Corporate Reorganizations: Debating the Adoption of Pakistan's Draft Corporate Rehabilitation Act 2004

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For over a decade, the Securities and Exchange Commission of Pakistan ('SECP') has been soliciting proposals and comments on iterations of a Draft Corporate Rehabilitation Act ('DCRA') that aims to provide companies facing bankruptcy with a legislative scheme to restructure their debts in order to return to productivity. The 2004 version of the DCRA, which until very recently was the most current form of the Act, attempted to enact the functional equivalent of Chapter 11 of the US Bankruptcy Code in Pakistan. Though many material aspects of the proposal have been finally shelved,[1] the current draft being considered by the parliament still retains some worrying features. Further, and more materially, the 2004 DCRA raised some interesting broader questions related to the viability and desirability of legal transplantation in the context of corporate law generally.

To examine some of these inquires, I examine: i) whether the enactment of the 2004 DCRA would have sufficiently emulated the benefits of Chapter 11 proceedings as conducted in the US; and ii) whether Pakistan's institutions are sufficiently similar to the US in order to sustain Chapter 11-type proceedings. In doing so, I posit: i) that the nature of Chapter 11 proceedings and its attempt to mitigate particular kinds of conflicts of interests are ill-suited to Pakistani firms; ii) that Pakistan, in fact, does not possess the necessary institutions to sustain the benefits of such a regime; and iii) that an open-market based approach to reorganization provides better answers.

Further, by comparing the 2004 DCRA and Chapter 11 reorganization, I also hope to discuss whether conventional corporate governance appropriately caters for the specific nature of financially distressed companies in Pakistan. A lot of the work on corporate governance has focused on the management of conflicts of interests in corporations that are going concerns. However, there is comparatively sparse academic

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[1] One new proposal minimizes the participation of courts in the restructuring process, and instead hands the reigns over to creditors <https://www.secp.gov.pk/document/corporate-rehabilitation-act-2016/> accessed 24 January 2018. On the other hand, the version of the Act currently on the floor of parliament, and already adopted by the Senate, envisions a court-driven process <http://www.senate.gov.pk/uploads/documents/ 1484902917_815.pdf> accessed 28 January 2018.

literature on what happens to these conflicts when the company is failing, i.e. moving towards liquidation or reorganization. Insolvency laws impose a new paradigm of regulation and structural constraints on the actions of corporate stakeholders, and it is important to understand how these interests are realigned. This paper is an attempt to begin a discussion on the matter.

Structurally, I first briefly discuss the nature of Chapter 11 proceedings under the US Bankruptcy Code and the ways in which the Code aims to structure and mitigate the conflicts of interests arising between creditors and shareholders. I subsequently move on to examine the framework of the 2004 DCRA, the extent to which it emulated Chapter 11 proceedings, and whether or not this made it a viable scheme for the Pakistani market. Finally, I suggest alternative strategies available, and give my opinion on whether a market-based approach to reorganization can prove more successful.

Reorganization under Chapter 11 of the US Bankruptcy Code

Insolvency proceedings are largely a settlement of affairs between shareholders and creditors. Once a business venture (in the form of a company) has proven to be financially unviable, the creditors are interested in recovering what they can of their investment, while shareholders are interested in preserving their equity. Needless to say, the classical third category of conflict of interests (arising between 'insiders' and 'outsiders') is most prominently evident in such situations.

Chapter 11 reorganization is a voluntary process for failing companies. Reorganization allows a debtor company to obtain stays on its obligations to its creditors, and invites the intervention of Bankruptcy Courts to act as mediators as the debtor company renegotiates its liabilities, while at the same time attempting to restructure its capital to make the company financially viable again.[2] There are two major components of a Chapter 11 reorganization: the Business Plan[3] and the Reorganization Plan.[4]

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[2] Lynn M. LoPucki and William C. Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 141 *University of Pennsylvania Law Review* 669.

