INSOLVENCY LAW IN THE GLOBAL KNOWLEDGE-BASED ECONOMY

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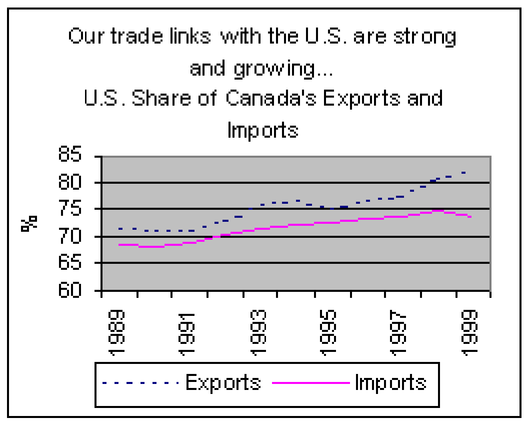
Insolvency law has two key objectives. A major role, at least as regards commercial insolvencies, is to help the marketplace achieve peak efficiency, to use its material and human resources to best advantage and maximize the production of goods and services. Another objective is fairness, to ensure that the losses involved in insolvencies are fairly distributed and do not fall disproportionately on the weaker parties.

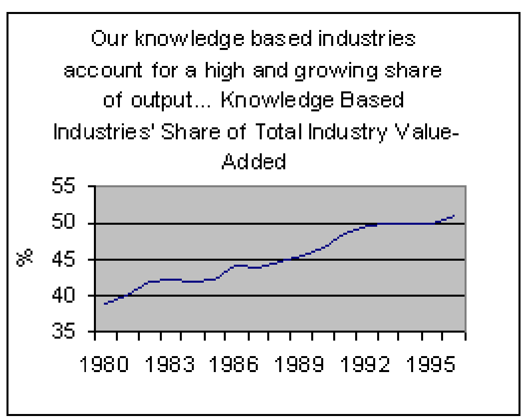
I. CANADIAN MARKETPLACE FEATURES

To contribute fully to marketplace efficiency and fairness, insolvency law must take into account key features of the Canadian marketplace. First, the Canadian marketplace is open and competitive. The Canadian economy operates within the global economy, largely without impediments to the flow of goods, services and capital into and out of Canada. Competition is more rigorous in Canada now and more reliance is placed on it, with all the rewards and punishments that go with it, to secure the highest volume of output.

Second, while participating in and forming part of the global economy, the Canadian economy is firmly situated in and committed to North America. Most of our trade is with the United States. The proportion, which has been high for decades, has increased further in recent years. Also, the NAFTA has encouraged the integration of North American business operations. Canadian companies are making more effort to develop US markets and to expand their operations there through acquisitions and start-ups. Larger US firms have always had a major presence in Canada. These firms are rationalizing their operations on a North American basis and other US firms are expanding into Canada. Canadian firms must compete in an ever more homogeneous and integrated North American market.



Third, Canada has a knowledge-based economy (KBE). That economy is characterized by rapid technological change, growing trade and reliance on foreign markets, a shift to producing more services and high value-added goods and a higher proportion of human capital and R&D investment. The KBE has posed new challenges for Canadian firms: shifts in demand to more high technology applications away from commodities, a quickening pace of change and increases in risk, a



growing importance in innovation in all aspects of production and firm organization and increasing competition. With the increased focus on innovation and the need to adopt quickly in developing and marketing new products, entrepreneurship is at a premium. Business success is increasingly dependent on it, on identifying and exploiting new ideas. Risk taking entrepreneurs must be supported if success is to be achieved in the KBE.

A fourth key feature of the Canadian economy, one which is closely related to insolvency, is its strong reliance on debt financing. Debt financing has always been a basic vehicle of investment and growth in Canada and continues to be so in the KBE. Debt financing is relatively more important in Canada than in the United States, where equity capital markets remain more fully developed. The emergence of the KBE, with its emphasis on human capital and high risk levels has raised important issues for debt financing. Financiers do not generally exercise close control over the business operations of their debtors, that being the prerogative of equity holders and management. To effectively manage lending risks, they rely on; (a) their knowledge of their debtors and their confidence in their debtors' ability to perform; (b) contractual or statutory rights to obtain key financial information about their debtors; and (c) contractual remedies, such as rights to seize assets, in cases of default. These risk management tools may be less applicable in the KBE where innovation and entrepreneurship are key, where products are subject to sudden shifts in demand, where inputs - machines, knowhow etc. - rapidly become obsolete and where business assets, largely human capital, may be less useful as loan collateral. Clearly, Canada must develop its equity capital markets for success in the KBE. However, debt's important role in generating growth in the KBE cannot be neglected. An efficient marketplace requires that debt financing be made attractive to both lenders and borrowers operating in the KBE.

