Rehabilitation Procedures

Objectives of Rehabilitation

The overall economic objective of rehabilitation procedures is to enable a financially distressed enterprise to become a competitive and productive participant in the economy, thereby benefiting not only the stakeholders of the enterprise (owners, creditors, and employees) but also the economy more generally. For a rehabilitation procedure to achieve this objective, it must create incentives for all stakeholders to participate in the proceedings, or—when necessary—prevent some stakeholders from undermining it. Thus, for example, the features of the procedures must be sufficiently attractive to encourage debtors to commence proceedings sufficiently early on in their financial difficulties, thereby increasing the chance of rehabilitation. On the other hand, the rehabilitation procedure must provide sufficient protection to creditors to gain their confidence that it will not be used merely as a device by a nonviable enterprise to delay liquidation, during which time the value of their claims will deteriorate. To ensure that the rehabilitation achieved under the procedure will provide for long-term competitiveness rather than merely a temporary respite, the insolvency law (and other relevant laws) must avoid placing undue constraints on the type of restructuring that can take place. Thus, for example, a rehabilitation plan should be able to provide for debt-for-equity conversions, as well as for the restructuring or forgiveness of debt.

A closely related objective of a rehabilitation procedures is to provide a means by which the value of creditors’ claims can be enhanced or, at least in the case of secured creditors, maintained. To achieve this objective, it is important that the law provide creditors an adequate opportunity to vote on the plan or, in the case of secured creditors, provide for measures that will ensure that their claims and/or property rights are not impaired. Moreover, creditors should also be given the oppor-
tunity to initiate a plan for rehabilitation, either directly or through the administrator.

For some countries, an additional and somewhat specific objective of rehabilitation procedures is to provide enterprise owners a “second chance.” By doing so, an effective rehabilitation procedure encourages the development of an entrepreneurial class. To achieve this objective, a rehabilitation procedure should give the debtor the opportunity to prepare and propose a rehabilitation plan, either directly or through an administrator.

From the perspective of the economic policymaker, another objective of a rehabilitation procedure is to ensure participation of private creditors during a financial crisis, thereby limiting the public cost of crisis resolution. Such participation also forces creditors to bear the costs of the risks they incur, which, in the long term, will generate more stability in the financial system.

Commencement Requirements

As was discussed in the chapter on liquidation, the ability of either the debtor or a creditor to initiate liquidation proceedings on the basis of a general cessation of payments serves a number of important objectives of the liquidation procedure. To what extent do the specific objectives of rehabilitation merit deviation from this condition for purposes of the commencement of rehabilitation proceedings?

Who May File

While it is undisputed that rehabilitation proceedings may be initiated by a debtor, there is less consensus as to whether such proceedings can also be commenced by a creditor. Given that one of the objectives is to provide an opportunity for creditors to enhance the value of their claims through the rehabilitation of the enterprise, it is preferable that the debtor not be given the exclusive authority to initiate such a rehabilitation. As is discussed in greater detail below, the ability of creditors to take the initiative in rehabilitation is also central to the question of whether the creditors can propose a rehabilitation plan, with a number of countries taking the position that the creditors should have an opportunity in this regard since, in many cases, they will be the primary beneficiaries of a successful rehabilitation. If creditors are given such a right, it would seem reasonable—and consistent—to also provide them with the opportunity to commence rehabilitation proceed-
ings; indeed, countries that allow creditors to propose plans normally allow them to commence rehabilitation proceedings.

**Commencement Criterion**

As noted above, one of the objectives of rehabilitation proceedings is to establish a framework that will encourage debtors to address their financial difficulties at an early stage, thereby increasing the chances of an effective rehabilitation. For instance, the way in which the debtor is treated during the proceedings (e.g., the degree of protection it is given and the amount of control it is able to retain) will have a major impact on whether a debtor will be encouraged to take advantage of these procedures. Providing such incentives may be particularly important where an alternative means of encouraging the early utilization of insolvency proceedings—that of penalties imposed on management—is not adopted.

Consistent with this objective, it would seem appropriate to design a commencement criterion that would not require the debtor to wait until it has ceased to make its payments generally (i.e., wait until it is illiquid) before commencing rehabilitation proceedings. Many countries have recognized the merit of this approach, albeit in different ways. In some cases, the rehabilitation procedure does not actually involve the application of a substantive criterion: the debtor may open the proceedings whenever it wishes. In other cases, the law will specify that the debtor may open the proceedings if it envisages that, in the future, it will not be in a position to pay its debts when they come due. Even among countries that have adopted unitary proceedings, such a prospective illiquidity criterion has been introduced for petitions filed by debtors, with the intention that this would encourage debtors to rehabilitate at an earlier stage in their financial difficulties.

It may be argued that such a relaxation of the commencement criterion could invite debtors to abuse the procedure. For example, a debtor that is not in financial difficulty may attempt to commence proceedings, submitting a rehabilitation plan that would enable it to shed a number of onerous obligations (e.g., labor contracts). However, whether such abuse would arise depends primarily on the design of the other elements of the rehabilitation procedure, such as the degree of control over the enterprise that the law permits the debtor to retain once the proceedings commence.

