



**The Efficiency of the Bankruptcy System
in Egypt**

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Abstract

The purpose of this paper is to assess the efficiency of Egypt's bankruptcy system, identify and analyze the main reasons for its inefficiency and offer specific proposals for bankruptcy reform. Its merit lies in focusing on market exit – a fundamental feature of a well functioning market economy that has remained largely unexplored in Egypt.

The paper concludes that a more efficient and effective bankruptcy system should provide appropriate incentives for the debtor, creditors and the bankruptcy trustee to reorganize potentially viable firms thereby preventing premature liquidation. Fulfilling these requirements will help protect the interests of various stakeholders, particularly workers and minority shareholders, and promote investment and credit.

ملخص

تهدف هذه الورقة إلى تقييم كفاءة نظام الإفلاس في مصر، وذلك من خلال تحديد وتحليل الأسباب الرئيسية لانخفاض كفاءته، وطرح مقترحات محددة لإصلاحه. وترجع أهمية هذه الدراسة إلى أنها تركز على مرحلة الخروج من السوق، وهي مرحلة لم تحظ باهتمام كاف في مصر على الرغم من أهميتها لضمان كفاءة اقتصاد السوق.

وتخلص الورقة إلى أن كفاءة وفعالية نظام الإفلاس في مصر، كآلية رسمية للخروج المنظم من السوق، هما رهن بتوفير الحوافز الملائمة لكل من المدين والدائنين والقائمين على إدارة عملية الإفلاس لإعادة هيكلة الشركات القابلة للاستمرار، وما يترتب على ذلك من حماية للعاملين وصغار المساهمين، وجذب مزيد من الائتمان والاستثمار للاقتصاد القومي.

1. INTRODUCTION

In a competitive market economy, less efficient firms are forced to improve their productivity or exit the market. Strong and efficient producers replace those that are not, and new processes and products replace older ones. This Schumpeterian concept of creative destruction is critical for a well functioning market economy, and requires a clear and predictable exit policy (Lansbury and Mayes 1996).¹

The ability to exit the market in an orderly manner assures potential investors and creditors that they can reallocate their resources, whenever needed, thus rendering the national economy more attractive to investment and credit. It could also help protect the rights of various stakeholders, particularly workers and minority shareholders. An efficient market exit process could therefore help accelerate the rate of economic growth, create more job opportunities, and achieve social equality.

Conversely, barriers to market exit such as excessive cost and bureaucracy have adverse repercussions on resource allocation, efficiency, and stability as well as on equality and fairness. Such barriers delay the necessary restructuring of potentially viable firms or the liquidation of those that are non-viable, and hinder the reallocation of assets and human capital. Exit restrictions can lead to increased disputes among various stakeholders, which in turn result in higher transaction costs and a loss of rights, ultimately undermining the investment climate.

To exit the market, a firm can either use formal processes, such as reorganization² and liquidation³ (regulated by bankruptcy laws), or informal methods such as out-of-court arrangements (usually conducted under general civil laws). The latter involve negotiations between debtors and creditors over a reorganization plan, and offer advantages and

¹ It is recognized that there are real social costs involved in such market reform and that it is important to have good social protection policies to help workers, in particular, adjust.

² Reorganization refers to a financial restructuring of a financially distressed firm. Claimants exchange their old claims against the firm for new ones, which because the firm has been unable to pay its debts, will necessarily be less than the face value of their old claims. A reorganization is functionally equivalent to a “going-concern” liquidation in which the existing claimants are the purchasers.

³ Liquidation refers simply to the conversion into cash, through sale, of a firm’s assets. The sale of assets can be either on a “going concern” basis, which involves a sale of the entire business including goodwill and other intangibles, or on a “break-up” basis, whereby the assets are sold piecemeal.

disadvantages.⁴ On one hand, costs are lower and negotiation approaches are more flexible and speedier than in formal bankruptcy proceedings. On the other hand, reaching an informal workout can be difficult due to, for example, the conflicting interests of creditors and the fact that they may prefer to pursue individual means of enforcement, which could lead a debtor into deeper financial distress and undermine the possibility of reaching a settlement that all parties accept (Claessens, Djankov, and Klapper 2003; Chanyarungroj 1999; Belcher 1997).⁵ Therefore, an efficient, collective and formal exit process is necessary to ensure an orderly and fair division of assets among creditors.

This paper deals with the formal method of exiting the market. In particular, it attempts to assess the efficiency of Egypt's bankruptcy system,⁶ identify and analyze the main sources of its inefficiency, and offer specific proposals for bankruptcy reform. While a growing body of literature focuses on obstacles to starting and operating firms in developing countries including Egypt, market exit – a fundamental aspect of a firm's life cycle – is not adequately documented or analyzed (e.g., Djankov et al. 2002; Emery et al. 2000; Caves 1998). Therefore, a study of this nature is particularly relevant, especially for Egypt.

Organizationally, this paper is divided into five sections. Beside the introduction, section 2 gives a brief overview of the main characteristics of an efficient bankruptcy system, followed by an assessment of the current system in Egypt. Section 3 identifies and analyzes reasons for the system's inefficiency. Section 4 proposes reforms based on international standards and best practices. Section 5 concludes.

2. EGYPT'S BANKRUPTCY SYSTEM

Before embarking on an assessment of the bankruptcy system in Egypt, it is important to highlight the main characteristics of an efficient bankruptcy system in general.

⁴ In the UK, large firms in financial distress often embark on an informal procedure known as the "London Approach" originally devised by the Bank of England in the 1970s (Kent 1997).

⁵As shown in Claessens and Klapper (2002) and Gilson, John, and Lang (1990), firms with a greater number of lenders tend to use in-court bankruptcy proceedings to coordinate among them.

⁶ In this paper, the term "bankruptcy" represents both liquidation and reorganization proceedings.

2.1 Characteristics of an Efficient Bankruptcy System

An efficient bankruptcy system should achieve an ex post efficient outcome, keep absolute priority of claims, and reduce transaction costs.

Achieving an ex post efficient outcome

A bankruptcy procedure should maximize the total value (measured monetarily) available to be divided between the debtor, creditors and possibly other interested parties (e.g., workers). A firm should be reorganized, sold for cash as a going concern, or closed down and liquidated piece-meal, depending on which option will generate the greatest total value (Ramasastry 2002; Hart 2000).

