesses. And even more problematically, it could buy claims from financial institutions in circumstances where the debtor had invoked or was likely to invoke the CRA procedure and the claims were at risk of being reduced or extinguished in the way described above. This could create a net loss to the public purse and pose a risk to fiscal responsibility.

Recommendation: Consideration should be given for an additional Article to be inserted in Chapter 6 to require that companies set up pursuant to that Chapter should be funded solely through private sector resources.

See discussion at Paragraphs 20 to 24 of the World Bank's October 2010 Comments, at Appendix, below.

75. Corporate Restructuring Companies.- (1) The provisions of this Chapter shall apply to companies licensed by the Commission under this Chapter to carry out the business of,-

- (a) acquisition, management, restructuring and resolution of non-performing assets of financial institutions; and
- (b) restructuring, reorganization, revival and liquidation of commercially or financially distressed companies and their businesses.

(2) No Corporate Restructuring Company shall be incorporated without prior approval of the Commission.

(3) No Corporate Restructuring Company shall carry on business unless it is established as a public limited company under the Ordinance and holds a licence issued in this behalf by the Commission and any such licence may be issued subject to such general or special conditions as the Commission may deem fit to impose.

(4) The Commission shall prescribe Regulations which may provide for conditions relating to,-

- (a) qualifications and termination of directors, chairman, chief executive, chief financial officer and auditors;
- (b) licensing, capital and audit requirements; and

- (c) any other matter which the Commission may deem necessary for the purposes of giving due effect to the provisions of this Chapter.

76. Functions and Powers.- (1) Without prejudice to the generality of the provisions of sub-section (1) of section 75, a Corporate Restructuring Company shall exercise any or all of the following functions and powers, namely,-

- (a) to acquire, buy, hold, manage, restructure, reschedule, resolve, settle, recover, assign, transfer and dispose off non-performing assets;
- (b) to deal with any loan, advance, financial commitment, lease, hire-purchase, rental, sale and buy-back arrangement, mudaraba, musharaka, ijara or other financial transaction or security interest relating to non-performing assets;
- (c) to acquire, take over, hold, re-organize, restructure, encumber, assign, sell, lease and otherwise deal with any asset, property, undertaking or collateral with respect to non-performing assets;
- (d) to acquire, hold, manage, restructure, reorganize, revive, merge, amalgamate, lease, liquidate, assign and dispose off distressed companies, their businesses and properties;
- (e) to advise, develop, advance, support, implement and raise finances for plans of rehabilitation, restructuring, reorganization or liquidation of distressed companies, their businesses and properties;
- (f) to enter into partnerships, joint venture agreement, profit or loss sharing arrangement or otherwise collaborate or participate with any company or other person associated or concerned with non-performing assets or distressed companies;
- (g) to commence, continue, defend, desist, enforce, implement and perform any and all actions or activities in relation to non-performing assets and distressed companies; and
- (h) to establish, promote, concur or participate in establishing or promoting any company or other entity, the establishment or promotion of which may seem, directly or indirectly, to benefit the business mentioned under sub-section (1) of section 75.

(2) No Corporate Restructuring Company or its directors, officers and agents shall perform any function and exercise any power under this Act so as,-

- (a) to involve in speculative transactions;
- (b) to aid an obligor with the sole object to avoid its debt obligations or performance of a contract, remove its assets and properties from the reach of its creditors, evade payment of any tax, duty or other fiscal charge to Government Agency;
- (c) to circumvent fair valuation and proper appraisal of non-performing assets and the collateral thereof by reputable evaluating and appraising entities;
- (d) to transact business other than at arm's length; and
- (e) not to comply with the applicable laws, except as expressly provided otherwise under this Act.

77. Transfer of non-performing assets.- (1) Notwithstanding anything to the contrary contained in any law, decree, judgment, order, contract, instrument or document,-

- (a) a financial institution may after the prior approval of its Board, transfer and assign its non-performing assets to a Corporate Restructuring Company, other than a Corporate Restructuring Company established, owned or controlled by itself, by entering into a transfer and assignment agreement with it on such terms and conditions as may be mutually agreed upon between them;
- (b) on the vesting date, all rights, title, interest, benefits, privileges and remedies of such financial institution, in and against the non-performing assets and the obligors thereto, shall stand transferred, assigned, conveyed, sold and vested in favour of the Corporate Restructuring Company without the need of any further action, agreement or instrument;
- (c) a transfer and assignment agreement under section 3 shall not be required to be stamped or compulsorily registered under any law; and
- (d) all contracts, deeds, instruments, approvals, commitments or consents relating to the non-performing assets subsisting or having effect immediately before the vesting date and to which the transferor may have been a party or beneficiary shall be of full force and effect in favour of or against the Corporate Restructuring Company and may be enforced or acted upon as fully and effectively as if, in the place of such financial institution, the Corporate Restructuring Company had been a party or beneficiary.