II. EFFICIENCY

What do these features of the Canadian marketplace imply for insolvency law as a contributor to marketplace efficiency? First, in an economy committed to competition, insolvency law should help competitive forces work effectively. The best way of doing this in many cases may be to recognize and give the fullest possible effect to the contractual arrangements made by marketplace participants. Of course, in other cases market failures may prevent contractors from achieving efficiency and insolvency law intervention in contractual rights may enhance value.

Second, relating to the Canadian economy's participation in the global economy and its growing integration in the North American economy, an important objective for Canadian insolvency law should be to minimize the difficulties involved in working out international financing arrangements and managing cross border insolvencies. This is especially true of Canada/US cross border financings and insolvencies given that a large and growing proportion of firms have operations, customers, suppliers and creditors in both countries. This does not necessarily imply outright harmonization of our insolvency law with the US law. Indeed, many features of the US bankruptcy law are uniquely tailored and suited to US conditions. Even where

US laws are not intended to address specifically American problems, Canadian insolvency law is often superior. On the other hand, where US provisions embody leading edge practices, it would only make sense to seriously consider adopting them. Harmonization, provided it is in areas where the US law is better in any case, could only ease the administration of insolvencies involving both Canada and the United States.

Third, it seems clear that multilateral initiatives at promoting more uniform insolvency legislation internationally should be carefully examined and adoption of uniform laws considered. These include the United Nations Commission on International Trade Law (UNCITRAL) Model Law On Cross Border Insolvencies, UNCITRAL's ongoing work on developing core features of commercial insolvency law and the work of the International Institute for the Unification of Private Law (UNIDROIT) and the International Civil Aviation Organization (ICAO) in developing an international convention governing the registration and enforcement of security interests in mobile equipment. In fact, progress has been made in recent years both in Canada and abroad in facilitating international insolvency administration. Provisions were added to the *Bankruptcy and Insolvency Act* (BIA) and *Companies' Creditors Arrangement Act* (CCAA) in 1997 to address cross border insolvency issues. Also, within the North American context, Canadian and US courts have started to work out arrangements ("protocols") on a case by case basis to facilitate the concurrent administration of insolvency proceedings involving the same debtors in Canada and the United States. On a global plane, the adoption of the UNCITRAL Model Law is on the agenda of several countries, including the United States and will be on Canada's upcoming insolvency law reform agendas. This offers the prospect of further harmonizing insolvency rules internationally and easing the administration of international insolvencies.

The KBE has several important implications for insolvency law. First, insolvency law should help foster the entrepreneurship and innovation so vital to success in the KBE. Innovation must be recognized as a key contributor to efficiency in the broad sense and encouraged as such. Substantial resources and effort must be devoted to innovation, to developing new and better products and processes to generate the highest value of output over time. One way to encourage entrepreneurship and innovation might be to encourage the individual entrepreneur, the "person with the idea" to take risks in developing and marketing good ideas. The "fresh start" feature of individual bankruptcy law supports entrepreneurship by assuring entrepreneurs that if their ventures fail, while they will have to leave their assets behind, they can otherwise walk away free to try again. Canadian law has this feature now, but perhaps changes could be made to it to better encourage entrepreneurship. Properly framed fresh start provisions should boost efficiency by supporting entrepreneurship without generating serious offsetting inefficiencies, such as reducing credit availability. They should still leave financiers with the ability to manage risks and balance risks with rewards in the KBE.

Second, developing and applying innovations requires high levels of investment. Insolvency law might encourage investment by respecting contractual rights acquired pre-insolvency, thus encouraging financiers to enter initial investment contracts with entrepreneurs, giving them the support thy need.

Third, the KBE, which is characterized by rapid change, where the process of "creative destruction" operates more quickly and entails a more frequent need to redeploy assets. In light of this, insolvency law should perhaps focus on quick and efficient redeployment. Clarifying contractual rights and obligations might be a way to do this. Removing rigidities which constrain entrepreneurs and financiers from making agreements which are clear and enforceable in insolvencies might be beneficial as well.