Keeping absolute priority of claims

If the debtor opts for liquidation, or if he is unable to prepare a reorganization plan that is acceptable to creditors and the court, his assets must be sold and the proceeds distributed among creditors in an order of priority that is established by law. Adhering to the absolute priority of claims ensures that secured creditors are paid first, followed by general creditors, and then shareholders if any residuals remain.

Abiding by the absolute priority of claims has various advantages. It helps to ensure that creditors receive a reasonable return from bankruptcy estates, which encourages them to lend. It also guarantees that contractual obligations entered into before bankruptcy are respected to the fullest extent possible after bankruptcy has been declared (Djankov, McLiesh, and Shleifer 2003).

Reducing transaction costs

The efficiency of a bankruptcy system is primarily measured by its ability to reduce the costs of bankruptcy procedures. Two types of costs are associated with bankruptcy: costs directly related to the bankruptcy procedure such as payment for the trustee, and opportunity costs resulting from the time needed to finish the bankruptcy process. In practice, prolonging the bankruptcy proceedings can harm both debtors and creditors and clog the court system. The interests of various stakeholders can only be assured if the bankruptcy proceedings take place in a timely fashion in order to preserve the value of the debtor's assets (Stern 2001).

Therefore, an efficient bankruptcy system should prevent premature liquidation, and speed up

the reorganization of potentially viable firms as well as the closure of those that are not (Ramasastry 2002; Stiglitz 2001).

2.2 Assessing the Efficiency of Egypt's Bankruptcy System

In view of the above characteristics, the following is an assessment of the current bankruptcy system in Egypt, which reveals that it is costly, time-consuming, and inefficient.

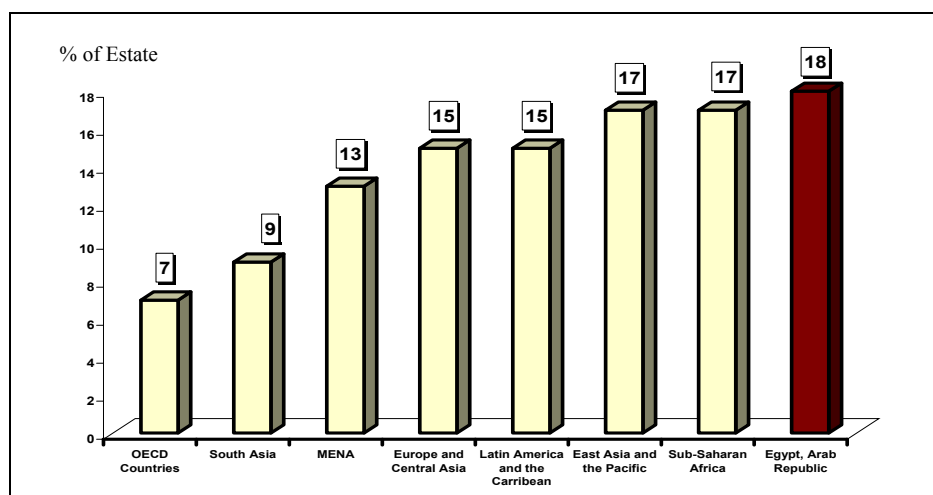
Costly bankruptcy process

The cost associated with resolving bankruptcy in court is defined as that of the entire bankruptcy process, including court costs, as well as those of bankruptcy practitioners, independent assessors, lawyers and accountants. In all cases, the cost estimate excludes bribes (World Bank 2004).

The bankruptcy process in Egypt is more expensive than in comparable countries. According to Figure 1, the cost of the entire bankruptcy process in Egypt represents about 18 percent of the bankruptcy estate, compared to 13 percent in other countries of the Middle East and North Africa, 15 percent in Latin America, and 17 percent in East Asia.⁷

After the bankruptcy estate has been fully administered, only a small sum is usually left over for distribution among creditors, who receive far less than even partial satisfaction of their claims. As a result, creditors tend to opt for informal workouts or settlements since the formal system does not help to mitigate their losses (World Bank 2004; Djankov et al. 2003).

Figure 1. Cost of Bankruptcy Process in Egypt Compared to Other Regions of the World



Source: Calculated from World Bank (2004).

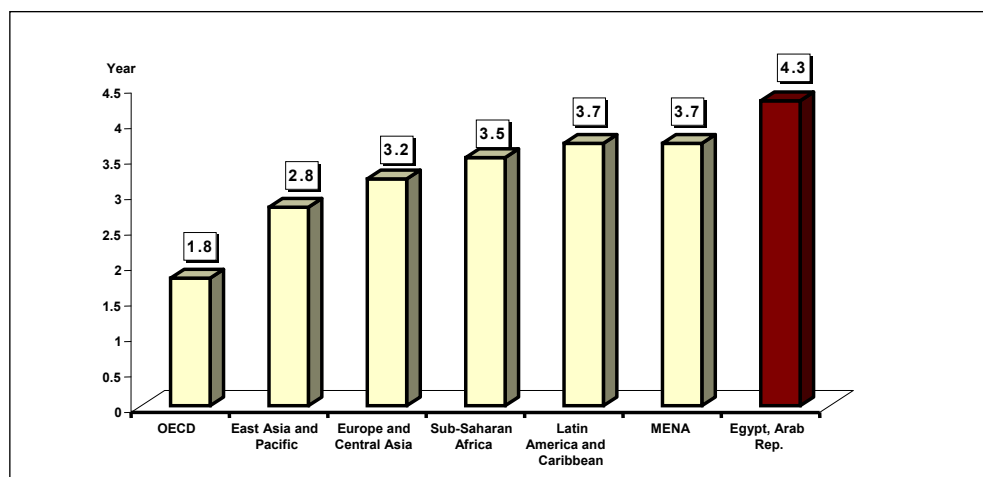
⁷ Cost figures are averages of the given estimates in a multiple-choice question, where the respondents choose among the following options: 0-2 percent, 3-5 percent, 6-10 percent, 11-25 percent, 26-50 percent, and more than 50 percent of the bankruptcy estate value (World Bank 2004).

Lengthy bankruptcy process

When an enterprise lacks viability or needs to be reorganized, an efficient bankruptcy procedure should be swift enough to preserve the interests of those involved and prevent further waste of both human and material resources.