(2) The rights, powers and remedies provided to a Corporate Restructuring Company under this Chapter may be exercised separately or concurrently by it and are in addition to and not in lieu or derogation of any other rights or remedies that it or any other person may legally have in respect of non-performing assets and the collateral thereof.

78. Legal proceedings.- (1) All proceedings by or against a transferor relating to the non-performing assets transferred to a Corporate Restructuring Company and the obligors and collateral thereof, which may be pending before any Court, tribunal, arbitrator or authority immediately before the vesting date, shall,-

- (a) be continued, prosecuted, defended, enforced and executed by or against the Corporate Restructuring Company in the same manner and to the same extent as might have been continued, prosecuted, defended, enforced and executed by or against the transferor;
- (b) proceed from the stage which such proceedings had reached on the vesting date and shall not require any fresh filing, recalling and rehearing of any witness or recording of any evidence already completed; and
- (c) be continued, decided and disposed off in accordance with the provisions of the respective law, as amended or re-enacted, under which the same were instituted or filed.

(2) Any new proceedings by or against the Corporate Restructuring Company may be filed and instituted and shall be entertained, adjudicated and disposed off in accordance with the laws, as amended or re-enacted, under which proceedings were authorized to be instituted and filed by or against the transferor, respectively, including, Financial Institutions (Recovery of Finances) Ordinance, 2001 (XLVI of 2001), the Companies Ordinance, 1984 (XLVII of 1984), the Offences in Respect of Banks (Special Courts) Ordinance, 1984 (IX of 1984), Code of Civil Procedure, 1908 (V of 1908) and the Code of Criminal Procedure, 1898 (V of 1898).

(3) Without prejudice to the provisions of sub-section (2), a Corporate Restructuring Company shall be deemed to be a financial institution for the purposes of clause (a) of section 2 of the Financial Institutions (Recovery of Finances) Ordinance, 2001 (XLVI of 2001) but shall not be treated as a banking company under the Banking Companies Ordinance, 1962 (LVII of 1962).

(4) Any reference to the transferor in the proceedings stated above, the record and documents of such proceedings or decrees, judgments and orders passed in such proceedings shall, except where the context otherwise requires, be construed and read as reference to the Corporate Restructuring Company.

(5) Without prejudice to the provisions of the foregoing sub-sections, the Corporate Restructuring Company may submit an affidavit of its chief executive officer, containing particulars of the proceedings mentioned under sub-section (1) above, with the registrar of the Court, tribunal, arbitrator or authority before which such proceedings are pending and on receipt of such affidavit the name of the Company in place of the transferor, as the case may be, shall be substituted.

79. Notice and discharge.- (1) A Corporate Restructuring Company may, on or after the vesting date, give a duly signed and sealed notice of transfer of the nonperforming assets to the obligors, State Bank, Commission and any other concerned person, including, in particular, to the registering authority in whose jurisdiction any security interest with respect to such non-performing assets or any other interest concerning the collateral or any indebtedness of the obligors relating to the non-performing assets, had been recorded or registered.

(2) A transfer and assignment agreement shall not be effective as against the obligors of the non-performing assets transferred by such agreement until due notice thereof is provided to such obligors.

(3) Subject to sub-section (2), the obligors of the non-performing assets transferred and assigned to a Corporate Restructuring Company by a financial institution shall make payment to the Corporate Restructuring Company and obtain any effective discharge from it after retirement of their liabilities to the entire satisfaction of the Corporate Restructuring Company.

80. Power to require information.- (1) The Commission may, at any time, by notice in writing, require one or more Corporate Restructuring Companies to furnish it within the time specified therein or such further time as the Commission may allow, any statement, information or document relating to the business or affairs of such Corporate Restructuring Companies.

(2) No Corporate Restructuring Company or its director, officer, employee, auditor or agent shall, in any document, prospectus, report, return, accounts, information or explanation required to be furnished in pursuance of this chapter or the Regulations made under this Act, make any statement or give any information which he knows or has reasonable cause to believe to be false or incorrect or omit any material fact therefrom.

81. Special Audit.- (1) The Commission shall monitor the general financial condition of the Corporate Restructuring Companies and may, at its discretion, order special audit and appoint an auditor to carry out detailed scrutiny of the affairs of one or more Corporate Restructuring Companies and the Commission may, at any time, issue such directions as it may be deemed appropriate.

(2) On the basis of the special audit report, the Commission may direct a Corporate Restructuring Company to do or to abstain from doing such acts that may secure the interest of its shareholders and creditors and any such directions shall be complied with within such time as may be specified by the Commission.

82. Inquiry by the Commission.- (1) On the request of any concerned person or on its own motion, the Commission may cause an enquiry or inspection to be made by any person appointed in this behalf into the affairs of a Corporate Restructuring Company or its directors, officers or an associated company or undertaking.

(2) Where an enquiry or inspection under sub-section (1) has been ordered, the director, officer or associated company or undertaking to which the enquiry or inspection relates and every other person who has had any dealing with the Corporate Restructuring Company, its director, officer or associated company shall furnish such information in his custody or power or within his knowledge relating to or having bearing on the subject-matter of the enquiry or inspection as the person conducting the enquiry or inspection may by notice in writing require.