The continued strong presence of debt financing in Canada has strong implications for insolvency law as well. Debt financing raises important efficiency issues. Insolvency law should help lending and borrowing in the marketplace work efficiently and address market failures relating to debt and loan risk management. When markets work well, market participants can manage the risks associated with debt most efficiently through private arrangements, using risk management tools available in the marketplace. Creditors can reduce the risk of not getting paid in several ways – such as by requiring timely payment; by reserving default remedies; by spreading their lending among several debtors; by taking more senior, higher-priority secured debt; or by taking insurance. Co-contractors can reduce risk, in various ways, such as by shifting it contractually to the other party, by carefully assessing the financial health of the other party; by reserving the right to take protective measures, or by buying insurance. In sales contracts, both buyers and suppliers can arrange delivery or payment terms so as to minimize risk, balancing safety against lower net returns.

In efficient markets, when insolvency strikes, participants can achieve an efficient redeployment of resources and apportion the gains and losses (primarily losses in insolvencies) in accordance with commitments made and risks borne. However, market failures can preclude efficient market solutions to firm insolvency. When a firm is large and many participants are involved in dealing with that firm, information gathering and other transaction costs in anticipating and dealing with an insolvency crisis contractually may be prohibitive. Operating in real-world markets is not costless: time and effort are required for market participants to make their arrangements, and this costs money. Insolvencies create new, unexpected and often complex situations, which may necessitate a major adjustment of marketplace arrangements. Renegotiating new arrangements from the beginning can be very difficult, slow and costly for market participants.

Properly designed insolvency laws can reduce the problems caused by transaction costs and information gaps by establishing an "off-the-shelf" framework of rights and procedures that operate automatically when insolvencies occur and, in some cases, by shifting risk to those market participants who have the knowledge and the ability to best manage it. Given that insolvencies are inevitable in a dynamic but risky marketplace, insolvency law can try to facilitate the process of "creative destruction" by enabling the assets of insolvent businesses to be quickly and efficiently redeployed to their most productive use, in new firms or within existing firms suitably restructured.[1] However, insolvency law should not limit its role to maximizing value in insolvencies themselves. It should also strive to encourage the most productive initial investment decision-making ("pre-insolvency"), to help maximize the value produced in the economy over time. This aspect of the efficiency objective of the law is sometimes overlooked, as attention tends to focus on its role in maximizing value after insolvency has occurred ("post-insolvency"). Nonetheless, it is important to bear this aspect in mind when assessing the overall efficiency effects of any insolvency law feature.

III. FAIRNESS

Insolvency law's role should not be limited to promoting marketplace efficiency. It should promote fairness in insolvencies as well. Some marketplace participants have little ability to manage or avoid risks. They lack the information needed to make the best decisions in their own interest, or the power or ability to protect themselves adequately. The employees of an insolvent firm are a prime example of this. In contrast, some market participants have great power and access to information that is not available to others, enabling them to extract windfall gains at the expense of weaker parties. In these situations, the marketplace may not produce fair solutions. Insolvency legislation may help to address at least some of these market shortcomings, by establishing measures to protect the weaker participants and by restricting the rights and privileges of the stronger. In a global, competitive economy, where market forces are less restrained, such measures may be more important. On the other hand, the KBE on its own does not appear to raise new problems of fairness for insolvency law. It does not appear to create new classes of vulnerable marketplace participants requiring additional protection.

Insolvencies can raise community-wide social issues. The impact of insolvency may extend well beyond persons with claims against the insolvent firm, especially when large firms are involved. Employees of these firms may have direct claims in the form of unpaid wages, but their interest in these insolvencies may go beyond that. They may be concerned about their future employment, especially if the insolvent firm accounts for much of the available employment in a community. A similar concern exists with respect to suppliers, who may have an interest in maintaining large firms as future customers. Other businesses in and beyond the local community may be affected as the insolvency ripples through the economy, even though they may have no contractual relations with the insolvent firm. Insolvency law can take these concerns into account in determining a course of action, such as pursuing a firm rescue or sale as a going-concern. Nevertheless, since insolvency law intervenes in the rights and obligations of a limited range of participants only – primarily the creditors of the insolvent firm and the firm itself – its ability to deal adequately with the broader social repercussions of major insolvencies may be

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[1] Randall Morck and Bernard Yeung, in their paper *Canadian Public Policy in a Knowledge Based Economy* prepared for Industry Canada suggest that the pace of economic evolution calls for streamlined bankruptcy laws, that bankruptcy laws should force quick and clean transfers of control from old to new owners and that creditors should be given immediate power to decide whether to liquidate or restructure a company. The preferred thrust of the authors seems clearly to make marketplace commitments binding and fully and immediately enforceable in insolvencies.

problematic. Insolvency law in this context interrelates with other laws governing economic and social matters. The role it should play may not be obvious. In some cases it may be forced into a social role. The wide discretion exercised by the courts in some CCAA cases to intervene in rights of persons not directly related to the debtor firms, may be linked to broader social issues and a search for means of addressing them.