The current bankruptcy process is characterized by excessive delay. A bankruptcy case takes more than four years to resolve in Egypt, longer than in countries at similar levels of economic development (Figure 2). In Tunisia, for instance, it takes about two and a half years, while in Poland it only takes a year and half (World Bank 2004; Casero and Varoudakis 2004).⁸

Figure 2. Average Time to Complete Bankruptcy Procedures in Egypt Compared to Other Regions of the World

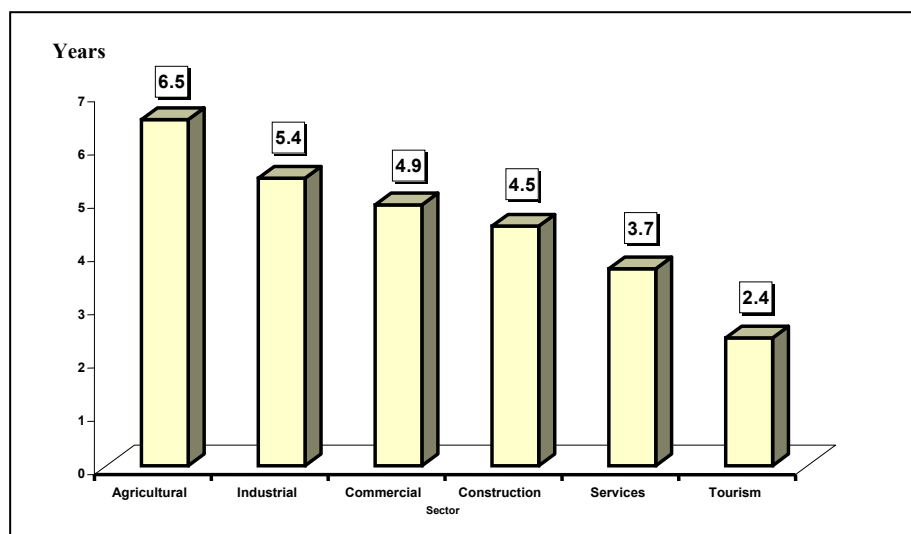


Source: Calculated from World Bank (2004).

The average time needed by Egyptian joint-stock companies to finalize bankruptcy procedures differs from one economic activity to another. It ranges from two and a half years for companies working in the tourism sector, to more than six years for those in the agricultural sector (Figure 3).

⁸ Time is recorded in calendar years. The time measure captures the average duration that is necessary to complete a procedure. If a procedure can be accelerated at additional cost, the fastest procedure, independent of cost, is chosen. The time measure includes all delays due to legal derailment tactics that parties to the bankruptcy may use. In particular, it includes delays due to extension of response periods or to appeals, if these are allowed under the law. As such, the measure represents the actual time of the insolvency proceedings, not the time that the law may mandate.

Figure 3. Average Time to Complete Bankruptcy Procedures by Egyptian Joint-Stock Companies According to Economic Activity, June 1998-August 2004



Source: General Authority for Investment and Free Zones, Egypt (2004).

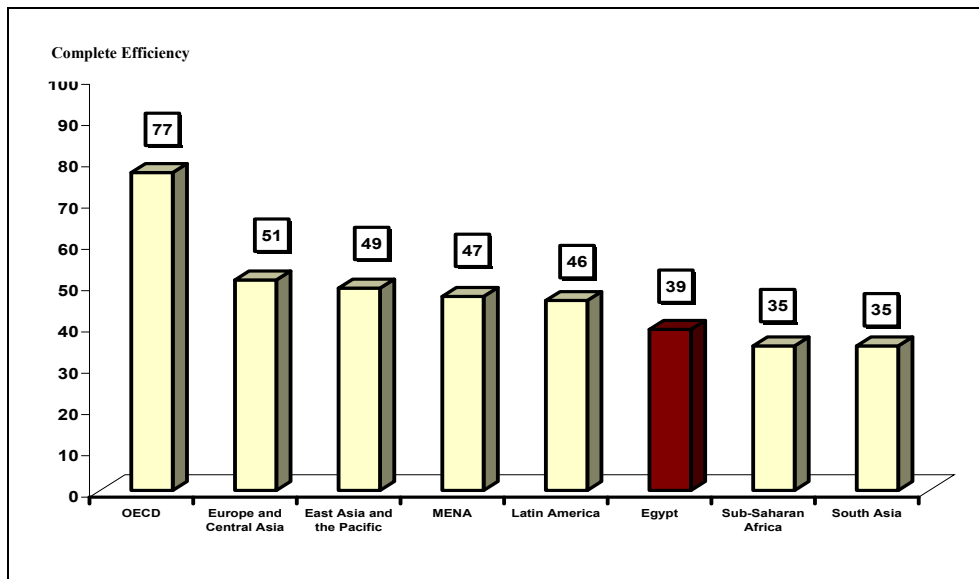
Inefficient bankruptcy process

Egypt's bankruptcy system is inefficient compared to systems adopted in other regions of the world. According to the index of bankruptcy efficiency which documents the cost and time of bankruptcy, the observance of absolute priority of claims, and the maximization of the total value available to be divided between all interested parties, Egypt scores 39 on a scale of 100. Only Sub-Saharan Africa and South Asia score lower (Figure 4).⁹

Expensive, drawn-out, and inefficient bankruptcy procedures leave creditors unwilling to push for a formal bankruptcy resolution. Creditors fear that their claims will likely be trapped in the bankruptcy process indefinitely and will not be resolved in a timely or satisfactory way. Therefore, they see informal workouts or out-of-court settlements as a way to get something in the short run rather than receive less or nothing at all after the administration process has consumed nearly all of the estate.

⁹ This index is calculated as the simple average of the cost of bankruptcy (rescaled from 0 to 100, where higher scores indicate less cost), time of bankruptcy (rescaled from 0 to 100, where higher scores indicate less time), the observance of absolute priority of claims, and the efficient outcome achieved. The bankruptcy index ranges from 0 to 100: a score of 100 on the index means perfect efficiency, and a 0 means that the bankruptcy system does not function at all (World Bank 2004).