(3) The person conducting an enquiry or inspection under sub-section (1) may call for, inspect and seize books of account and documents in possession of the Corporate Restructuring Company or its directors, officers or associated companies.

83. Penalty of non-compliance or contravention.- (1) Notwithstanding anything contained in any other provision of this Act, if a Corporate Restructuring

Company or its director, officer or associated company fails or refuses to comply with or knowingly contravenes any provision contained in this Chapter or of any of the provisions of the Regulations made under this Act or any order or direction passed by the Commission under the provisions contained in this Chapter or knowingly and willfully authorizes or permits such failure, refusal or contravention or makes a false statement, shall, in addition to any other liability under this Act, be punishable by imprisonment for a period up to six months or fine of an amount not exceeding ten million rupees or both.

(2) Without prejudice to the provisions of sub-section (1), in case of contravention of any provision of this Act or the Regulations made under this Act or non-compliance of any direction given or order passed thereunder by the Commission, the Commission may cancel the licence of a Corporate Restructuring Company, after issuing a show cause notice and giving it an opportunity of being heard or pass any other order which may be deemed appropriate by the Commission.

(3) Upon cancellation of the licence, the functions and carrying on the business of a Corporate Restructuring Company shall cease and the Commission may move the Court for winding up of the Corporate Restructuring Company.

Chapter 7 Miscellaneous

84. Removal of difficulties.- (1) Except for Chapter 6, if any difficulty arises in giving effect to any provision of this Act, the Federal Government may, by notification in the official Gazette make such provisions as may appear to it to be necessary for the purpose of removing the difficulty.

(2) If any difficulty arises in giving effect to any provision of chapter 6, the Commission may, by notification in the official Gazette make such provisions as may appear to it to be necessary for the purpose of removing the difficulty.

85. Repeal and Savings .- (1) The following sections of the Ordinance shall be repealed,-

(a) Section 295; and

(b) Section 296.

(2) The repeal of any provision of law by this Act shall not affect, nor be deemed to affect, any proceedings pending under such provisions of law and such proceedings may be continued as if the said provisions had not been repealed.

86. Power to make Regulations.- The Commission may by notification in the official gazette make such Regulations as may be necessary to carry out the purposes of this Act.

87. Power to make Rules.- The Commission shall with the approval of the Federal Government and by notification in the Official Gazette make such Rules as may be necessary to carry out the purposes of this Act.

Provided that, before making any such rule, the draft thereof shall be published by the Federal Government in the Official Gazette for eliciting public opinion thereon within a period of not less than fourteen days from the date of publication.

APPENDIX

PAKISTAN DRAFT CORPORATE REHABILITATION ACT

COMMENTS FROM THE WORLD BANK

October 2010

EXECUTIVE SUMMARY

If appropriately amended, the draft Corporate Rehabilitation Act has the potential to plug an important lacuna in the legal governance of the market. It would do so by introducing, for the first time in the jurisdiction, a set of mechanisms by which distressed but viable enterprises may be rehabilitated and their causes of distress remedied.

As currently structured, however, the draft legislation is unlikely to realise these benefits. Instead, there is considerable risk that it may cause harm. It would enable non-viable enterprises to be continued, contrary to their creditors' wishes and in a socially value-destructive manner. It would permit debtors and their erstwhile owners to rid themselves without justification of legal obligations that they had freely accepted, obligations on the strength of which they would have raised money for the business. By the same token, it would prevent lenders from recovering what they are owed, thereby weakening their own viability, and in the process, would generate significant moral hazard. It would vest key technical decisions in the restructuring process in a proposed 'Technical Assistance Committee' whose members would be appointed in a non-transparent manner, without checks against the risk of political influence, and would not be meaningfully accountable to either the parties or the courts. This would cast doubt both on the suitability of their appointment and on the validity of their decisions. And finally, the legislation as currently drafted raises concern that public money would be used to acquire distressed claims and businesses in a way that would distort market signals, undermine the parties' ability to learn how properly to price such assets, and risk fiscal stability.

These potential problems with the draft legislation are fundamental and go to its heart, but they could be mitigated through relatively minor textual changes. Drawing on extensive discussions with the drafters of the legislation and other key stakeholder representatives, the World Bank team has formulated recommendations for improving the expected dynamics of the proposed framework, which have been discussed with Pakistani authorities, including the Secretary, Ministry of Finance. These are as follows: (1) The Court should not be given jurisdiction to forcibly confirm any plan which has not received support from at least a majority of creditors; (2) The draft legislation should dispense with the Technical Assistance Committee; instead, insolvency professionals licensed by the proposed 'Corporate Rehabilitation Board' should be appointed on a case by case basis at the parties' behest to advise them and the court; (3) The provisions suspending and extinguishing guarantees for the company's debt should be eliminated; (4) The government should be explicitly precluded from investing in any of the proposed 'Corporate Restructuring Companies'; and (5) At the next stage in the legislative reform process, efforts should be directed at creating a modern, streamlined liquidation system that could be functionally integrated with an appropriately amended corporate rehabilitation framework, and which, in addition to dealing with distressed non-viable businesses, would also provide the correct incentives for parties to corporate rehabilitation proceedings.