Applying a lower standard for petitions filed by creditors will, however, be more difficult to justify. For example, if the law allows a debtor
to initiate a rehabilitation proceeding on the basis of prospective financial difficulties, it is difficult to envisage how creditors would have adequate information to assess whether the debtor has, in fact, met this standard. As a general matter, it would seem unreasonable for any form of insolvency proceeding (whether it be liquidation or rehabilitation) to be initiated against a debtor’s will unless the creditors can demonstrate that their rights have been impaired.

For the above reasons, it would seem more appropriate that the principal commencement criterion that is applied to creditors with respect to the commencement of a liquidation procedure (general cessation of payments) also be applied in the context of rehabilitation. Indeed, in those cases where a country adopts a two-track approach (i.e., separate liquidation and rehabilitation procedures), it appears that any differences in the commencement criterion would be less attributable to the procedure being utilized, and more attributable to whether the petitioner is the creditor or the debtor. In the case of creditor petitions, the principal criterion one would expect is that of a general cessation of payments, irrespective of which procedure is used. In the case of debtor filings, a more relaxed standard could—at least in practice—be available under both of these procedures. For countries that utilize a unitary proceeding, such a creditor-debtor petition distinction would also be relevant for formulating the commencement criterion. The exception to this approach would be those countries that, for public policy reasons, preclude either a debtor or a creditor from initiating liquidation procedures until a determination is made that rehabilitation is impossible. In those cases, the commencement criterion for a liquidation procedure is not a general cessation of payments but, in effect, a determination that rehabilitation cannot succeed.

Conversion From Liquidation to Rehabilitation

As noted in Chapter 3, in those cases where separate liquidation and rehabilitation procedures are utilized, the right of a creditor to commence liquidation proceedings upon a determination of a general cessation of payments requires the establishment of additional safeguards to ensure that viable companies are still given the opportunity to be rehabilitated. It is therefore important that the insolvency law allow for conversion from liquidation to rehabilitation, to be initiated by the debtor, the administrator, the court, or even the creditors. Some countries permit the debtor to initiate such a conversion as a matter of right—that is, there is no need to demonstrate that there is a likelihood of rehabilitation. However, such laws generally provide for a conver-
sion back to liquidation if, in fact, rehabilitation is not considered feasible. In cases where a conversion to rehabilitation is initiated by the debtor, a shareholders’ resolution may be necessary to forestall abusive filings by management.

**Principal Conclusions**

The law should allow for rehabilitation proceedings to be initiated by the debtor or by a creditor. To encourage a debtor to commence a rehabilitation proceeding early, thereby increasing the chances of a successful rehabilitation, the commencement criterion should not require a demonstration of a general cessation of payments. However, such a demonstration should normally be relied upon in the case of a petition filed by a creditor. The law should also provide for commencement of rehabilitation proceedings through a conversion from liquidation proceedings.

**Consequences of Commencement**

Once liquidation proceedings have commenced, control over the debtor's assets is normally transferred to an independent liquidator and such assets are protected from the actions of creditors. Given the objective of the rehabilitation procedure, to what extent should such an approach be followed in these proceedings?

**The Stay**

In a liquidation procedure, one of the reasons for a stay on the ability of creditors to enforce their legal remedies is to avoid a premature dismemberment of the enterprise, thereby providing an opportunity for the liquidator to maximize the value of the assets of the estate. It should be of no surprise, therefore, that the existence of a stay in the context of a rehabilitation procedure is critical. An enterprise cannot be rehabilitated if it is being dismembered through the attachment of its assets by creditors.

In addition, since the design of a rehabilitation procedure needs to take into consideration the objective of encouraging debtors to attempt to rehabilitate as early as possible, the imposition of a stay on the ability of creditors to enforce legal remedies provides an important incentive for debtors to initiate rehabilitation proceedings. Moreover, since rehabilitation proceedings are also designed to maximize the value of creditor claims through the rehabilitation of the enterprise,
such a stay will not, in and of itself, be inconsistent with the interests of creditors. Most countries provide for such a stay during rehabilitation proceedings and, as will be discussed below, it is important that the stay also apply to secured creditors.

Debtor Control

Upon the commencement of liquidation proceedings, the debtor is normally removed from the operation of the business and comprehensive measures are put in place to protect the assets of the enterprise from actions of the debtor. Indeed, legal title to the assets or control over the assets is transferred from the debtor to the liquidator, who is responsible for the management of the estate for the benefit of the creditors. There is considerable debate about the extent to which rehabilitation proceedings should also result in the displacement of the debtor from the management of the enterprise once rehabilitation proceedings commence, and there is no uniformity regarding the way countries address this issue. If rehabilitation proceedings mirrored liquidation proceedings in terms of the degree of control that the debtor is given over the enterprise, such an approach would clearly undermine any incentive for the debtor to voluntarily make use of rehabilitation proceedings. Moreover, the removal of the debtor's incumbent management in all cases could undermine the possibility of rehabilitation, since management will, in some cases, have the best understanding of the business's operation.