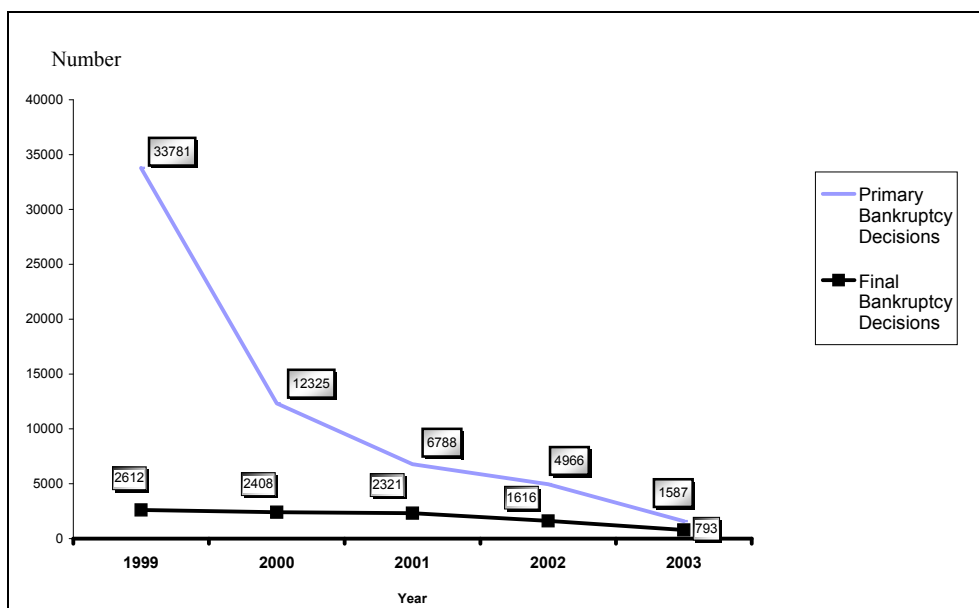
Figure 4. Index of Bankruptcy Efficiency



Source: Calculated from World Bank (2004).

Debtors and creditors alike are less willing to incur the high cost of a lengthy and inefficient bankruptcy procedure. This is reflected in the declining trend of primary and final adjudications during 1999-2003, despite economic recession, which would indicate a likely increase in bankruptcies (Figure 5).

Figure 5. Number of Primary and Final Adjudications, 1999-2003



Source: Information and Decision Support Center, Egypt (2004).

3. REASONS FOR THE SYSTEM'S INEFFICIENCY

An in-depth analysis of Egypt's bankruptcy system reveals two main deficiencies. First, the system does not provide appropriate incentives for the debtor, creditors, and the bankruptcy trustee to enter the bankruptcy process, conduct it in a cost-effective way, or to reorganize potentially viable firms and avoid their premature liquidation. Second, the bankruptcy system is not effectively enforced.

3.1 *Inappropriate Incentives*

Egypt's bankruptcy system does not provide the necessary conditions to motivate honest debtors to make a fresh start or to prepare a sensible reorganization plan. The system decreases creditors' confidence in secured lending, undermines their rights, and increases the opportunity cost of their claims. The bankruptcy trustee is subject to various motives that lead to lengthy bankruptcy procedures.

3.1.1 *Inappropriate incentives: The debtor*

A number of indicators illustrate that Egypt's bankruptcy system acts as a deterrent to a fresh start by honest entrepreneurs who have failed due to no fault of their own, and reduces their chance to prepare a sensible reorganization plan. These include the legal effects of bankruptcy; the lack of discharge from remaining debts; and the absence of a stay on creditors' claims.

Legal effects of bankruptcy

Egypt's bankruptcy system imposes restrictions, disqualifications and prohibitions on the bankrupt debtor. The debtor is automatically prohibited from managing or conducting transactions related to his property.¹⁰ He is stricken from the commercial register, and is therefore not allowed to work in any commercial or industrial profession (until rehabilitation occurs, if ever). Moreover, the debtor is deprived of his political rights. He can not vote or be a member of parliamentary councils, local councils, the chambers of commerce or industry or professional associations. The debtor also has limits placed on his freedom: he must report any change of address and may be forbidden to leave the country (World Bank 2003; Nathan Associates Inc.1998).

¹⁰ Under article 645 of the Commercial Code, upon the trustee's request, the bankruptcy judge may permit the debtor to continue the operations of the *Commerce de font* under the trustee's supervision.

These severe legal sanctions can be justified if a debtor committed fraud, behaved against creditors' interests or willingly caused the firm's bankruptcy. However, these kinds of measures harm the image of an honest entrepreneur who failed due to, for example, an economic crisis or an illness, and deter him from making a fresh start (European Commission 2003).

Egypt's bankruptcy system makes no clear distinction between honest but unlucky, and dishonest bankrupts. As such, little regard is given, in terms of their treatment, to the facts of an individual case. Therefore, honest bankrupts are stigmatized and have an incentive to delay a bankruptcy filing, all the while becoming more insolvent.

No discharge from remaining debts

A debtor is not discharged from his debts. He continues to owe his creditors the amounts he was unable to pay following liquidation and payment distribution. He can not be rehabilitated until he pays all remaining debts to his creditors, or until three years have passed since the bankruptcy was finalized. The long discharge period severely restricts the debtor's ability to make a fresh start.

No stay on creditors' claims

The current bankruptcy system does not allow a stay of creditors' actions against the debtor while he continues to operate his business under bankruptcy court protection. Under Paragraph 3 of Article 605 of the Commercial Code, secured creditors can initiate or pursue individual legal actions and enforce a levy on collateral without waiting for liquidation, provided that said actions are brought against the bankruptcy trustee.

The absence of a stay often positions creditors against each other in a race to seize assets, thus increasing the possibility of further financial distress and liquidation, and reducing the debtor's chance to prepare a sensible reorganization plan.

3.1.2 Inappropriate incentives: The creditors

In the current bankruptcy system, the absolute priority for creditors' claims is not fully observed, unfair transfers made prior to the debtor's payment cessation cannot be annulled, and no time limit is set for finalizing bankruptcy procedures.

No absolute priority for creditors' claims

An efficient bankruptcy procedure ensures that priority among creditors is respected. Secured lending enables creditors to make loans with less risk and collect those loans more easily, promoting a flow of credit into the economy (La Porta et al. 1998, 1997).

Given the role and importance of secured credit, bankruptcy systems in mature market economies almost always give secured creditors priority over other creditors. However, Egypt's bankruptcy system does not allow secured creditors the highest payment priority. Payments to workers and government taxes have top priority and must be paid before the secured creditors are compensated. If these super-priority claims are not kept to a minimum, they can undermine the investment climate by decreasing lenders' confidence in secured lending, increasing the risk and cost of capital, and reducing the total amount of credit (Djankov, McLiesh, and Shleifer 2003; La Porta et al. 1998).