[3] The Business Plan is the proposal of the Debtor-in-Possession to the Court demonstrating the measures and strategies the management plans to adopt to proceed with the business of the company once its reorganization is confirmed. Its purpose is to demonstrate to the Court that the company can sustain financially viable operations.

[4] The Reorganization Plan is also proposed by the Debtor-in-Possession.

Chapter 11 reorganizations are substantially pro-debtor; they include the creation of entitlements that water down the secured interests of creditors, suspend personal guarantees, and create the right to write-offs of unsustainable debt. Beyond this, the debtor company has the first right to file a Reorganization Plan, usually during a period of exclusivity, and the creditors seldom oppose these plans.[5] This is not to say that the ownership and control paradigm of the company remains the same as it was before the filing of Chapter 11 proceedings; the supervision of the company is either handed over to the US Trustee, or the existing management, or a debtor-in-possession. A significant benefit that the Chapter 11 route confers on the debtor company is that it reduces the transaction costs of negotiating settlements with creditors, especially in the cases of big, public companies. In certain circumstances, even the Reorganization Plans not agreed to by a majority of creditors can be implemented.[6]

This is not to suggest that the creditors have no protections under Chapter 11. Perhaps the most important limitation placed on the ability of shareholders to influence the Business Plan and the Reorganization Plan is the court's right to enjoin shareholder meetings when they result in 'clear abuses'.[7] This rule is in place to prevent the replacement of the management in order to leverage their bargaining position. Further, all creditors have a right of appearance before the court,[8] and can ask for relief against the automatic stay, or that the proceedings be converted to Chapter 7 Insolvency. The responsibility of determining whether or not to accept the restructuring plan falls on the shoulders of the Bankruptcy Court. Further, the creditor committees have a significant role in steering both the Reorganization Plan and the Business Plan. The biggest impediment to their interests, of course, remains the automatic stay of recovery proceedings and the suspension of their ability to recover as soon as a filing is made under Chapter 11. This includes the claims of both secured lenders as well as trade creditors. In addition to this, the absolute priority rule is also suspended, with senior creditors gaining priority over junior creditors during recovery.

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[5] 'Structural Option for Developing the Corporate Rehabilitation Law of Pakistan' Advisory Opinion to the Security and Exchange Commission of Pakistan (SECP) <http://www.secp.gov.pk/Reports/2015/ConceptNote_ CorporateRehabilitationLaw_20150420.pdf> accessed 17 December 2015.

[6] This is known as a 'cramdown'. It allows courts to employ a standard of fairness and equity to selectively modify the terms of loans in order to improve the outcomes for all parties involved.

[7] Mark E. Budnitz, 'Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, Or Should the Meeting Be Canceled Altogether?' (1990) 58 *George Washington Law Review* 1214.

[8] 11 U.S.C. § 1109 (b).

Numerous institutional complementarities enable Chapter 11 proceedings to have some degree of viability, the most important of which is the existence of specialized Bankruptcy Courts, which possess a high level of judicial sophistication to operate successfully within the complex statutory scheme laid out by the Bankruptcy Code.[9] Despite this, the activism of judges in Chapter 11 Reorganization cases has little correlation with the success of reorganization.[10] Further, owing to the cumbersome process, and the need for constant judicial intervention/approval, the average time span for Chapter 11 proceedings to conclude is about 4-5 years.[11]

Reconciling Conflicts of Interests: The Creditors or the Shareholders?

Reorganization emphasizes the disparity between the interests of shareholders, creditors, and management in financially distressed companies. Creditors are interested in securing the repayment of their dues; and, in the particular circumstances of firms that have filed for insolvency or reorganization, they stand to lose the most because they bear the brunt of the risk when it comes to new business ventures. Shareholders, on the other hand, bare lesser risk, particularly under Chapter 11 proceedings, owing to the termination of personal guarantees and the stay on recovery proceedings. It is in their interest for the company to opt for riskier investments that can revive the fortunes of the firm/company. For these reasons, the most important issues concerning governance and management that tend to surface concern the relative autonomy of managers to make decisions during a reorganization, the risk the firm ought to undertake during a reorganization, and for whose benefit should the management make decisions.[12]