In light of these considerations, one approach is to enable the debtor to retain full control over the operation of the business, with the consequence that the court does not appoint an independent administrator once the proceedings begin. This approach has been followed by the United States, which relies on the concept of “debtor in possession” during the rehabilitation proceedings. Notwithstanding the advantages of this approach, a number of policy considerations need to be borne in mind when contemplating the possibility of allowing the debtor to retain full control during the proceedings.

The first consideration relates to the type of incentives such an approach may create. As noted earlier, if a debtor perceives that it has everything to gain (the stay on creditors) but nothing to lose (no loss in control in the business), it may be tempted to utilize the rehabilitation procedures when rehabilitation is clearly not possible. Specifically, a debtor that is no longer viable may attempt to use rehabilitation proceedings solely to delay the inevitable, with the consequence that the assets of the debtor continue to be dissipated. Accordingly, instead of
promoting rehabilitation, such a system may merely encourage debtors to delay liquidation to the prejudice of creditors.

A second disadvantage with a system that enables the debtor to retain full control is that, even when the enterprise can be rehabilitated, there is the possibility that the debtor's management may act irresponsibly and, in some cases, even fraudulently during this period. Not only will this undermine the possibility of rehabilitation, but it will also prejudice interests of creditors in the event of liquidation.

In some respects, the above problems can be mitigated by providing for a mechanism that allows the court (either on its own motion or at the request of the creditors) to convert the proceedings to liquidation proceedings when there is no reasonable likelihood of rehabilitation or when there is evidence that the debtor is not acting responsibly and in good faith. The shortcoming of this approach is that it places considerable emphasis on the exercise of discretion by the judiciary. Such reliance may not prove to be effective, particularly if the capacity of the judiciary is limited.

In light of the above considerations, an alternative approach is for the procedure to mandate the establishment of a “power-sharing” arrangement between the debtor and the administrator. Under this approach, which is followed by a number of countries, although the debtor continues to operate the business of the company on a day-to-day basis and is given an opportunity to prepare a rehabilitation plan (discussed below), its activities are supervised by a court-appointed administrator, who is also responsible for approving all (or the most significant) transactions conducted by the debtor. Not only does such an approach attempt to establish a better balance of incentives for the debtor that will reduce the chance of abuse (loss of control but retention of an opportunity to rehabilitate), it also safeguards the interests of the creditors during the proceedings, since it enables an independent party to obtain sufficient information to form an assessment of viability and also limits the ability of the debtor to dissipate its assets. While the law can allow the judiciary to determine the scope of the administrator's powers in individual cases, the grant of too broad a discretion will create its own risks and could undermine the effectiveness of such a power-sharing arrangement. Moreover, without relatively precise rules regarding the division of authority, all parties in interest will be uncertain as to how the rehabilitation proceedings will operate. However, if the debtor demonstrates gross mismanagement or has squandered or misappropriated the assets, the court should have the authority, on its own motion or on that of the administrator or the creditors, to displace the debtor completely.
Principal Conclusions

It is important that the rehabilitation procedure provide for a stay on the ability of creditors to enforce legal remedies against the assets of the debtor once rehabilitation procedures are commenced. The scope of the stay should be at least as comprehensive as the minimum requirements outlined under Liquidation Procedures, discussed above. As is discussed below, the stay should also apply to secured creditors.

Total displacement of the debtor from the management of the enterprise will eliminate the incentive for debtors to avail themselves of rehabilitation procedures at an early stage and may undermine the chances of successful rehabilitation. On the other hand, allowing the debtor to retain full control over the enterprise creates a number of risks, including that the assets of the debtor will be dissipated to the detriment of creditors. It is therefore preferable for the law to provide for an arrangement whereby the debtor continues to operate the enterprise on a day-to-day basis, but under the close supervision of an independent, court-appointed administrator. However, the court should have the authority to displace the debtor's management entirely when there is evidence of gross mismanagement or misappropriation of assets.

Transition to Liquidation

There are risks that rehabilitation proceedings may be abused by the debtor and, in these circumstances, it is important that the law provide for a mechanism to convert the rehabilitation proceedings into liquidation. In designing the conversion mechanism, the administrator must be given a central role to play in this process. Other than the debtor's management itself, it is usually the administrator who has the greatest knowledge of the debtor's business, and so often learns at an early stage whether or not the debtor's business is viable. Accordingly, it would seem reasonable to give the administrator the power to recommend to the court that the proceedings be converted if it determines either that there is no reasonable likelihood of viability or that the debtor is not cooperating with the administrator (withholding information, etc.) or is otherwise acting in bad faith (e.g., fraudulent transfers). In addition, it is reasonable for the creditors, perhaps through the creditors' committee, to have standing to request the court to convert the proceedings on similar grounds. Finally, this power can also be given to the court, which would be able to convert the proceedings on its own motion.
The effective implementation of the above safeguard will ultimately depend on the quality of the judiciary and, in some countries, this may prove problematic. One alternative approach would be to supplement the above safeguard through a provision that enables creditors to actually convert the proceedings on the basis of their own vote at any time (or after a specified initial period), thereby eliminating the role of the court in this process. The difficulty with this approach is that, unless a very high majority requirement is relied upon, it may actually give too much power to creditors, who may merely use this authority to convert the proceedings even before the debtor has had an opportunity to prepare a plan.