No annulment of unfair transfers prior to payment cessation

Efficient bankruptcy systems usually give the creditor and trustee "avoiding powers" to annul any unfair or fraudulent property transactions made within a specified period before the bankruptcy filing (usually one year). The Egyptian bankruptcy system also provides creditors and trustees with "avoiding powers" to nullify a debtor's transactions, but only during the so-called suspect period. The suspect period starts on the date the debtor ceases to pay his debts and ends on the date of the bankruptcy adjudication. If the exact date of payment cessation is unknown, it is determined by the court.¹¹

Although "avoiding powers" are given, the system does not allow for the annulment of a debtor's property transactions *prior* to the date of payment cessation. As a result, unfair transfers made *before* payment cessation cannot be recovered for the benefit of the estate and creditors' rights may be undermined.¹²

¹¹ Under article 562, in order to determine the date of payment cessation, the court may rely upon any conduct, statement or act by the debtor that indicates that he is undergoing business difficulty, or any attempt to pursue commercial activities by unlawful methods or in a manner detrimental to his creditors.

¹² Perfection of mortgage, liens and judgment liens on the bankrupt's property will be deemed legally ineffective with regard to the mass of creditors if they were recorded *subsequent* to the date of payment cessation and after 30 days from the date of closing such transactions (Article 601 of the Commercial Code).

No time limit for terminating bankruptcy procedures

The bankruptcy system does not set any time limit for the formulation, confirmation, or implementation of a reorganization plan. As for liquidation, if the bankruptcy trustee is unable to complete the liquidation within six months, he is required to present the bankruptcy judge with a report on the state of liquidation and the reasons for delay. The bankruptcy judge is required to call for a creditors' meeting to discuss the report. The same procedure is repeated every six months as long as the trustee fails to complete the liquidation. The indefinite timeframe for terminating bankruptcy procedures increases the opportunity cost of creditors' claims, due to freezing their resources.

3.1.3 Inappropriate incentives: The bankruptcy trustee

Three main incentives can lead the bankruptcy trustee to prolong the procedure: his vast range of responsibilities, his legal liability for any unintended or intended negligence, and his method of remuneration.

Trustee's vast range of responsibilities

Once bankruptcy is declared, a bankruptcy estate is created. The estate consists of all legal or equitable property interests of the debtor as of the commencement of the case, including property owned or held by another person if the debtor has an interest in it.

A trustee is appointed by the court to manage the property of the estate, and operate and preserve the debtor's business until a reorganization plan is agreed upon. If the plan is rejected, the trustee's role is to liquidate the debtor's assets in a manner that maximizes the return to the debtor's unsecured creditors.

The trustee also assumes a number of other responsibilities. Within ten days of the bankruptcy judgment, the trustee must publish a summary in a daily newspaper. Within thirty days he must also record a summary of the judgment at every real estate office where the debtor has property.

The trustee must prepare the balance sheet and deposit it at the court's clerks office if the debtor fails to present one; take all the necessary actions to preserve the bankrupt's rights with regard to third parties, in addition to claiming and recovering such rights; perfect the bankrupt's real rights with respect to third parties; verify the debts; and initiate actions to nullify any questionable transactions that took place prior to the adjudication.

Trustee's legal liability

The trustee must conduct a thorough investigation of the debtor and his assets and obligations, find all of his properties and ascertain the nature and amount of creditors' claims. If the trustee fails to find certain assets, or fails to distribute certain properties to the creditors, he may be liable to creditors for the loss.

Trustee's method of remuneration

The bankruptcy system does not set compensation levels for the trustee. Thus, the trustee's own self-interest drives him to prolong the bankruptcy procedure. By conducting a lengthy investigation and drawing out the asset entitlement litigation process, the trustee is able to prolong the proceedings and, as a result, charge more as his fee.

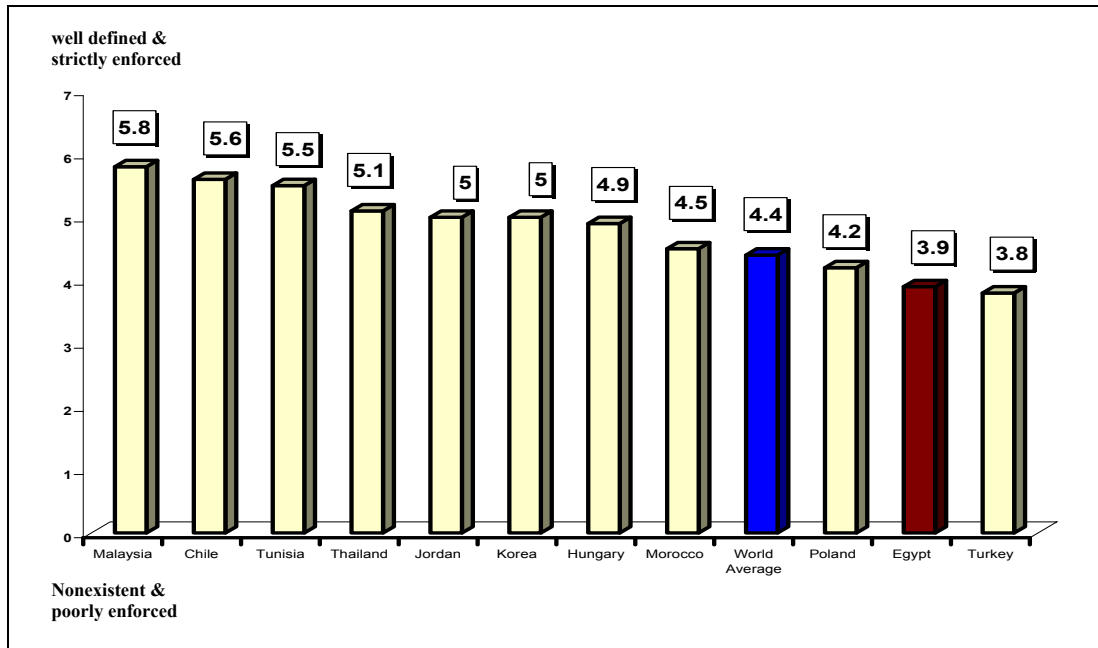
3.2 Ineffective Enforcement

As shown in Figure 6, Egypt's bankruptcy system is not effectively enforced in comparison to systems adopted in similar developing countries.¹³ Weak enforcement of the system may help explain why debtors and creditors are reluctant to push for a formal bankruptcy resolution, preferring to resolve the situation through private negotiations (Berkowitz, Pistor, and Jen-François 2003; Modigliani and Perotti 2000).

The ineffective enforcement of Egypt's bankruptcy system could be mainly attributed to the high level of court involvement, the multiplicity of appeals, and the lack of enforcement mechanisms.