For the reasons explained in this document, implementation of the proposed legislation in an unmodified form risks doing considerably more harm than good. By contrast, implementation of the proposed legislation incorporating the textually minor amendments proposed here could constitute a most significant first step in the creation of a world-class corporate rehabilitation system. It could also pave the way for international donors to assist Pakistan in developing the institutions and building the capacity required to effectively implement the legislation.

CONTEXT

- 1 An appropriate legal and institutional treatment of distressed enterprises is a key element in the effective governance of the market. A legal system equipped to distinguish distressed but nevertheless viable firms from non-viable ones can aid growth and development by (i) cost-effectively liquidating non-viable distressed enterprises and transferring their assets to new, more productive uses; (ii) enabling the rehabilitation of viable distressed enterprises which are more valuable when kept as going concerns than they would be if disposed of piecemeal; and in both these circumstances, (iii) protecting to the maximum extent the rights of the creditors of the enterprise, thereby minimising moral hazard for borrowers and incentivising potential creditors to lend in the first place.

BACKGROUND

- 2 The Government of Pakistan (**GoP**) is in the process of preparing a new Corporate Rehabilitation Act (**CRA**), the current draft of which is presently in the initial stages of the legislative process. At GoP's invitation and with a view to meeting the particular economic and social needs of Pakistan consistently with international best practice, the World Bank has provided comments on several drafts of the CRA. The Comments in this paper encapsulate the results of a mission by the Bank team to Pakistan from 19 to 23 July 2010, and are informed by extensive discussions in person and by phone and video conference between the Bank team and the Chair and legal team of the Securities and Exchange Commission of Pakistan (**SECP**) which has drafted the proposed CRA; interviews with representatives of lender and borrower communities in Karachi, Lahore, and Islamabad, the acting Chief Justice of the Sindh High Court, and relevant Ministries; and detailed dialogue with the Secretary, Ministry of Finance. The Comments build on those provided to GoP by the Bank team on 1 February 2010, and take into account responses from the SECP legal team received by email on 21 June 2010 and in person on 21 July (though dated 27 April 2010). The Comments also draw on the international 'best practice' guidance as reflected in the *United Nations International Trade Commission's Legislative Guide on Insolvency* (**Guide**) and the *World Bank Principles on Effective Insolvency Systems* (**the Principles**).

THE AGREED PRINCIPLES

- 3 The analysis of the draft CRA in these Comments proceeds by reference to a set of axioms or 'principles' (**the Agreed Principles**). These axioms were formulated by the Bank team as a result of its preparatory work (cf. paragraph 2, above), and presented during an Opening Meeting with the Secretary, Ministry of Finance, on 21 July 2010, which was also attended, among others, by the Chair and legal team of the SECP. Agreement was reached at the meeting that, in principle, these axioms accurately capture the rationale underlying both, GoP's objectives in introducing the draft CRA, and relevant international best practice in enterprise rehabilitation law and policy. The Table overleaf provides statements of these Agreed Principles.

Table: AGREED PRINCIPLES

1	An effective legal system would respond to distress in one of two closely inter-related ways: it would liquidate non-viable distressed enterprises, and would rehabilitate viable though distressed ones.
2	In order to preserve and recycle the valuable assets of non-viable distressed enterprises, liquidation should be fast, relatively unhindered, and cost effective.
3	In relation to viable distressed enterprises, distress may, broadly, be caused by either managerial failings or reasons independent of any such failings.
4	Restructuring plans should, first and foremost, recognize and address the causes of distress by relating the steps to be taken in the restructuring process to the causes.
5	The acceptability of a restructuring plan should be determined by the very parties who stand to gain or lose from its implementation, and who have the most knowledge about the debtor's business and prospects and about the competence of its management.
6	To minimise moral hazard, those who take on risk should bear the losses when the risk materializes.
7	The Court is the guarantor of the integrity of the distress resolution process but should not be required to make technical non-legal judgments.
8	A creditor would rather that the debtor services its obligations than that it be in need of being chased for repayment, or liquidated, or that its business have to be run by the creditor.

SUMMARY OF CONCERNS

- 4 The Bank team's analysis of the proposed CRA by reference to the Agreed Principles gives rise to very significant concern. For a small group of the largest distressed companies in the economy, the CRA would create a mechanism that could allow the write down, write off or subordination of creditor claims; the suspension and subsequent discharge of third party guarantees held by such creditors; the maintenance of existing shareholders as the company's owners even though their equity had been extinguished by the company's financial state; and the retention of a management team that may have lost the creditors' confidence. Each of these mechanisms could operate without reference to any market-based test for the viability of the affected company and without an adequate valuation mechanism, and could override even the unanimous objections of the company's creditors, who by virtue of the company's financial state would have a direct economic stake in the company's assets and business. These mechanisms would operate by decision of the Court on the advice of a Technical Assistance Committee ("**TAC**"), a quasi non-governmental organisation over the appointment and operations of which, absent appropriate checks and balances, state authorities could exercise significant influence.

