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REVIEW OF 2009 DRAFT LAW ON BUSINESS INSOLVENCY (MOZAMBIQUE)

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ABBREVIATIONS

CB	Closing a Business Indicator, in the World Bank Doing Business Survey
DB	Doing Business Survey (Annual) published by the World Bank
EBRD	European Bank for Reconstruction & Development
S&C	Sal & Caldeira and Associates
ROSC	The World Bank Creditor Rights and Insolvency Assessment Methodology (2005)
UNCITRAL	United Nations Commission on International Trade Law
USAID	United States Agency for International Development
WB	World Bank Group

EXECUTIVE SUMMARY

The purpose of this Memorandum is to summarize an independent review of a draft law on business insolvency for Mozambique, conducted by SPEED for USAID/Mozambique. The Draft Law on Insolvency dated 2009 (Draft Law) is intended to replace the current insolvency legal framework in the Code of Civil Procedure of 1967 and was prepared by legal experts at the request of the Government of Mozambique's technical unit for legal reform (Unidad Técnica de Reforma Legal -UTREL), under a project to strengthen the financial sector (Projeto de Assistência Técnica ao Setor Financeiro – FSTAP) funded by the African Development Bank and the World Bank.

The Draft Law will likely be submitted to Parliament in the fall of this year. The SPEED team deemed it necessary to assess its strengths and weaknesses and determine if further revisions or discussion are needed before submission. Since SPEED may also support the implementation process of the new law should it be enacted, this Memorandum also provides input on possible issues which may be encountered during implementation, based on experience in other countries that have undertaken insolvency reform.

DAI Senior Legal Reform Expert Rémy Kormos undertook a desk review of the Draft Law. The review, presented in **Part I** of this Report, found the following:

- The Draft law is modeled on the 2005 Brazilian law, is clearly drafted and complete and would completely overhaul the existing insolvency legal framework in Mozambique and replace it with a far more modern model;
- The text of the Draft Law conforms to current international standards and would score well under legal framework assessment methodologies, as developed by UNCITRAL, the World Bank, EBRD and USAID;
- While the choice of Brazilian law as a model is appropriate, the draft may need further revisions to address the Mozambican context, so more research and stakeholder input may be needed;
- There are a number of technical areas where further discussion may be needed; the implementation of the law will require significant resources;
- Although it is not possible to predict its impact, passage and implementation of the law will likely improve Mozambique's "Closing a Business" score on the Doing Business survey;

Part II of this Memorandum outlines some of the possible implementation issues relating to the new insolvency law, including:

- Transitioning to the new system, including the need to conduct outreach on the new law to the private sector, the financial sector, and the public at large
- Strengthening the judicial system's capacity to manage and decide insolvency cases through training, preparation of manuals, strengthening court staff and enforcing ethics rules;
- The need to ensure that related legal and institutional frameworks that support creditor rights and are necessary to insolvency, such as the enforcement of judgments and secured transactions, are also reformed;

- Strengthening the capacity of Mozambique's insolvency administrators, and establishing self-regulatory and/or licensing mechanisms;
- Supporting the other legal, management and accounting professionals who will be involved in implementing the law.

Considerable work and resources will be needed to strengthen the institutions and professionals responsible for implementing the legal framework. The scope and resources needed to effectively strengthen these institutions should not be underestimated, and in many cases are dependent on broader judicial reform initiatives.

In conclusion, after considering the above factors, we recommend that the USAID SPEED program proceed with technical assistance in the area of insolvency reform in Mozambique on the basis of the Draft Law. Future technical assistance and training could be provided with respect to strengthening the Draft Law, obtaining input from stakeholders on the draft, and/or implementing it as a new law.

INTRODUCTION

The Support Program for Economic and Enterprise Development (SPEED) is a four-year private-sector-led project funded by USAID/Mozambique intended to help Mozambique overcome major obstacles to trade and investment, with a focus on improving the quality, quantity, and process of beneficial business climate reforms. With the contribution of both the Government of Mozambique and the private sector, the project aims to build key policy reforms; strengthen private sector participation in policy dialogue; and create the capacity and systems to ensure that key reforms are implemented effectively.

In January 2011, SPEED was asked by the Minister of Industry and Commerce to explore what can be done in the short term to improve the country's ranking in the World Bank's "Doing Business" survey. A review of existing analysis and interviews with key informants yielded a number of recommendations, including one to accelerate the passage of a draft bankruptcy law which was prepared between 2007and 2008 by Sal & Caldeira and Associates (S&C) at the request of the Government of Mozambique's technical unit for legal reform (Unidad Técnica de Reforma Legal -UTREL). This law was one of several that were developed under a project to strengthen the financial sector (Projeto de Assistência Técnica ao Setor Financeiro – FSTAP) funded by the African Development Bank and the World Bank.

Sal & Caldeira were asked to review the applicable legislation in place at the time, including both the Civil Procedure Code and the Commercial Code. Tasks in the scope of work included:

- Assessing the current legal and institutional frameworks for insolvency in Mozambique, principally the applicable provisions of the Code of Civil Procedure of 1967;
- Providing a comparative analysis of different countries' experience in developing new bankruptcy laws,
- Drafting a new insolvency law,
- Supporting the Mozambican government in the legislative process to approve the law, especially with regards to public consultation,
- Assisting the government with the establishment of an association of insolvency professionals, and
- Delivering training for insolvency professionals.