¹³ The indicator of the effectiveness of bankruptcy systems was obtained from the Global Competitiveness Report (World Economic Forum 2004). Inputs for this survey were received from 102 countries in the form of questionnaires answered by leading business executives. The questionnaire was divided into 13 sections including the macroeconomic environment, under which the "Effectiveness of Bankruptcy Systems" indicator was present. Participants were asked to rate certain issues regarding their economic environment using a one to seven bipolar scale.

Figure 6. Egypt's Bankruptcy System as Compared to Other Systems in Select Developing Countries



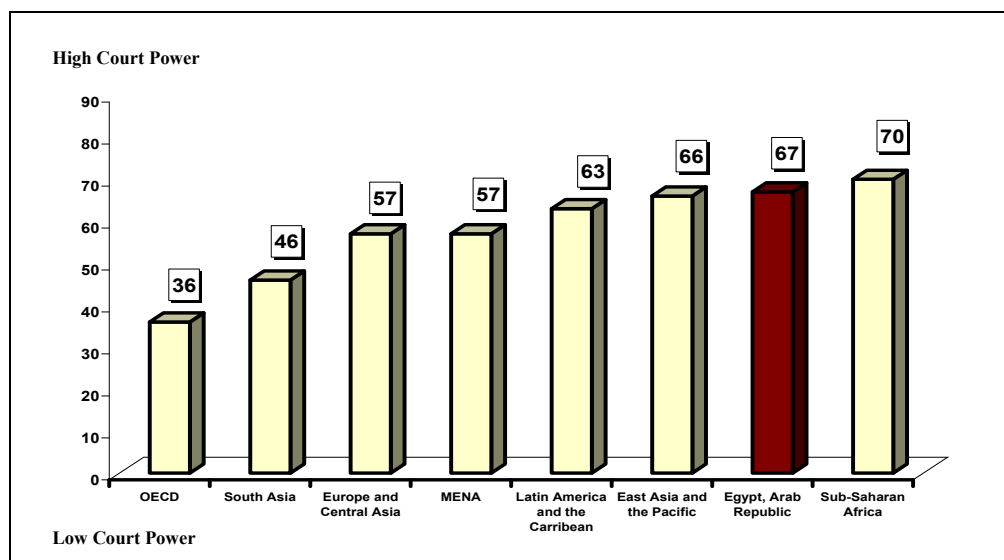
Source: World Economic Forum (2004).

High level of court involvement

As indicated by the court power index¹⁴ shown in Figure 7, the Egyptian bankruptcy system gives the court broad powers to handle the complex bankruptcy rules and procedures. Moreover, recent cross-country evidence shows that greater court power is inversely related to the likelihood of achieving one of the main goals of an efficient bankruptcy system—preserving the value of creditors' claims (World Bank 2001, 1999; USAID 1998; Buscaglia and Dakolias 1996; Sherwood, Shephard, and Souza 1994).

¹⁴ The Court Power Index documents the degree to which the court drives bankruptcy proceedings. It is an average of three indicators: whether the court appoints and replaces the insolvency administrator with no restrictions imposed by law, whether the reports of the administrator are accessible only to the court and not the creditors, and whether the court is the one that decides on the adoption of the reorganization plan. The index is scaled from 0 to 100, where higher values indicate more court involvement in the bankruptcy process.

Figure 7. Court Power in Egypt and Other Regions of the World



Source: World Bank (2004).

The high level of court involvement is indeed one of the major impediments of the system. For example, for every decision affecting creditors, the court-appointed trustee must seek the approval of the judge overseeing the case.

The bankruptcy judge is in charge of supervising the bankruptcy proceedings including the liquidation phase. He is also in charge of monitoring the administration of the estate, and ordering the actions necessary to preserve the bankruptcy estate. In addition, the bankruptcy judge is responsible for calling for and presiding over creditors' meetings, submitting a quarterly report to the bankruptcy court on the estate's condition, and submitting a report concerning any dispute related to the bankruptcy estate that the court has the jurisdiction to settle. He is in charge of calling upon the debtor, his inheritors, agents, employees or any other person at any time to hear their statements on matters related to the bankruptcy estate.

Multiple appeals

The bankruptcy process is also time-consuming because the system allows for multiple appeals in both the adjudication and administration phases of bankruptcy. The bankruptcy judge's decisions may be challenged, and competing claimants often resort to litigation to challenge the actions of the trustee.

Weak enforcement

Egypt's bankruptcy system requires a debtor in arrears over fifteen days to voluntarily file for

bankruptcy. And because penalties are not enforced for failing to file, the debtor has no difficulty prolonging his activities at the growing risk of creditors.

4. PROPOSED REFORMS

The above analysis reveals Egypt's need for a new bankruptcy system that provides the appropriate incentives necessary to allow the debtor, creditors, and the bankruptcy trustee to reorganize potentially viable firms and to effectively enforce the system. A review of countries' experiences and best practices show that bankruptcy reform in countries such as Argentina, Indonesia, Thailand, Hungary, Australia, France, Germany, and the US have been very *reorganization-oriented* (Foley 1999; Inter-American Development Bank 1999; Rowat and Astigarraga 1999; Gray, Schlorke, and Szanyi 1995).

The main rationale for such reform is that *reorganization* is often preferable to liquidation, and if successful, will likely produce better results, preserve job opportunities, achieve social equality, and help stimulate economic growth.

4.1 Appropriate Incentives: The Debtor

The new system should include removing the severe legal sanctions that are imposed on honest debtors, offering discharge from remaining debts, and imposing a stay on creditors' claims during the process of reorganization.

Removal of severe legal sanctions

While it is not easy to gather evidence proving good faith in a collective procedure, the bankruptcy system should attempt to clearly distinguish between fraudulent and non-fraudulent debtors.

Upon filing of a voluntary petition for bankruptcy, the debtor should automatically assume the identity of a "debtor-in possession." The term refers to a debtor that keeps possession and control of his assets while undergoing reorganization, without the appointment of a case trustee.