Further, the CRA would provide a framework within which a Corporate Restructuring Company (“**CRC**”) with significant state ownership is envisaged as drawing on public (and other) funds to buy non-performing loans from banks and distressed assets from companies.

- 5 In the result, the mechanisms that would become available under the draft CRA would call into question the governance and integrity of the corporate rehabilitation mechanism as a whole. By eliminating fundamental checks and balances and by centralising decision-making powers in state (or quasi-state) bodies, it would hamper rather than assist stakeholders in finding sustainable, economically effective solutions for corporate distress. Further, the operation of the CRA could raise critical issues of financial stability (because banks would be forcibly required to absorb the loss of significant levels of non-performing loans), and/or could give rise to significant concern about fiscal discipline (because of the contemplated use of public funds to purchase claims but also assets with no clear market value).

PARTIAL COMPLIANCE WITH THE AGREED PRINCIPLES

- 6 Before addressing the reasons for these concerns, it is important to note that the draft CRA goes some way towards meeting the requirements of the Agreed Principles. Most notably:
- 6.1 It introduces, for the first time in the jurisdiction, a legal framework within which large corporations in distress may be rehabilitated; further, it incentivises the debtor’s managers to initiate CRA proceedings by leaving them in control of the debtor’s business notwithstanding the initiation of these proceedings (**Agreed Principle 1**);
 - 6.2 It has the potential for speeding up the (distinct) liquidation process by requiring the debtor wishing to avail itself of the CRA process to admit insolvency and the fact of its liability (**Agreed Principle 2**);
 - 6.3 It creates mechanisms by which a restructuring plan may be formulated which can identify and address the causes of distress (**Agreed Principles 3* and 4***);
 - 6.4 It introduces a party-led process that encourages debtors and creditors to propose plans, and which enables creditors to assess the viability of these plans through voting (**Agreed Principle 5***); and
 - 6.5 It creates a mechanism to feed non-legal technical content into the Court’s decision-making (**Agreed Principle 7***).
- 7 Unfortunately, however, other key elements of the draft CRA fundamentally violate several of the Agreed Principles. The harm brought about by these aspects of the proposed legislation would, among other things, also negate or severely dilute the benefits that would otherwise have resulted from the draft CRA’s compliance with Principles 3, 4, 5 and 7 (cf. paragraphs 6 (c), (d), and 3, above), a fact indicated in the previous paragraph by the asterisks (*).

FORCIBLE CONFIRMATION OF PLANS REJECTED BY CREDITOR MAJORITY

- 8 The central and fundamental problem with the draft CRA resides in this issue. Borrowing from Chapter 11 of the US Bankruptcy Code, the CRA introduces an exquisite and extensive framework for dividing the creditors into classes, and of ascertaining their views

about any or all proposed rehabilitation plans.⁷ The CRA then, however, proceeds to negate the utility of this framework by providing that the Court, at the advice of the TAC, may forcibly confirm a plan even if the creditors had unanimously rejected it.⁸

9 This structure poses serious risk to the likely efficacy of the rehabilitation framework proposed by the draft CRA, and it is crucial to understand why. To simplify, four important considerations are at play:

9.1 **Is the business viable?** Voting on proposed rehabilitation plans in relation to a distressed business is an inherently difficult process. The fundamental issue for decision is whether the business, even though distressed, nevertheless remains viable. Empirical evidence and experience in other jurisdictions suggest that most distressed enterprises are not viable. Such non-viable distressed businesses ought to be liquidated quickly and cost-effectively so that their constitutive assets would be put to more socially valuable uses. A minority of distressed businesses may indeed be viable. A crucial task for a rehabilitation framework, then, is to identify this minority of cases. (**Agreed Principles 1 to 3**) Creditors can be expected to have developed considerable knowledge of the debtor business by virtue of having lent money to, and then attempting to recover it from, it; or by having supplied it with goods and services. They would thereby be in a better position, compared with any other party outside the debtor business, to determine the causes of the distress, to ascertain whether it resulted from managerial incompetence or other factors, and to judge whether the business is still viable.

9.2 **How best to identify and remedy causes of distress?** If a distressed business is duly identified as capable of being rescued, the rehabilitation plan should be structured so as to maximise the likelihood of the rehabilitation of the business. This means it should identify and remedy the underlying causes of the distress. (**Agreed Principles 4 and 5**) Better than any other party outside the business, creditors are able to and ought to be enabled to use their knowledge of the causes of the debtor's distress to assess whether the proposed plan would be likely to give the business the best chance of being rehabilitated, and since their own money is at stake, they have a strong incentive to get this decision right. No other party can be expected to be in a better position to make such decisions, and no other party has the same incentives.