Owing to the termination of most contractual obligations upon the filing of Chapter 11 reorganization, most management compensation arrangements that attempt to tie shareholder interest to management self-interest become non-binding, and can be rejected.[13] As a result, the post-filing process creates an opportunity for creditors and other stakeholders to capture management loyalty. The management's duty of loyalty to the firm still remains intact; however, because the priorities of interest concerning the firm's capital change, there is a degree of ambiguity as to whether the

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[9] Ruth Lane Neyens 'Principles of Corporate Restructuring and Asset Resolution' World Bank Report <http://www1.worldbank.org/finance/assets/images/neyens_paper.pdf> accessed 17 December 2015.
[10] (n 1).
[11] (n 9).
[12] Ibid.
[13] 11 U.S.C. § 365 (1988).

management is being loyal to the company by mitigating risk to ensure recovery for the creditors, or by attempting to maximize shareholder value. Creditors may still find it viable to tie management compensation to the success of the company,[14] particularly because courts are likely to abide by the wisdom of conventional fiduciary duty of the manager to the company, rather than the shareholders. On the other side, the autonomy of the management depends significantly on their incentive to stay in office and maintain favorable standing with the stakeholders who have the power to dismiss them. Managers have little employment incentives beyond the maintenance of their jobs because the stigma of being associated with a company going into reorganization/liquidation means their employability depends significantly on their ability to perform during the reorganization proceedings. In the ordinary course of events, this would have meant that the management acts in the interest of shareholders because they possess the means to discipline them through proxy contests etc., but, as discussed earlier, Bankruptcy Courts have placed a significant restriction on shareholder activism during reorganization proceedings. Simultaneously, creditors possess the means of displacing the management by petitioning for the appointment of a trustee, and despite being a rare practice,[15] it remains a looming threat.

As far as the autonomy of the creditors and shareholders is concerned, it is possible for both classes to resist the Business Plan proposed by the management through their respective committees. Their success, though, is highly dependent on the degree of leverage that they have. Creditors, for instance, have far more leverage when the company requires additional finance to fund its Business Plan, and must enter into a new arrangement with its pre-existing creditors to provide new financing. This leverage is also greater with respect to the Reorganization Plan, which usually requires the consent of a majority of creditors, with the interests of equity holders taking a back seat.

On the other hand, shareholders are more successful in marshaling the loyalty of the management in circumstances where there is block shareholding by an activist shareholder. The threat of replacing management is more imminent and pressing in circumstances where the escalated transaction costs of organizing a proxy contest are absent.[16]

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[14] Stuart C. Gilson & Michael R. Vetsuypens, CEO Compensation in Financially Distressed Firms: An Empirical Analysis (1992) 48 *The Journal of Finance* 425.
[15] (n 1) 778.
[16] Ibid, 785.

In either case, however, there is a notable neglect of other stakeholders' interests, such as those of the company's employees, suppliers, and the public at large. Scholars have suggested that the management ought to also consider the ramifications of the Business Plan on the society-at-large, owing to the fact that corporations also play a role as social institutions.[17]

In all of these cases, the issue of loyalty and to whom it ought to be owed arises from the separation of the risk of future loss from the probability of gain, both in insolvent and marginally insolvent companies.[18] In both circumstances, creditors stand to lose substantial portions of their investment, while they benefit only marginally from any potential gains, because the gains benefit 'underwater' shareholders. However, at the same time, too conservative Business Plans foreclose the possibility of rehabilitation because the creditors are interested in cutting their losses and recouping their investment through the liquidation of any remaining value.[19]

The Draft CRA in Pakistan: A Cause for Concern?