The debtor-in-possession may use, sell, or lease property of the estate in the ordinary course of his business, without prior approval, unless the court orders otherwise. If the

intended sale or use is outside the ordinary course of his business, the debtor must obtain permission from the court.¹⁵

Generally, the debtor-in-possession performs many of the functions of a trustee including accounting for property, examining and objecting to claims, and filing informational reports as required by the court. He also has the right, with the court's approval, to employ attorneys, accountants or other professionals to assist him during his bankruptcy case. According to the US Bankruptcy Code, the debtor-in-possession has the exclusive right to submit a reorganization plan to the creditors and the court for the first 90 to 120 days after the date of bankruptcy filing.¹⁶

An advantage of this system is that it often prompts a debtor to take responsibility for his case. If a debtor knows that he will remain in charge of the firm, he will be more likely to file for bankruptcy early, as soon as the need becomes apparent. Filing early would allow him time to prepare a reorganization plan before financial distress becomes unmanageable. This procedure is employed in many market economies such as the US and transition economies such as Hungary (Mecham 2004; Gray, Schlorke, and Szanyi 1995).

Early discharge from remaining debts

Although irresponsible debtors should not be given an easy way out, discharging remaining debts is one of the conditions necessary to give honest debtors a fresh start. A discharge releases a debtor from personal liability for specific debts and prohibits creditors from ever taking action against him to collect those debts.¹⁷

The discharge should occur upon the confirmation of a reorganization plan, and it should be subject to certain criteria. Most countries accept a discharge only following the completion of a procedure (e.g., reorganization in Austria, Belgium and Germany), often linked to the notion of an “innocent” bankruptcy. Countries such as Denmark and Italy allow for a total or partial discharge of debts, but only after the debtor has met certain strict

¹⁵ A debtor-in-possession may not use cash collateral – i.e., collections of accounts subject to security interests or proceeds from the sale of pledged inventory or equipment – without the consent of the secured party or authorization by the court, which must first examine whether the interest of the secured party is adequately protected.

¹⁶ In the Czech Republic, the time limit for submitting a proposal is 90 days with a possible 90 day extension. In Hungary, the limit is 90 days with a possible 60 day extension.

¹⁷ Not all types of debts are discharged. The most common types of non-dischargeable debts are certain types of tax claims.

conditions. For example, the debtor must fully cooperate with the court during the administration phase, after which the debts could be discharged.¹⁸

The US Bankruptcy Code provides a complete discharge of debt, subject to litigation involving objections by creditors and other limited exceptions. Generally, no restrictions are placed on the debtor following the discharge of debt, allowing him to enter freely into other business ventures. However, restrictions are placed on any debtor who has been convicted of a criminal offence related to fraud, gross negligence or willful misconduct that led to bankruptcy (Mecham 2004).

When discharge is readily available to the debtor, he has little reason to fear the legal consequences of a bankruptcy. Accordingly, he will not be motivated to delay his adjudication or prolong the administration of his bankruptcy estate.

Imposing a stay on creditors' claims

Upon filing for reorganization, no creditor should be allowed to seize or sell any of the firm's assets during the process. As long as the stay is in effect, all judgments, collection activities, foreclosures, and repossessions of property are suspended. Creditors may not pursue any debt or claim that arose before the filing of the bankruptcy petition.

A number of bankruptcy systems in transition economies exclude the payment of taxes and salaries from the coverage of the stay. However, these exceptions should be kept to a minimum and exceptions should only be made for those assets that are irrelevant to the sale of a firm as a going concern.¹⁹

A crucial point to consider is whether relief from creditors should be automatic or a possibility that must be approved by a court or by creditors. Research on developing principles and guidelines for an effective bankruptcy and creditors' rights system suggest that there should preferably be an automatic stay on assets for at least some initial period. The absence of an automatic stay may lead creditors to race to seize assets, increasing financial distress and the possibility of liquidation (World Bank 2001).

¹⁸ Very few countries provide for an automatic discharge of debts such as the UK. It provides automatic discharge only in cases where the debtor cooperates with the court.

¹⁹ In specific circumstances, the secured creditor can obtain an order from the court granting relief from the automatic stay. For example, when the debtor has no equity in the property and that property is not necessary for an effective reorganization, the secured creditor can seek an order of the court lifting the stay, thereby allowing the creditor to foreclose on the property, sell it, and apply the proceeds to the debt.

In the US, there is a 90-day automatic stay on claims for firms filing for Chapter 11 bankruptcy reorganization. In the Czech Republic, the court offers the debtor a 90-day protection period during which he can produce a “settlement plan” that must meet certain conditions and be approved by the court. During the protection period there is a stay on claims against the firm (except for the claims of employees and the state arising from current operations). In special circumstances, the protection period can be extended by another 90 days.²⁰

4.2 Appropriate Incentives: The Creditors

A country with a strong investor and creditor protection record usually has higher rates of capital investment and productivity growth (Modigliani and Perotti 2000). Therefore, it is important that Egypt's new bankruptcy system incorporates and enforces strict time limits on drafting, voting, and confirming a reorganization plan. The system should also prevent a dissenting minority of creditors from delaying a sensible reorganization plan, and should allow the annulment of unfair transfers made prior to the debtor's payment cessation.

Time-limited reorganization period

The reorganization plan filed by the debtor-in-possession should be accepted or rejected within a specified number of days from the date his plan was filed (e.g., 60 days). The debtor-in-possession should file a plan within his exclusive 90 to 120-day period or seek an extension; otherwise his exclusive right to file a reorganization plan is lost. A creditors' committee would then be organized to formulate an alternative plan, or to convert the case to liquidation.

A creditors' right to file an alternative reorganization plan provides an incentive for the debtor to file a plan within the exclusive period and also helps avoid excessive delay in the case.

Creditors' consent

Secured creditors should be compelled to accept a change of status or a lower priority in order to protect the interests of the creditors as a group. This arrangement would help prevent a sensible plan from being substantially delayed by a dissenting minority and allows it to be

²⁰ In Hungary, the 90-day relief from creditors is subject to the discretionary vote of creditors.

imposed on that minority (albeit with suitable safeguards) for the benefit of the interested parties as a whole.

Under the “cram-down” procedure of Chapter 11 of the US Bankruptcy Code, the court can impose a plan on any class of creditors, including secured creditors, that varies their rights (e.g., by extension of the period of payment). Provided that creditors receive at least as much as they would in the case of liquidation (which is estimated by the court based on the value of the available assets and the expenses of liquidation) and that the proposal is equitable, the court may approve such a plan despite the opposition of some creditors.

The "cram-down" provision is especially important as it enables the debtor to compel even a substantial portion of his creditors to accept less than full payment of their debts, with the remainder discharged. It gives the debtor leverage to prevent a few large creditors from taking control of the reorganization, thereby enabling the debtor to negotiate a reasonable arrangement (Mecham 2004).