9.3 **Is modification of creditor rights legitimate?** Any rehabilitation plan would modify the legal rights of the creditors of the business. In virtually all plans, they would be required to delay, reduce, or even to write off their claims in whole or part. (**Agreed Principle 5**) That it is some majority of creditors themselves who may vote to confirm a plan requiring the modification of creditor rights is evidently the best guarantee that any such modifications would be legitimate.

9.4 **Would rehabilitation create moral hazard?** By the same token, the rehabilitation process allows the debtor company to walk away from some of its legal obligations. This intensifies financial agency costs and creates moral hazard. The owners and managers of the debtor company may be tempted *ex ante* to invest in excessively risky projects, in effect gambling the value received by the business from its creditors in the expectation that they would capture any increased returns (the lenders are restricted to their principal and interest), but that any losses would be also be shared by the creditors. A rehabilitation process increases the probability that even if such excessively risky strategies resulted in disaster, at least some part of the business would continue to be owned and run by at least some of its pre-

⁷ CRA, Article 56.

⁸ CRA, Article 57.

distressed owners/managers, which in turn intensifies this socially harmful incentive. (**Agreed Principles 5 and 6**) Since it is the creditors' money at stake in the decision whether, and if so, how to attempt a rehabilitation of the distressed debtor, they have an incentive to assent to the rehabilitation only if they believe the business became distressed because of factors unrelated to managerial incompetence or excessive risk-taking. Owners and managers would anticipate that, in their business's distress, creditors would either vote to liquidate rather than rehabilitate; or else, approve a rehabilitation plan only on the condition that incompetent managers would be replaced and excessively risk-preferring owners deprived of equity stakes. This controls moral hazard.

- 10 It is in consideration of these and other factors that international best practice has converged on vesting important decision-making powers in the rehabilitation process in a majority or super-majority of creditors.⁹
- 11 Against this background, the present wording of Article 57 of the draft CRA creates the most serious risk to the efficacy of the proposed legislation. Pursuant to its current wording, the Court could “forcibly confirm” a plan at the TAC’s advice¹⁰ even if all creditors had rejected it.¹¹ While an aggrieved party could object before the Court,¹² the Court would be able to decide against it – indeed, would possess jurisdiction to accept the entire plan – without any reference to the market value of the debtor’s assets.¹³ This despite the fact that neither the Court nor the TAC can be expected to possess requisite knowledge of the business, its managers, and its industry; neither the Court nor the TAC legitimately stand to gain from getting the reorganise/liquidate decision right or lose from getting it wrong; and neither the Court nor the TAC would be best placed to ensure that the rehabilitation plan would be best designed to address and remedy the causes of distress. The overall result of the law would be an insolvency system based on centralized decisions, isolated from market forces, and possibly influenced by non-economic factors. By the same token, the operation of this element of the CRA could result in a substantial transfer of wealth from creditors – notably, financial institutions – to large corporate debtors, and even more so, to their controlling shareholders. This would weaken – and in extreme cases, cast doubt on the viability of – the lender institutions themselves.
- 12 **Recommendation:** It would be a relatively easy matter to amend Article 57 to ensure that no plan could be forcibly confirmed by the Court unless it had attracted the support of an appropriate majority by value of the distressed company’s creditors. Unless this were done, it is difficult to envisage that the CRA framework would be either efficacious or credible, and difficult to escape the conclusion that it would do more harm than good.

TECHNICAL ASSISTANCE COMMITTEE

- 13 This is the second troubling element of the draft CRA. The proposed legislation envisages that the Chair of the SECP and the Governor of the State Bank of Pakistan (“SBP”) would jointly appoint the members of the TAC.¹⁴ The Court would be required to seek the TAC’s advice on all key questions concerning the plan, including whether a secured creditor had “adequate protection”; whether a proposed plan or an amendment thereto

⁹ As an indication of international best practice, see *Principles*, Principle C.12.5.

¹⁰ CRA, Article 10(9).

¹¹ CRA, Article 57. By way of contrast and as an indication of international best practice, see *Guide*, Chapter IV, Recommendation 150; and *Principles*, Principle C.14.3.

¹² CRA, Article 10(12).

¹³ CRA, Article 57, for example, paragraph 2(a).