Another alternative is to supplement the ability of the court to convert the proceedings (on the recommendation of either the administrator or the creditors) with time limits that are actually prescribed in the law itself. Following this approach, a rehabilitation proceeding would not be able to continue beyond a prescribed period (e.g., 120 days from the date of commencement) and the court would not be given the authority to extend this period. While such an approach runs the risk of imposing constraints that may prove unwarranted in certain cases, it has the advantage of providing all participants with a "bright line" that acts as a catalyst for the preparation and approval of the plan. A variation of this approach that would give greater leverage to the creditors (and would avoid the outside deadline being perceived as a target) is the establishment of an initial time period (perhaps 60 or 90 days) that could be extended only by a vote of the creditors (perhaps on the basis of a report by the administrator regarding the feasibility of rehabilitation), but which, in any event, could not exceed an outside time period (perhaps 120 days).

**Principal Conclusions**

To ensure that rehabilitation proceedings are not abused by the debtor, there must be provisions that allow for the conversion of rehabilitation proceedings to liquidation proceedings. Such provisions should include a mechanism that allows the court to immediately convert the proceedings on its own motion, or upon a recommendation by the administrator or the creditors, when it is clear that rehabilitation is not feasible or when there is evidence that the debtor is acting in bad faith. To strengthen such a conversion mechanism, countries should also consider specifying in the law that rehabilitation proceedings may not, under any circumstances, exceed a specified period. Such time limits may be of particular importance in countries where the capacity of the judiciary is limited.
Proceedings: The Plan

Identifying the Preparer

For a rehabilitation procedure to achieve the objectives set forth at the beginning of this chapter, the debtor must be given some opportunity to prepare the rehabilitation plan. If the debtor is denied this opportunity, it will have less of an incentive to utilize the rehabilitation procedure. Moreover, given that—at least for some countries—one of the objectives of a rehabilitation procedure is to foster an entrepreneurial class, denying the debtor the opportunity to prepare a plan (which will presumably involve the debtor retaining some equity and/or some management role) would undermine this objective because it would effectively deny the debtor the possibility of having a "second chance." Finally, and perhaps most important, since the debtor may be in the best position to determine what steps are necessary to make the enterprise viable again, enabling it to prepare the plan may enhance the chances of successful rehabilitation.

A subsequent issue is whether the debtor should be given the exclusive opportunity to prepare the plan and, if not, who else should have that opportunity, and when. Since a plan will be successful only if it is approved by the requisite majority of creditors, there is always a risk that rehabilitation will fail, not because the enterprise is no longer viable but because the plan presented by the debtor is not acceptable. For example, creditors may only wish to approve a plan that deprives the debtor's shareholders of a controlling equity interest (or even all equity interest) in the enterprise and/or may also deprive the incumbent management of any responsibilities. If the debtor is given the exclusive opportunity to prepare the plan and refuses to consider such an arrangement, the rehabilitation will fail, to the detriment of the creditors, the employees of the enterprise, and the economy in general.

Accordingly, to increase the possibility that an enterprise will be rehabilitated, it may be necessary not to give the debtor the exclusive opportunity to propose a plan. One approach that attempts to maintain some incentive for the debtor to utilize the rehabilitation procedure is to provide the debtor with an initial period in which it has the exclusive privilege to propose a plan and, at the expiration of this period, the creditors may also propose a plan. This can be achieved through reliance on a creditors' committee, the features of which are discussed in Chapter 5. If such an approach is followed, limiting the court's ability to extend this exclusivity period may be worth consideration. As with the discus-
sion regarding the conversion from rehabilitation to liquidation, while the use of firm time limits in the law might sometimes lead to arbitrary results, it will increase confidence in the procedure in countries where the capacity of the judiciary is limited. In practice, the mere possibility of a creditor plan will encourage the debtor to quickly propose a plan that has a reasonable chance of garnering creditor support. As with many other aspects of the rehabilitation procedure, the option of a creditor plan provides the necessary leverage to one participant that will persuade the other participant to compromise.

Once a debtor has exhausted its opportunity to propose a plan, it may be reasonable to give the administrator a chance to do so, either as an alternative or as a supplement to a creditor-proposed plan. Given that it will have had the opportunity to become knowledgeable about the enterprise, it will be well placed to determine what measures are necessary for viability. If the administrator is to be given this authority, however, it is important that it have the expertise to engage in this exercise, which requires highly specialized skills.

Whether the administrator or the creditors, or both, are given the authority to propose a plan may, in fact, be of less significance in circumstances where approval by the requisite majority of creditors is a necessary condition for the effectiveness of the plan: when designing the plan, the administrator will clearly need to ensure that whatever is proposed will be acceptable to creditors. However, in circumstances where creditor approval is not necessary or can be overruled by the court, the ability of the administrator to propose a plan may have important implications as to its content.

In addition, a few countries provide for the court's consideration of opinions on the plan from third parties (such as governmental agencies and labor unions). Such a procedure has the potential to lengthen the duration of the proceedings and will need to be carefully monitored by the court, perhaps through the imposition of time limits.

While the law may give a number of parties in interest the opportunity to propose a plan, it is generally recommended to avoid having a number of plans proposed simultaneously. Such a multiplicity of plans (including a multiplicity of creditor plans) will only complicate the negotiating process and undermine the efficiency of the rehabilitation proceedings.