IV. EFFICIENCY/FAIRNESS TRADE-OFFS

The efficiency and fairness objectives of insolvency law are interdependent and trade-offs must sometimes be made between them. Measures to increase fairness by protecting wage earners or vulnerable debtors may have an impact on efficiency and vice versa. Measures that shift risk from wage earners to other creditors may affect credit availability and investment – and, ultimately, value produced and efficiency in both positive and negative ways. Also, efforts to reorganize or sell insolvent firms as going concerns are motivated by both efficiency and fairness objectives. Focussing on efficiency entails trying to quickly identify situations in which reorganization of insolvent firms is likely to succeed and putting the others into liquidation. Focussing on fairness might suggest giving a reorganizing firm every chance to succeed in order to save jobs, reduce potential losses to unsecured creditors, and so on. At some point, as success becomes less and less likely, a trade-off often has to be made between efficiency and fairness. Further, in a global economy, the costs and benefits of whatever solution for an insolvency is adopted are distributed internationally and not necessarily equally between countries, complicating the calculation of trade-offs from a domestic perspective.

V. CONCLUSIONS

Efficiency and fairness are key insolvency law objectives. How can Canadian insolvency law best achieve those objectives given Canada’s situation: a participant in an open, competitive global economy, participating fully in the North American economy, adopting the KBE, relying on innovation and investment for strong growth and continuing to rely on debt financing for much of its investment? There are several means by which insolvency law might enhance efficiency: by adopting pro-competitive measures, by facilitating international, especially North American financing arrangements and minimizing the difficulties in administering international and North American insolvencies, by supporting international insolvency law harmonization efforts, by supporting entrepreneurship and investment and by providing adequate incentives to debt financing.

Insolvency law might promote fairness by adopting measures to protect weaker parties. However, in framing such insolvency law measures, trade-offs between efficiency and fairness must be taken into account.

APPENDIX

Insolvency law objectives identified in other studies

A number of studies of insolvency law and policy conducted in Canada and abroad in recent years have proposed a variety of objectives – in some cases quite lengthy lists of roles and purposes. In all cases, however, the lists can be reduced to two basic goals: to maximize value (efficiency) and to ensure fair treatment of those who are affected by insolvency. Other objectives put forward are variants of one of these two, or are features of an insolvency system deemed desirable because they would help to achieve one of the two objectives; in other words, they are means to attain the goals rather than goals themselves.

In its 1970 report, the ***Study Committee on Bankruptcy and Insolvency Legislation*** (Tassé Committee)[2] – proposed two main goals for insolvency law: to promote equity and to protect the integrity of the credit system and curb abuse of that system. The value-maximizing objective did not loom large in the Committee's report. Under the equity promotion heading, the Committee recommended measures to diffuse the burden of insolvency by treating creditors equally and avoiding fraudulent preferences. Protecting the credit and economic system, and promoting commercial morality would, according to the Committee, further efforts to attain the more basic goal of enhancing efficiency.

The 1986 report of the ***Advisory Committee on Bankruptcy and Insolvency*** (the Colter Committee) listed seven objectives of bankruptcy law: 1) to be fair and equitable; 2) to allow for effective reorganizations and support viable enterprises; 3) to facilitate debtor rehabilitation; 4) to be flexible; 5) to ensure fair treatment of debtors; 6) to encourage commercial morality and curb abuse of the bankruptcy system; and 7) to be understandable and administratively workable.

These objectives all relate to efficiency and fairness. The first relates clearly to the fairness objective, which the Colter Committee defined as aiming at equilibrium and balance between debtors, secured creditors and unsecured creditors. The second objective advocates one means of promoting the value maximization objective. It implicitly assumes that reorganizations of viable enterprises are often value-maximizing. The third goal is a consumer insolvency objective. The fourth is a means of achieving maximum value and also, in some respects, fairness. The fifth relates to fairness. The sixth, encouraging commercial morality and curbing abuse, furthers both efficiency and fairness. The seventh goal is a means of maximizing value and, insofar as it includes transparency, fairness.

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[2] The Study Committee, chaired by Roger Tassé, was appointed by the Justice Minister in 1966 to review and report on Canada's bankruptcy and insolvency legislation. Its report, released in 1970, formed the basis for a series of insolvency bills introduced in Parliament between 1975 and 1984, none of which were passed.