¹⁴ CRA, Article 10(2).

was “fair and equitable”; which creditor classes were underwater; and it seems, even the overall acceptability of the plan.¹⁵

- 14 The rationale for a mechanism such as the TAC is understandable. The formulation and assessment of the rehabilitation plan requires possession of technical knowledge – most notably, that for the assessment of discounted cashflow projections – that the Court neither does nor should be expected to possess. This technical content is best derived from an independent expert source, on whose advice the Court and parties alike may rely. **(Agreed Principle 7)**
- 15 However, the structure of the TAC and the mode of appointment of its members is open to misuse and risks being corrosive to the establishment of a proper rehabilitation system. This is for two main reasons:
- 15.1 **Appointment:** The TAC is based on what may be called a ‘closed list’ system, i.e. it will consist of a small, fixed number of members (currently 15) to be appointed by the SECP and SBP heads, each of whom is themselves a government appointee. There is considerable risk that appointments to this body – which the Bank team understands are intended to be prestigious, and on a case by case basis, well remunerated – would be, and be perceived to be, tainted by the politics of patronage and perks.
- 15.2 **Operation, accountability, reputation:** Relatedly, TAC members would be fully accountable neither to the parties in rehabilitation proceedings nor the Court. Parties to rehabilitation proceedings would have little control over who serves in their case; could not veto a member’s nomination; would have no control over their fees; and would not be able to effectively hold them accountable in Court. Correspondingly, TAC members would have no incentive to develop a credible reputation in the market so as to attract appointments in future rehabilitation proceedings. If anything, their incentive would be to please their two joint appointors and their appointors’ political masters. This bodes well neither for the actual nor the perceived integrity of the proposed system.
- 16 **Recommendation:** While it is possible to envisage improving on this aspect of the proposed legislation in one of several ways, the Bank team commends the alternative enshrined in the draft CRA itself. The proposed legislation envisages that the Corporate Rehabilitation Board (**‘CRB’**) would train, license and accredit professionals to perform various roles within the rehabilitation process. With relatively minor amendments, the CRA could provide for the CRB to licence Insolvency Professionals (**‘IPs’**) on the lines of the various licensing bodies in medicine, engineering, architecture, auditing, law, etc. In any given rehabilitation proceeding, the parties could nominate and the Court could appoint a licensed IP to assist the Court through the non-legal technical aspects of the rehabilitation process. If the parties (debtor and creditors) failed to reach consensus on the identity of the IP, each could be entitled to nominate one IP, and the two nominees would together select a third member of the panel to serve in that case. Subject to appropriate guidance in subordinate legislation, the IPs’ fees would have to be approved by the creditors (whose money would be at stake in the proceedings), or in the alternative, by the Court. This would mitigate the danger of unsuitable and unaccountable appointees distorting the insolvency process through the TAC, and would instead encourage IPs to invest in building a credible reputation for expertise and impartiality in order to attract nominations by parties to future proceedings.

¹⁵ “The Court *shall* refer all plans...” (CRA, Article 10(9), emphasis added).

TREATMENT OF PERSONAL GUARANTEES

- 17 The third problematic element of the draft CRA is its treatment of personal guarantees. It should be noted at the outset that, firstly, the acquisition of personal guarantees from a company's owners/managers to secure corporate borrowing serves to reduce financial agency costs, and is thus an absolutely standard part of the armoury of prudent bank lending in every corner of the world. Secondly, such guarantees are doubly important in jurisdictions where corporate financial reporting practices are underdeveloped or otherwise unreliable, and where it is difficult to enforce the legal boundaries between corporate revenues and the personal assets of the company's owners/managers. The Bank team understands that financial lenders in Pakistan consider practices in the country to fall into both these categories (unreliable corporate reporting; weak checks against misappropriation of corporate assets). And thirdly, it is important in order to minimise moral hazard for those who have undertaken personal guarantees to be required to stand by them when duly called upon to do so. (**Agreed Principle 6**)
- 18 Notwithstanding these factors, the draft CRA proposes the following:
- 18.1 **Suspension:** The imposition of the 'automatic stay' upon the initiation of CRA proceedings would also suspend enforcement action against the guarantors of the company's liabilities.¹⁶ This is a highly unusual provision, since the stay in insolvency proceedings is generally intended to protect the going concern of the debtor company, not the financial position of owners or other third-party guarantors. In a restructuring system in which the consent of at least some affected creditors was required, such extension of the ambit of the stay would be regarded as objectionable because it would make the proposed plan less likely to attract creditor consent. Correspondingly, it would weaken the incentives of the debtor's managers/owners to cooperate in the timely completion of the rehabilitation process.
- 18.2 **Extinguishment:** Even more problematically, even a "forcible" confirmation of a plan would prima facie result in the extinguishment of all relevant natural-person guarantees.¹⁷ Again, this provision is highly unusual, and taken together with the Court's jurisdiction to forcibly confirm a plan which has not attracted majority creditor support, is fundamentally objectionable because it enables the guarantors, who had freely accepted their liabilities and benefited from doing so, to walk away from them, thus loading unbargained-for losses on to creditors. This would create moral hazard, and would tend to undermine the viability of the lenders themselves. (**Agreed Principle 6**)
- 19 **Recommendation:** This problem could most simply be addressed by deleting the provision that suspends guarantees during the rehabilitation process (Articles 37(2)), and that which prima facie extinguishes them at the culmination of this process (Article 58(3)). Suspension of guarantees is on balance not justified by the rationale of corporate rehabilitation; and if the creditors, whose money is at stake in the process, are persuaded of the business case for extinguishing guarantees (for example, because they can thereby persuade guarantors to provide new money for the rehabilitated business), then they would vote of their own accord for a plan which would bring about this extinguishment.