Principal Conclusions

To encourage debtors to utilize rehabilitation procedures, the law should normally provide the debtor with the opportunity to prepare a
plan. This opportunity should not be given exclusively to the debtor. The administrator and/or the creditors should also be given the opportunity to prepare a plan, possibly after the expiration of an initial "exclusivity" period. For purposes of enhancing the efficiency and effectiveness of the negotiation process, it is preferable that the law limit the ability of different parties to propose their respective plans at the same time.

Content

Virtually all countries have laws requiring, to a greater or lesser extent, that the rehabilitation plan adequately and clearly disclose to all parties information regarding both the financial condition of the company and the transformation of legal rights being proposed by the proponent of the plan. (A few countries also impose substantive limits on the terms of a reorganization plan.) Beyond this, however, the question of what should or should not be included in a rehabilitation plan is difficult to discuss in isolation of issues relating to the approval of the plan and effect of approval. As a general rule, to the extent that a plan can be approved and enforced upon dissenting creditors, the law will need to ensure that the content of the plan provides adequate protection for such dissenting creditors.

Whether or not other limits should exist regarding the nature of the plan also requires an assessment of the appropriateness of other laws. For example, to the extent that the company law precludes debt-for-equity conversions, a plan that provides for such a conversion could not be approved. Since debt-for-equity conversion can be an important feature of rehabilitation, it will be necessary to eliminate this prohibition at least in the context of a rehabilitation proceeding: if features of the plan are limited to debt forgiveness or the lengthening of maturities, the plan may not receive adequate support from the creditors and, perhaps even more importantly, may not result in effective rehabilitation.7

The policy considerations arising from the application of other laws, however, may be more complicated. While authorizing debt-for-equity conversions may not be controversial, the removal of limits on foreign investment, particularly foreign direct investment, may well be. Such a

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7 In its recent work, the IMF has found that, in some countries, the company law restricts debt-for-equity conversions, even when shareholder consent to such a conversion has been given.
restriction may limit the possibility of effective rehabilitation in circumstances where many of the creditors are nonresidents. On the other hand, in financial crises where the entire corporate sector is in stress, the authorities may be concerned that the rehabilitation procedure will become a device by which foreign creditors may acquire a controlling interest in nationally important industries. Similarly, the flexibility that a plan proponent will have with respect to the treatment of employees under the relevant labor law may be limited, unless these rules are explicitly derogated from in the insolvency law. While it is generally accepted that the terms of an employment agreement approved under a plan should not deviate from the standards established under the labor law, a more difficult question is whether, for example, a plan can effectively modify an existing collective bargaining agreement.

**Principal Conclusions**

With respect to the permissible contents of a plan, an insolvency law should normally impose only those constraints necessary to protect creditors that may be bound by the terms of a plan that impairs their rights without their consent.

**Approval and Effect**

Designing the rules regarding the approval and effect of the plan requires balancing a number of competing considerations. On the one hand, it is important that these rules provide a way to impose a rehabilitation plan upon a minority of creditors. Such a mechanism will not only increase the chances of success of rehabilitation, but will also provide a means by which creditors can be “bailed into” the resolution of financial crises. On the other hand, to the extent that the approval procedure results in a significant impairment of creditors’ claims without their consent, such a procedure runs the risk of undermining the willingness of creditors to provide credit in the future, which would be to the detriment of the economy in general. Any discussion of issues relating to the approval and effect of the plan is inextricably linked to issues of the plan’s content and, in circumstances where a plan can be imposed on dissenting creditors, the law may need to ensure that the interests of these creditors are adequately protected.

**Secured and Priority Claims**

In many cases, secured claims will represent a significant portion of the value of the debt owed by the debtor. To the extent that the law
ensures—as is the case with traditional “composition” plans—that an approved plan will in no way preclude secured creditors from exercising their rights, there is generally no need to give secured creditors the right to vote, since their interests will not be impaired by the plan. Priority creditors are treated similarly under such a composition plan. These creditors (including, for example, post-petition creditors and—depending on the law—employees) do not vote on the plan but, upon the plan’s approval, they are entitled to receive full payment on their claims; the plan cannot impair the value of their claims.

The limitation of the above “composition” approach is that it effectively reduces the chances for a successful rehabilitation. For example, in the case of a secured creditor, the assets securing the claim may be vital to the success of the rehabilitation plan. Accordingly, unless the secured creditor is bound by the plan or the plan provides for full satisfaction of the secured creditor’s claims, the exercise of the creditor’s rights may render the plan’s implementation infeasible. Similarly, in certain circumstances, the only way in which a rehabilitation plan may succeed is if priority creditors receive less than the full value of their claims immediately upon the plan’s approval.