In 1999, in the wake of the financial difficulties in Asia, the ***International Monetary Fund*** (IMF) released a study entitled *Orderly and Effective Insolvency Procedures*. The study proposed two overall objectives of insolvency laws: first, to allocate risk among market participants in a predictable, equitable and transparent manner; and second, to protect and maximize value for the benefit of all interested parties and the economy in general. The risk allocation objective has both value-maximizing and fairness aspects. Predictability of risk allocation is directly related to value maximization. The report states that predictability enables marketplace actors to manage risk and make credit and investment decisions in line with their preferences, with direct implications for value and growth. Equitable risk allocation is directly related to fairness. The report goes on to say under this heading that it is not necessary to give all creditors the same treatment, that it may be appropriate to treat creditors differently in different circumstances, but that creditors in like circumstances should be treated alike. The report defines transparency as ensuring full information for participants in insolvencies – a fairness-related objective.

In its discussion of the second overall goal – protecting and maximizing value – the IMF mentions its obvious link to reorganization (implicitly presuming that, in many cases, reorganizations generate more value than liquidations), but it points out that value maximization also has primary importance in liquidations. The IMF study illustrates the interdependence of the fairness and value-maximizing objectives. It suggests that allocating risk equitably, thus furthering fairness, often maximizes value. It notes the tension between the predictability component of risk allocation (which promotes value maximization) and the equitable component (which promotes fairness), thus signalling the trade-off that must sometimes be made between fairness and value maximization. The IMF study also notes that choices may have to be made regarding the value that should be maximized – the creditors', the shareholders' or the employees' – again illustrating the links between efficiency and fairness.

The ***Working Group on International Financial Crises***, established by the G-22 countries in response to the Asian crisis, listed nine "key principles" of insolvency laws in its October 1998 report. The first is a concern for *maximizing value*. In this regard, the Working Group noted the importance of rehabilitation as an alternative to liquidation, the presumption being that rehabilitation often allows for a more productive use of resources. The second principle is that priority should be given to *new financing*. The Working Group did not elaborate on this theme, but the implication is that the marketplace on its own will tend to underfinance insolvent enterprises and that new financing for these firms should be facilitated. The Working Group's third principle is the *need to balance liquidation and reorganization*, which is basically an elaboration of its value maximization principle. The Working Group noted that strong creditor power may lead to premature liquidations, while strong debtor power may lead to delays, added costs and reduced credit availability. The fourth principle is *equitable treatment* of like-situated creditors, an obvious fairness objective. The fifth principle is quick, efficient and impartial resolution of insolvencies, a value-maximizing goal for the most part, with a fairness connotation in its impartiality aspect. The sixth principle is prevention of premature dismemberment – a value-maximizing goal. It suggests that market forces alone may not give participants the opportunity to produce and distribute among themselves the maximum value obtainable. There is a distribution/fairness aspect to this principle too. Some participants, such as secured creditors, who stand to benefit by quick liquidation may argue in favour of that option even though postponing liquidation and assessing the prospects for rehabilitation might enhance overall value. Creditors whose security fully covers their loans will have nothing to gain by such delays: since any gains from postponement will go to others, they have no incentive to wait. The seventh principle is transparency, which is related to fairness. The eighth principle is predictability. In this regard, the Working Group notes the need to recognize pre-existing creditor rights and priorities, so that creditors can know when they make their initial lending decisions where they will stand should insolvency strike. This is related to value maximization. The final principle is the establishment of a cross-border insolvency framework. This no doubt arises from the Working Group's primary concern about international insolvencies. Its aim also is value maximization.

The ***World Bank*** issued a "Consultation Draft" entitled "Effective Insolvency Systems: Principles and Guidelines" in October 2000. The draft referred to and commented on the G-22 Working Group principles, implicitly adopting them in large part. It saw the first G-22 objective, of maximizing asset values, as pivotal. The second G-22 objective respecting firm rehabilitation or rescue was seen as an extension of the maximizing value objective. The World Bank saw the timely, efficient and impartial resolution objective as supporting that of maximizing value also. It commented as well on the equitable distribution objective, noting that it embodied the notion of equal treatment of creditors with similar legal rights. It also commented on the objective of properly balancing policies, noting that both economic (value maximizing) and social goals may be at play and that the balance may vary from country to country depending on a country's economic and social goals.

The ***United Nations Commission on International Trade Law*** (UNCITRAL) has examined insolvency law objectives in considering whether to develop a model corporate insolvency law. It outlines seven key principles in a document entitled *Possible Future Work on Insolvency Law*, published in September 1999. It clearly has drawn on insolvency studies in other international fora, in particular the work of the G-22 Working Group. In fact, its seven principles are virtually identical to the first, third, fourth, fifth, sixth, seventh and ninth principles of the G-22 Working Group.