CORPORATE RESTRUCTURING COMPANIES

¹⁶ CRA, Article 37(2).

¹⁷ CRA, Article 58(3).

- 20 Chapter 6 of the draft CRA proposes to create a framework for the creation and operation of ‘Corporate Restructuring Companies’ (‘CRCs’) whose role would be to trade in distressed assets. The Bank team’s discussions with various stakeholder representatives confirm, however, that there is neither clarity nor agreement amongst stakeholders as to the rationale, design, or ownership of these companies.
- 21 In principle, the legal system may usefully stimulate the creation of a secondary market in distressed assets by, among other things, enabling private sector market participants to set up in the business of buying assets from and/or claims against distressed enterprises. Some stakeholder representatives informed the Bank team that this is indeed what Chapter 6 of the draft CRA is intended to accomplish.
- 22 More troubling is the suggestion, made to the Bank team by more than one stakeholder representative, that the government is intended to have a significant equity stake in at least one CRC set up pursuant to Chapter 6, which would be utilised as a way of consolidating capacity in the textiles sector. It should be noted that international experience strongly suggests that there are at most three situations in which, *if* carefully structured and disciplined, publicly funded CRCs can play a useful role: (i) in resolving systemic banking crises; (ii) in resolving sector-wide industrial distress; and (iii) in transferring businesses from the public to the private sector. Outside of these limited domains, experience with publicly funded CRCs has been invariably negative. None of these three sets of circumstances currently prevails in Pakistan.
- 23 In the Pakistani context, a publicly funded CRC could bid for and take into the public sector assets that would more effectively have been utilised in the private one. Its operations could distort nascent distressed asset markets in the private sector by confounding price signals and by impeding private sector players’ ability to learn to price assets properly and to develop skills to turn around distressed businesses. And even more problematically, it could buy claims from financial institutions in circumstances where the debtor had invoked or was likely to invoke the CRA procedure and the claims were at risk of being reduced or extinguished in the way described above. This could create a net loss to the public purse and pose a risk to fiscal responsibility.
- 24 **Recommendation:** This problem could most simply be addressed through the insertion of a provision in Chapter 6 of the CRA requiring that companies set up under that framework should be funded solely through private sector resources.

AN EFFECTIVE LIQUIDATION FRAMEWORK

- 25 In a well-functioning legal system, an effective liquidation framework is, as it were, the conjoined twin of an effective rehabilitation process. As noted in paragraph 1, above, most distressed companies are distressed because their business proposition is no longer viable, and a well functioning legal system would cost-effectively recycle their assets to more promising uses. Additionally, the credible threat of speedy liquidation can be a potent catalyst for distressed debtors to initiate rehabilitation proceedings in the first place. (Agreed Principles 1 and 2)
- 26 Evidence available to the Bank team suggests that the Pakistani corporate winding-up framework is dysfunctional: it is procedurally cumbersome, involves unnecessarily lengthy delays, and can be costly. For these reasons, the threat of its invocation against them does not constitute an effective inducement for debtors to initiate rehabilitation proceedings.
- 27 The absence of a credible threat of liquidation appears to have had a distortive effect on the design of the CRA. As if to compensate for its absence, the CRA seeks to provide inducements for debtors to initiate rehabilitation proceedings – for example, in relation to

personal guarantees (see paragraphs 17 to 19, above) – that in fact are corrosive to its rehabilitative efficacy.

- 28 **Recommendation:** Instead of creating self-defeating inducements for debtors to initiate CRA proceedings, stakeholders should be encouraged at the next stage of the legislative reform process to design a modern and effective liquidation regime that would properly integrate with the CRA, and which would create incentives for the parties to initiate and cooperate in the successful conclusion of CRA proceedings.

CONCLUSION AND NEXT STEPS

- 29 The current draft of the CRA goes some way towards creating a modern corporate rehabilitation framework. Because of the features discussed above, however, it presently risks doing more harm than good. The changes recommended in these Comments are textually minor, yet could fundamentally alter the dynamics of the proposed system. Thus amended, the CRA could constitute the first and significant step towards plugging this important lacuna in the governance of the market. The Bank team stands ready to assist at every stage of this process.
- 30 Enactment of a suitably amended CRA would enable international donors to assist GoP with many of the expertise- and resource-intensive steps in the implementation of the corporate rehabilitation framework. These include, among others:
- 30.1 Formulation of the secondary rules and regulations for detailed implementation of the CRA;
 - 30.2 Programme of capacity-building for the CRB;
 - 30.3 Programme for the training and licensing of IPs;
 - 30.4 Programme of capacity-building for the judiciary;
 - 30.5 Review of associated laws, including those governing non-bankruptcy claim enforcement and land title registration; and
 - 30.6 Plan for three-yearly reviews of the implementation and functioning of the CRA to incorporate lessons from experience.