One approach that has been adopted by some countries to address this problem is to allow for secured creditors and priority creditors to vote as separate classes on a plan that would otherwise impair the value of their claims. The creation of separate classes is considered necessary since the nature of their rights under liquidation differ from those of unsecured creditors, and they accordingly also have different interests. To the extent that majority support is obtained from each of these classes, all secured creditors and priority creditors would be bound to the terms of the plan. In these circumstances, the law requires that any dissenting creditors be entitled to receive at least as much as they would have received under liquidation. A majority of secured creditors may be willing to accept an impairment in the value of their claims in circumstances where they have a long-term interest in the continuation of the enterprise (e.g., financial institutions), and such continuation requires the adoption of a plan that provides them with less than immediate cash payment on their collateral. Similarly, employees that are priority creditors may very well be willing to receive less than full payment on back wages if this is necessary to ensure the survival of the enterprise.

**General Unsecured Creditors**

Even if the law does not provide for voting by secured or priority creditors, it must provide an effective means by which general unse-
cured creditors can vote on a plan. A number of mechanisms may be used to increase the chance that a rehabilitation plan will be approved by these creditors.

**Majorities.** Irrespective of whether the law provides for voting of classes of creditors, all insolvency laws must set forth rules that identify the minimum threshold of support of general unsecured creditors required to bind such creditors, and the voting procedures that are to be used to determine this support. Various majorities can be envisaged (two-thirds or three-fourths of the total value of unsecured claims), with the chances of approval increasing as the minimum percentage of required support goes down. One issue that needs to be addressed in this regard is whether calculation of votes should be based exclusively on the percentage of the value of the debt that supports the plan or whether it should also take into consideration the number of creditors that are supportive. For example, the law may require that the plan must be supported by both (i) two-thirds of the value of the debt, and (ii) one-half of the creditors in number. While such a two-tiered voting requirement will effectively raise the hurdle for approval, it may be justified on the basis of the principle that the insolvency law is designed to be a collective proceeding: if a single creditor holds a majority of the value of the debt, this rule prevents that creditor from imposing its support of the plan against the will of all the other creditors.

Regarding voting procedure, many countries have found it preferable to calculate the percentage of support on the basis of the percentage of those creditors that actually participate in the voting. Absentees are considered to have little interest in the proceedings, normally because their claims are small. To the extent such an approach is relied upon, it is critical that there be adequate notice provisions and that these notice requirements be effectively implemented. This is of particular importance when many of the creditors are nonresidents.

**Classes.** Some countries that have established classes for secured creditors and priority creditors also provide for the division of unsecured creditors into different classes.\(^8\) The creation of such classes is designed to enhance the prospects of rehabilitation in at least two respects. First, as in the case of secured and priority creditors, such classes are a useful way to identify the varying economic interests of unsecured creditors and, therefore, provide an appropriate framework.

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\(^8\) Some countries also allow for the creation of different classes of secured creditors on the basis that, depending on the nature of their claims, they may have different economic interests from each other.
for structuring the terms of the plan. Experience demonstrates that, as with secured and priority creditors, some unsecured creditors have different interests in terms of what they feel they need to receive under the plan. For example, while certain unsecured creditors may only be interested in immediate cash payments (e.g., discontinued vendors), other creditors that have a long-term interest in maintaining a relationship with the enterprise (e.g., ongoing trade creditors) may be willing to accept deferred payment or equity. The creation of classes on the basis of these interests and the structuring of the plan to accommodate them provide a greater chance that a rehabilitation plan will receive adequate support.

The second way in which the creation of classes of unsecured creditors enhances the chances of rehabilitation is that it provides a means for the court to utilize the requisite majority support of one class to make the plan binding on other classes, which do not support the plan. This is discussed more generally below.

"Cram-down" Authority. A few countries that provide for voting by secured and priority creditors and for the creation of different classes of unsecured creditors also include a mechanism that will enable the support of one class to make the plan binding on other classes (including classes of secured creditors and priority creditors) without their consent. Such a mechanism, which is designed to further enhance the chances of rehabilitation, is often referred to as a "cram-down" provision. If such a mechanism is relied upon (the merits are discussed below), it is important that protection be provided to the dissenting class to ensure that the priority rules that are established in liquidation procedures are respected. In particular, in addition to providing for the minimum level of protection for each dissenting creditor (which ensures that a creditor receives at least as much as it would have received under liquidation), discussed earlier, laws that seek to protect the relative rights of "crammed-down" classes of creditors also apply what is known as the "absolute priority rule." Under this rule, a dissenting class of creditors may not be forced to receive less than the full value of its claims if creditors of a junior class receive any value.9

The creation of classes and the application of "cram-down" rules complicate both the law and its application by the court and the administrator. Where the institutional infrastructure is relatively well developed, such complexity may be merited, especially given the lim-

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9 For this purpose, seniority is based on the ranking applicable in liquidation (secured creditors, priority creditors, general unsecured creditors, subordinated creditors).

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itations of the traditional "composition" model, which can severely limit the opportunities for rehabilitation. However, where the capacity of the institutional infrastructure is limited, the inclusion of such rules will require careful consideration given that, among other things, their application may require the exercise of considerable discretion on economic issues. For example, the creation of separate classes of unsecured creditors will often require a categorization of such creditors by the court on the basis of their economic interests. Where creditors do not have confidence in the ability of the institutional infrastructure to exercise this discretion in an informed, independent, and predictable manner, such rules may actually undermine creditor confidence.