The 2004 DCRA circulated by the SECP drew on many of the prominent features of Chapter 11 reorganizations. There was a procedure for both voluntary filing on behalf of the company,[20] and involuntary cases on behalf of 'interested parties'.[21] The High Court had original jurisdiction to hear matters under the DCRA.[22] To assist the Court in its dealings with the business aspects of the reorganization, a Technical Assistance Committee ('TAC') was proposed, which would be composed of financial experts 'from the fields of accountancy, banking, economics, finance, insolvency, law or management'.[23] Much like Chapter 11 proceedings, there were two procedures that the court could opt for. It could either appoint an administrator to take over the operations of the company,[24] or appoint the existing management as the debtors-in-possession.[25] The DCRA also

[17] Donald R. Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 *Columbia Law Review* 717.
[18] (n 1) 787.
[19] Ibid.
[20] Draft Corporate Rehabilitation Act (DCRA) 2004, s. 11 <http://www.secp.gov.pk/draftamendments/2013/draft_cra_oct2013.pdf> accessed 17 December 2015.
[21] Ibid, s. 12.
[22] Ibid, s. 4.
[23] Ibid, s. 9.
[24] Ibid, s. 24.
[25] Ibid, s. 22.

incorporated the much dreaded Automatic Stay provision through section 15, which lasted until either the dismissal of the case, the finalization of the reorganization, the expiry of 180 days after the TAC had submitted its expert opinion, or upon conversion of proceedings to winding up proceedings.[26] Much like its American counterpart, the court was given substantial powers to mediate between and deal with the various stakeholders in the company, including creating exceptions to the Automatic Stay, ordering the delivery up of assets, and ordering appointments to assist the administrator etc.

The DCRA also mandated the creation of Creditor and Shareholder Committees,[27] but the pro-debtor regime seemed to remain intact, especially in the cases of voluntary filing, where the debtor has the exclusive right to file a reorganization plan.[28] The acceptance of a plan required the approval of 'creditors holding at least two-thirds in value of the allowed claims of such class',[29] though under section 53, the court could still enforce a plan despite its rejection under the provided formulae if it comes to the conclusion that '(a) the plan does not discriminate unfairly; (b) the plan is accepted by at least one class of creditors; and (c) is fair and equitable with respect to each class of claims or interests', much like a cramdown under Chapter 11. In addition, the DCRA established two new types of entities: the Corporation Rehabilitation Board, which is tasked with devising standards of administrations for distressed companies, and Corporate Restructuring Companies, whose purpose would be to acquire, restructure, manage or other deal with companies described above so as to restore them to financial health.

To assess the viability of importing Chapter 11 provisions into Corporate Insolvency law in Pakistan, it is important to evaluate whether the institutional configurations, ownership and control patterns, and the incentives of stakeholders are similar in both jurisdictions. The work that already exists in this respect suggests that this is not the case. The majority of large companies are closely-held family corporations with concentrated shareholding and a strong fusion of ownership and control.[30] For this reason,

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[26] Ibid, s. 15(3).

[27] Ibid, s. 33 and s. 34.

[28] Ibid, s. 48.

[29] Ibid, s. 51(2).

[30] Ali Cheema, Faisal Bari and Osama Siddique 'Corporate Governance in Pakistan: Ownership, Control and the Law' in Sobhan Farooq and Wendy Werner (eds), *Comparative Analysis of Corporate Governance in South Asia* (Bangladesh Enterprise Institute, 2003); Attiya Y. Javid and Rubina Iqbal, 'Ownership Concentration, Corporate Governance and Firm Performance: Evidence from Pakistan' (2008) 47 *The Pakistan Development Review* 643.

there is a substantially higher risk of pro-shareholder expropriation at the expense of creditors and the company through proceedings under the 2004 DCRA. While the court may still maintain discretion to block board actions or shareholder meetings that can be shown to be clear abuses, it has been demonstrated that even in the US, there is no predictability concerning the kinds of actions the court will block or allow,[31] thereby giving a management strongly aligned with the shareholders ample room to maneuver.

A problem raised specifically in the context of family firms where family members are both owners and managers of the company is the release of personal guarantees. Creditors often demand personal guarantees from managers of corporations as collateral for the extension of credit, but since the managers of family-owned companies are also shareholders, they benefit from the windfall of the cancellation of personal guarantees. This drastically distorts the incentives of the existing shareholders/management to provide a financially viable, rather than an inflated, optimistic Business Plan, knowing that they will not have to bear the consequences of it failure.