Annulment of unfair transfers prior to the debtor’s payment cessation

It is not always easy for creditors to prove a debtor’s intention to discriminate against them. Therefore, it is necessary to establish clear rules that allow creditors to examine past transactions. In a limited number of circumstances, the burden of proof may even shift to the debtor who could be required to prove that the disputed transactions were made in good faith.

The power to annul transfers of money or property should be effective against transactions made up to one year *prior* to the filing of the bankruptcy petition.

4.3 Appropriate Incentives: The Bankruptcy Trustee

The appointment of a bankruptcy trustee is a rarity in a reorganization-oriented bankruptcy system. A trustee should be appointed only if there is a just cause including fraud, dishonesty, incompetence, gross mismanagement, or if such an appointment is in the interest of creditors, any equity security holders, and other interests of the estate (Mecham 2004; World Bank 2001, 1999).

However, once appointed by the court, the trustee has significant discretion over the assets of a debtor enterprise, especially when it comes to their liquidation and disposal. Therefore, the trustee should be competent, impartial, and insured or bonded against loss due

to fraud or other malpractice. Appropriate rewards and penalties should be established and enforced in order to ensure the integrity of the trustee.

Remuneration of the bankruptcy trustee

The remuneration of the trustee is crucial to creating the appropriate incentives to motivate him to maximize the value of recovered assets and satisfy creditors' claims. The method of remuneration of the trustee is one way of bringing his interests in line with those of creditors and debtors. A proper incentive structure will tie the remuneration of the bankruptcy trustee to the level of proceeds earned upon the disposal of assets, or to the nature of the firm's recovery upon successful reorganization.²¹

Accountability of the bankruptcy trustee

Equally important, the trustee must be held accountable for his actions and be subject to maintaining professional standards of quality. It is essential that the trustee is properly qualified. His knowledge and practical understanding of the law and his job requirements should be tested by an impartial examination.

In order to ensure that the trustee has the appropriate training and is subject to some form of professional monitoring, it is necessary to officially register him with a professional organization. For example, in the Czech Republic the new bankruptcy law requires all court administrators to be members of the association of bankruptcy practitioners. This not only certifies that they are suited for the job, but it also helps prevent unscrupulous administrators from continuing to practice in one district after being found guilty of misconduct in another (Lizal 2002; Ramasastry 2002).

A professional association of this nature should be responsible for, among other things, keeping a register of official members; exercising oversight on the profession; monitoring performance and compliance with statutory requirements and standards; testing members' suitability; imposing sanctions on members who bring the association into disrepute (for

²¹ The method of remunerating the trustee may affect the outcomes of procedures. If he is rewarded for keeping firms in operation and maintaining them as going concerns, he may prefer this option even if it is against the interest of creditors. This was the case in Hungary, where the strong position of liquidators enabled them to perform reorganizations even if debtors had filed for liquidation. Hence, a considerable share of liquidation filings actually ended through workouts and the sale of going concerns.

example if they are found guilty of misconduct by courts); formulating best practice guidelines; and setting professional education standards.

The professional association should also help members with the provision of a collective insurance policy. Trustees are legally responsible for their actions and can be sued for making wrong decisions on asset disposal or for having inflicted losses on third parties. The fear of such legal responsibility may distort their decisions. The insurance provided by the professional association would reduce such burden, allowing the trustee to focus on doing his job rather than the consequences associated with it.

4.4 Effective Enforcement

Efficient bankruptcy procedures require effective implementation efforts. Getting the debtor and his creditors more involved in the reorganization process, and providing enforcement mechanisms to avoid delays in the filing of a bankruptcy petition, are keys for the successful reorganization of potentially viable firms (Gitling and Watkins 2000; Greif 1996).

Promoting direct negotiations between the debtor and creditors

Reorganization cases proceed quite quickly when bankruptcy rules and procedures are simple, and the level of involvement by courts and trustees is minimal.

Once a case is approved to proceed, the judge should no longer be substantially involved. The role of the court (and the bankruptcy judge) should be limited to cases where there are implementation problems, important points of the proceedings such as the approval of any reorganization plan and its extension, and at the end when the case is being completed. The process of reorganization should be managed by the debtor and his creditors, and in this decentralized mode could proceed quite rapidly (Buscaglia and Dakolias 1996).

Providing enforcement mechanisms

In Egypt's current bankruptcy system, the debtor is required to declare his insolvency within fifteen days of defaulting on his debts. However, many debtors ignore this requirement and often delay filing for bankruptcy. This often leads to a worsening of the firm's financial position and liquidation ends up being the only option. Thus, it is essential to provide incentives (e.g., less penalties, easier settlement) for a debtor who is aware that he can no longer pay his debts as a way of encouraging early action.

If a debtor fails to declare bankruptcy within the specified time period, two kinds of penalties could be imposed. First, the debtor could become liable for any damage caused to creditors and may be sued by them. Second, the debtor could be deprived of the right to run another economic activity on his own (sole proprietorship) or manage another company, unless he proves that he is not guilty of failing to declare bankruptcy within the obligatory time limit.

5. CONCLUSION

Egypt needs a clear and predictable market exit policy in order to improve productivity, promote investment and credit flows, and protect the rights of various stakeholders. Currently, the bankruptcy process in Egypt is costly, lengthy and inefficient, such that both debtors and creditors have very little incentive to use the bankruptcy system as a formal mechanism for an orderly market exit.

A thorough analysis of bankruptcy systems in other countries reveals that Egypt needs to introduce a more efficient bankruptcy system that is effectively enforced and provides appropriate incentives for the debtor, creditors, and the bankruptcy trustee, to reorganize potentially viable firms, thereby preventing their premature liquidation. This new system should allow honest debtors a fresh start and give them a chance to prepare a sensible reorganization plan. This can be possible through removing the severe legal sanctions imposed on them, providing them with a discharge of their remaining debts, and imposing a stay on creditors' claims during the process of reorganization.

The proposed system should also strengthen the rights of investors and creditors by setting strict time limits for drafting, voting and confirming a reorganization plan, preventing a dissenting minority of creditors from delaying a sensible plan, and providing creditors and trustees with "avoiding powers" to annul unfair transfers made prior to the debtor's payment cessation. Establishing appropriate rewards and penalties for the bankruptcy trustee would bring his interests in line with those of creditors and debtors, and create the right incentives for him to maximize the value of the recovered assets and satisfy creditors' claims.

Essential for a successful reorganization are both promoting the involvement of the debtor and his creditors in the process and the availability of an enforcement mechanism that ensures the early recognition of financial difficulties, the disclosure of information, and timely intervention.

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