**Shareholders.** Some laws provide for the approval of plans by shareholders of the debtor enterprise, at least where the corporate form, the capital structure or the membership will be affected by the plan. In addition, when the debtor's management proposes a plan, the terms of the plan may already have been approved by the shareholders. Depending on the type of enterprise in question (publicly traded or privately held), this may be required under the terms of the constitutive instrument of the enterprise. This is particularly the case when the plan involves debt-for-equity conversions, either through the transfer of existing shares or through the issuance of new shares. However, in circumstances where the law permits creditors or an administrator to propose a plan, and such a plan contemplates a debt-for-equity conversion, some countries allow this plan to be approved over the objection of the shareholders, irrespective of the terms of the constitutive instrument of the enterprise. As a result, such plans can result in existing shareholders being entirely displaced in the new enterprise without their consent.

**Court Approval.** As has been discussed above, many countries enable the courts to play an active role in "binding in" creditors by making the plan enforceable upon a class of creditors in circumstances where they have not approved the plan. Conversely, in cases where the plan has been approved by the requisite majority of creditors, the court will normally have the authority to reject the plan on the grounds that the interests of dissenting creditors have not been adequately protected (because, for example, they have not received as much as they would have received in liquidation) or if there is evidence of fraud in the approval process. In addition, some laws may give the court the authority to reject a plan on the grounds that it is not feasible. This may be justified, for example, where secured creditors are not bound by the plan but the plan does not provide for full satisfaction of the secured claims of these creditors. In these cases, the court may reject the plan if it considers that
secured creditors will exercise their rights against the collateral and that such an event will render the plan nonviable. The risk of this occurring is quite limited, however, if a qualified and independent administrator has been involved in the plan’s preparation and approval. In such circumstances, the court would normally be expected to approve a plan that has been approved by the requisite majority of creditors.

After the approval of the plan by the court, several countries permit the court to authorize continued supervision of the affairs of the debtor, to varying degrees, by a supervisor or administrator after the confirmation of the plan.

**Principal Conclusions**

It is important for the law to provide a means by which a plan can be imposed upon a minority of dissenting creditors while providing a mechanism that protects the interests of such creditors if their interests are impaired. At a minimum, a dissenting creditor should not be bound by a plan if it does not provide the creditor with at least as much as it would have received under liquidation.

To enhance the chances of rehabilitation, consideration can be given to allowing secured creditors and priority creditors to vote—but only as separate classes—and to enable the court to divide unsecured creditors with different economic interests into different classes. In addition, consideration can also be given to providing the court the authority to use the support of one class to make the plan binding on other classes. If this approach is adopted, rules such as the absolute priority rule should be applied so as to ensure that the dissenting classes of creditors are treated equitably in terms of the priority ranking that applies in liquidation. The implementation of such an approach normally requires the exercise of discretion by the institutional infrastructure. Accordingly, when the capacity of the institutional infrastructure is limited, the establishment of classes and cram-down authority may undermine confidence in the law and, therefore, its inclusion requires careful consideration.

If the requisite majority of creditors has approved the plan and the plan is also endorsed by the administrator, it is recommended that the law only give the court the authority to reject the plan in limited circumstances, such as where dissenting creditors have not been treated fairly or where there is evidence of fraud in the voting process.
Chapter 3 identified a number of issues that need to be addressed when considering the design of effective liquidation procedures. These issues are all also relevant in rehabilitation procedures. If they are resolved in a manner that enables an administrator to maximize the value of the assets of the estate prior to liquidation, this will increase the chances of an effective rehabilitation. This section summarizes those issues that merit special attention in the context of rehabilitation. It also discusses issues relating to the treatment of post-commencement financing, which is critical to an effective rehabilitation proceeding, and briefly discusses the benefits of pre-negotiated and prepackaged bankruptcy procedures.

**Treatment of Encumbered Assets and Secured Creditors**

A rehabilitation procedure will not be effective unless it provides for a stay on the ability of secured creditors to exercise their rights with respect to the encumbered assets. Such a stay ensures that continuation of the enterprise is not prevented by the ability of a secured creditor to dismember the enterprise. While a stay under the rehabilitation procedure is of considerable importance and, unlike in the case of liquidation, should be in place throughout the proceedings, this does not diminish the need to ensure that the interests of secured creditors are adequately protected during the period of the stay. Although a liquidation proceeding will often normally run its course relatively quickly, a rehabilitation proceeding may be protracted. During this period, the value of the secured creditor’s collateral could depreciate significantly and the ability of the administrator to provide adequate protection may become more limited. In these circumstances, it is imperative that the secured creditor be given an opportunity to request relief from the stay. The imposition of time limits with respect to the duration of the rehabilitation proceedings may also be of assistance in this regard.