Related to the issue of state capacity and institutional complementarity, one of the major issues related to implementing the 2004 DCRA is the absence of an efficient apparatus to implement the complex arrangements that come about under Chapter 11-type proceedings. While there are specialized Bankruptcy Courts that deal with Chapter 7 and 11 cases in the US, the DRCA tasked the High Courts with this responsibility. Despite the creation of the TAC to aid the courts, it is foreseeable that proceedings under the 2004 DCRA would have been even more protracted and cumbersome than those in the US. Even if that concern could be remedied by instituting specialized courts, the 2004 DRCA had a mechanism for several appeals, the determination of which could delay the finalization of reorganizations far beyond the time-scales envisioned by the DCRA. The delay of proceedings would create an incentive for debtor companies to use the statute to defeat debt-recovery proceedings by their creditors, and take full advantage of the Automatic Stay provision to postpone restructuring indefinitely. Rather than facilitating the realization of Non-Performing Loans, the DCRA would have provided for the means to even further delay their recovery and conversion.

[31] (n 1) 776.

Looking Elsewhere: Private Corporate Restructuring

The discontentment with the broad, ill-defined, and open-ended process under sections 284-287 of the Companies Ordinance 1984 spurred the need for more clearly defined procedures for corporate rehabilitation, but the 2004 DCRA represented too significant departure from convention. As the current version of the DCRA also reflects, any legislation on the subject should aim to build on existing structures and conventions rather than attempt to reinvent the wheel. For this purpose, there are many other models that can be consulted.

A majority of jurisdictions around the world find out-of-court settlements to be much more viable. Iterations of the UK model of Company Voluntary Arrangements ('CVA') have been adopted in many common law jurisdictions such as Canada and Australia.[32] The UK Insolvency Act provides that a company propose a scheme of arrangement for restructuring to its creditors, through which the creditors accept some variation of an immediate settlement, in combination with write-offs and equity interest in return for a deferral in making all debts immediately due and payable.[33] Owing to the contractual nature of the arrangement, it is highly flexible, and can be tailored to the terms and circumstances of the imminent default. Further, it minimally involves the court apparatus and is thus much speedier and expeditious. The proposal needs to be approved by creditors who hold three-fourths of the value of the debt, and binds dissenting creditors to the plan. A licensed insolvency practitioner mediates the CVA, and while a company is under administration, there is a bar on creditor proceedings against the company except with the court's permission. This model has proven fairly successful in the UK.[34]

By contrast, corporate rehabilitation in India is largely state-driven and has had mixed results.[35] The process of identifying and dealing with 'industrial sickness' is laid out in the Sick Industrial Companies Act 1985 ('SICA'). The SICA established a Board for Industrial and Financial Reconstruction ('BIFR'), which acts as a quasi-judicial body tasked with devising appropriate strategies for identifying, taking control of, and reviving

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[32] (n 3) 17.
[33] Part I of the UK Insolvency Act 1986 <http://www.legislation.gov.uk/ukpga/1986/45/pdfs/ukpga_19860045_en.pdf> accessed 17 December 2015.
[34] (n 20); In the UK, about 75 percent of companies that open a CVA procedure survive.
[35] (n 3) 18.

sick industrial units.[36] The SICA regimen is also voluntary in nature, and shares similarities with the American system in that there is an Automatic Stay on recovery proceedings and executive contracts. The biggest problem with the SICA is the inherent procedural and legal time delays built into the statute that prolong proceedings to well beyond the 4-5 years estimate under Chapter 11 proceedings. As a matter of fact, it can take up to a year just to determine whether or not a particular company falls within the definition of a 'sick unit' under SICA.[37] Further, because the scheme places the determination of the Rehabilitation Plan on the shoulders of the state, the incentive to enable better coordination between creditors and debtors in undermined, leading to inefficient outcomes. Rent-seeking and political pressure further complicates proceedings. Cumulatively, these problems have disabled SICA from becoming an efficient way of solving India's rampant industrial sickness.[38]

Studies conducted by the World Bank, too, have concluded that the State should have a minimal role in the resolution of corporate reorganization and asset management. One such study proposes 12 principles around which countries should plan their Insolvency Laws. These principles include restricting the role of the government to facilitation, coordination and leadership (Principle 1), the need for speedy recognition and enforcement mechanisms (Principle 2), prompt recognition of losses (Principle 4), supervision and regulation (Principle 6), legal frameworks for creditors rights during insolvency (Principle 7), informal corporate workouts and restructuring (Principle 8), and involvement of the private sector (Principle 12).[39]

At the same time, it would be helpful to institute minor corporate governance reforms that are specifically targeted towards companies opting for reorganization. LoPucki and Whitford suggest that the best course of action regarding corporate governance is to adopt a rule mandating that the management aims to maximize the value of the company's assets instead of pursuing the interests of any one class of stakeholders while contracting to provide.[40] They argue that while wealth maximization may create the possibility of greater loss, it has significant distributional effects such as creating countervailing influences to discipline company management.[41]

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[36] Ibid.
[37] Ibid.
[38] Ibid, 5.
[39] Ibid.
[40] (n 1) 716.
[41] Ibid.

They simultaneously argue that in order to deter excessive risk taking, there should be schemes of risk compensation payments[42] for such creditors so that management is disincentivized from excessive risk-taking. While it is difficult to predict accurately where the loyalties of the management will swing during reorganization proceedings, there is data to suggest that management gains more from avoiding the question of loyalty altogether.[43]

It is also important to consider whether the law should treat business of different sizes the same way. Undoubtedly, a developing country like Pakistan ought to create legal regimes that enable small and medium businesses to thrive. Jurisdictions across the world, including the US and the UK, have special provisions for the reorganization of small enterprises, and the DCRA should provide for special considerations and relaxations for small businesses. The same argument may also be applied to infant industries and emerging markets, such as IT. It would not be appropriate to comment on the viability of these measures given the limitations and constraints of this paper, but this area of inquiry requires further research.

Conclusion

It seems that the more viable route to take concerning the DCRA is to move in the direction of lesser state intervention, and adopting stronger corporate governance practices, rather than putting even more pressure on an already strained judicial system. Some of the newer drafts of the DCRA appear to be moving in this direction. Chapter 11 proceedings are extremely sophisticated and cumbersome and are only suitable for jurisdictions that have developed all the necessary complementarities to make it effective. Further, while Chapter 11 proceedings operate in a paradigm where they aim to curb the influence of strong financial institutions so that companies can be given room to recover, the balance of power in Pakistan is substantially different. Here, the volume of non-performing loans is excessive, and any measures that will exacerbate that problem ought to be avoided.

As an afterthought, I think it may be helpful to be cognizant of the political determinants influencing the passage of the 2004 DCRA. After all, it was strongly resisted by a number of large commercial banking establishments and financial institutions for over 12 years.[44] The pressure to

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[42] Mark J. Roe, 'Bankruptcy and Debt: A New Model for Corporate Reorganization' (1983) 83 *Columbia Law Review* 527.
[43] Ibid.
[44] Nasir Jamal 'Waiting For Corporate Rehabilitation Law' (*Dawn*) <http://www.dawn.com/news/1209442> accessed 26 December 2015.

introduce Chapter 11 proceedings, on the other hand, appeared to come from industrialists, who evidently have sizeable influence.[45] While an investigation of the political determinants of corporate law with respect to corporate rehabilitation is beyond the scope of this review, it may be worthwhile to investigate how the relative powers of these two stakeholders in various jurisdictions determine the nature of rehabilitation law a jurisdiction adopts. From the pace of things, such an inquiry and a corresponding prediction will probably precede the legislation that confirms or rebuts it. At any rate, the fight over the DCRA appears to be far from over.

[45] Ibid.