**Principal Conclusions**

In the context of a rehabilitation proceeding, a stay on the ability of secured creditors to exercise their rights against the collateral during the entire period of the proceedings is critical. However, this does not reduce the need to provide such creditors with adequate protection (including relief from the stay when such protection cannot be given) and, in that context, this provides an additional reason for imposing time limits on the duration of the proceedings.
Avoidance of Pre-Commencement Transfers and Transactions

Avoidance powers will be of considerable benefit to an enterprise that is utilizing the rehabilitation procedure. However, the considerations identified in Chapter 3 regarding the drawbacks of avoidance powers are also of relevance when considering the costs and benefits of these powers in rehabilitation procedures. One issue peculiar to rehabilitation arises when the debtor retains total control over the operation of the enterprise during the rehabilitation proceedings and an administrator is not appointed. In these circumstances, creditors may need to be given the power to request the court to avoid pre-commencement transactions since the debtor may be reluctant to avoid a transaction where it has a conflict of interest—because, for example, the transfer is made to an insider. This may not be satisfactory, however, and argues further for the appointment of an administrator in the context of rehabilitation, particularly if there has been considerable lending among related entities and allegations of fraud taking place prior to the commencement of the insolvency procedure.

Principal Conclusions

The existence of avoidance provisions is a critical component of rehabilitation proceedings. The application of such proceedings may be more effective in circumstances where an independent administrator has been appointed.

Treatment of Contracts

As noted in Chapter 3, a number of particularly difficult policy choices need to be made when assessing the treatment of contracts under a liquidation procedure, particularly in the area of continuation. In some respects, these choices become even more stark in the context of rehabilitation. Specifically, if a country does not provide for the nullification of contract termination clauses upon the commencement of rehabilitation, it will be more difficult for the enterprise to rehabilitate if the contracts in question are critical, such as lease agreements. With respect to the powers to discontinue contracts, the treatment of labor contracts will take on particular importance. In liquidation, the rejection of labor contracts is not particularly relevant, unless the enterprise is being sold as a going concern. In rehabilitation, however, the ability of the debtor to terminate such contracts may, in and of itself, provide a motive for commencing rehabilitation proceedings, and countries may find it necessary to impose limits in this respect.
Principal Conclusions

The policy choices regarding the breadth of the power to interfere with contractual terms become particularly important in the context of rehabilitation procedures. Broad powers to continue or terminate contracts will significantly enhance the possibility of rehabilitation, but some countries may be concerned that the aggressive application of this power may undermine predictability. As under liquidation, if the administrator is given the authority to nullify termination provisions and/or the law does not provide for set-off of independent monetary claims, exceptions to these rules should be made to allow for the netting of financial contracts.

Post-Commencement Financing

In liquidation proceedings, it may be necessary to continue to operate the business for a temporary period and, for that purpose, the liquidator may need to obtain credit, which would be treated as an administrative expense. The continued operation of the business is critical for rehabilitation and it is therefore important that the law contain provisions that empower the administrator to obtain credit for that purpose. The central issue is the breadth of that power or, more specifically, the range of inducements that the administrator can offer a potential creditor as a means of obtaining credit.

It is generally accepted that the administrator can obtain unsecured credit without creditor or court approval, and that such credit will be treated as an administrative expense. In cases where the credit is not made in the ordinary course of business, some countries will require approval by the court or the creditors. Many countries also allow the administrator to obtain credit by giving a security interest on unencumbered property or a second-priority security interest on encumbered property. In addition, if these inducements are not sufficient (or are not available) to facilitate the provision of credit, some countries allow the administrator to give a creditor a “super” administrative priority; that is, a priority over other administrative creditors. An extreme approach is one that allows an administrator, when it is unable to otherwise obtain credit, to grant a post-petition creditor a “super” priority security interest, namely, a priority that is senior to existing liens. However, such an approach risks hampering the extension of secured credit and, therefore, is not recommended.
Principal Conclusions

Given the importance of new financing for an enterprise during rehabilitation, it is important that the law give the administrator adequate powers to obtain such financing. This should normally include the power to give a post-petition creditor administrative priority or a security interest on unencumbered assets. Where necessary, consideration may also be given to granting a creditor priority over other administrative creditors. In contrast, permitting the granting of priority over secured creditors is not recommended as this runs the risk of severely undermining the value of security.

Prepackaged and Pre-Negotiated Rehabilitation Plans

As a means of enhancing the efficiency of the rehabilitation process, some countries permit the approval of “prepackaged” rehabilitation plans. In these cases, both the negotiation and voting for the plan take place prior to commencement of the rehabilitation procedure and court approval is sought immediately upon commencement. As a variation to this approach, the plan can be negotiated prior to commencement but formal voting takes place once the proceedings have commenced. While the former approach will normally require the adoption of specific rules (either in the legislation or in the regulations), the latter will not.

The advantages of prepackaged and pre-negotiated plans are important. In effect, this technique draws upon the most significant advantage of a court-approved rehabilitation—the ability to impose a plan on dissenting creditors—but, at the same time, seeks to benefit from the efficiency of the informal process. From a debtor’s perspective, it provides certainty with respect to its retention of control of the enterprise and, overall, minimizes the disruption of the business. In circumstances where the capacity of the institutional infrastructure is limited, shortening the amount of time spent in formal proceedings is particularly important. Of course, the most significant limitation of this technique is that it does not provide the debtor with any protection (i.e., the stay) while it conducts negotiations with its creditors.

Principal Conclusions

To enhance the efficiency of the rehabilitation process, the law should allow for the approval by the court of rehabilitation plans that have been voted upon (or, at a minimum, negotiated) before commencement of the rehabilitation proceedings.