In their Preliminary Report dated 2007 and their Final Report dated 2009,the S&C experts summarize their assessment of existing insolvency laws and implementing institutions, as well as their comparative legal analysis. Based on the available data and interviews, the S&C consultants concluded that there were very few cases of insolvency entering the courts in Mozambique—perhaps ten cases per year in recent years. This indicates that there is essentially no insolvency practice in the country and that the system has basically ceased to function. According to the World Bank, a twelve of the 46 countries in Sub-Saharan Africa are considered to have no insolvency practice because fewer than five insolvency cases per year were reported. [1]

[1] World Bank Doing Business 2011, p. 80. Note that the World Bank deems that a country where five or fewer cases are reported per year has "no practice" and data for the Closing a Business is not collected for that country.

In terms of comparative legal analysis, the experts looked at Portuguese, Brazilian, and South African insolvency law, and the Draft Law is closely based on the current Brazilian Business Insolvency Law (Nova Lei de Falencias e Recuperacao de Empresas, Law No. 11101 dated February 9, 2005) (Brazilian Insolvency Law). Brazilian legal experts participated in the drafting process with S&C. The S&C experts did not look at the Organisation pour l'Harmonisation en Afrique du Droit des Affaires (OHADA) model insolvency law, which is based on the French model and is not considered effective, and in any case is currently being revised.

Two public consultation events were held, in February and October of 2007, and the resulting comments were incorporated to the draft law. During the following year, comments provided by the Ministry of Justice were also incorporated into the draft. The Ministers' Council (Conselho de Ministros) approved the draft law in February 2009, with some slight changes mostly relating to a clarification that in the event of sanctions. The law was then submitted to Parliament during its March 2009 session, but was not considered. It is expected to be resubmitted in 2011.

The purpose of this memorandum is to conduct an independent review of the merits of the proposed insolvency law, based on international legal standards, practice, and experience.

A copy of the Statement of Work for DAI Senior Legal Reform Expert Rémy Kormos is attached hereto as Annex 1. In brief, Mr. Kormos:

- Reviewed the 2009 Draft Law on Business Insolvency, the existing legal framework in the Code of Civil Procedure and the S&C research and materials;
- Analyzed the Draft Law in light of current international standards and applied legal framework assessment methodologies to assess its completeness and compliance with international standards;
- Reviewed the Brazilian Insolvency Law and conducted research on its implementation and impact on insolvency in Brazil;
- Contacted World Bank experts in Washington DC to discuss Mozambique's ranking in the Doing Business Report; a phone conference will be set up early next month for this purpose.
- Estimated the potential impact on the "Closing a Business" indicator on the World Bank's Doing Business Survey if the Draft Law were to be implemented.

This Memorandum is limited to a review of the Draft Law, the explanatory materials prepared by the S&C consultants who prepared the draft law and a brief review of Mozambique's current legal framework for insolvency. As with any desk study of the text of a law, this study did not include an assessment of how the existing insolvency system in Mozambique is functioning in practice, nor does this Memorandum evaluate the capacity of the institutions and professionals responsible for implementing insolvency law, such as the courts, insolvency administrators, the legal profession, or the banking sector. The compatibility of the draft law with other related laws, regulations and institutions in Mozambique has likewise not been addressed in this Memorandum.[2]

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[2] As noted above, the Sal & Caldeira consultants undertook an assessment of the existing legal and institutional framework prior to preparing the Draft Law.

This assessment referred to the most recent and applicable international standards and/or assessment methodologies relating to legal frameworks for insolvency developed by the following:

1) United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law (United Nations, New York 2005) (UNCITRAL Legislative Guide);

2) The World Bank Creditor Rights and Insolvency Assessment Methodology (ROSC) (2005), based on the World Bank Principles for Effective Insolvency and Creditor Rights Systems (Revised) (2005);

3) European Bank for Reconstruction and Development (EBRD) Insolvency Law Assessment Project (2009) and the EBRD Insolvency Office Holder Principles (2007); and

4) The BizCLIR 2008 Questionnaire developed by Booz Allen Hamilton for USAID (BizCLIR Questionnaire).

A NOTE ON INSOLVENCY SYSTEM'S ROLE IN ECONOMIC DEVELOPMENT AND THE REFORM CHALLENGES

An effective and predictable insolvency system is a key part of the business enabling environment, since such a system can help foster the development of credit markets by reducing credit risk, plays a key role in removing failing businesses so more efficient firms can enter the market, and in certain cases can help save businesses which are encountering temporary financial problems and are worth saving.

A business insolvency system, however, it is a complex legal framework with multiple institutional actors and competing economic interests, and reforming such a complex system is always a challenge. While the legal framework is important (and in itself complex since it combines both procedural and substantive rules), its implementation by the courts, insolvency professionals, banks and business community is perhaps even more important.

Unlike other areas of business regulation reform, where one can generally speak about "the private sector" on one hand as the "public sector" on the other, insolvency reform is more complex. For example, there are distinctly different interests and concerns within the "private sector"—for example bankers (who are typically the secured creditors in an insolvency proceeding) will have different concerns than the managers/directors of businesses that face insolvency.

The different stakeholders in the insolvency process include:

- Business enterprises, from sole proprietorships to large corporations, who can potentially fall into financial difficulties as debtors, and their managers and shareholders / owners;
- Labor, including the employees of a struggling business;
- The broader community where a struggling business is located;
- Creditors, including the banking sector (typically secured creditors) and unsecured creditors such as trade creditors);
- Judges and court staff and the judiciary in general;
- The legal and accounting professions;
- Insolvency administrators; and

- Local, regional and national government institutions and stakeholders, including tax authorities.

This complex set of interests makes the process of insolvency as well as the process of insolvency reform more challenging than many other types of business regulation and business regulatory reform.

PART I: REVIEW OF 2009 DRAFT LAW ON BUSINESS INSOLVENCY

OVERVIEW OF 2009 DRAFT LAW

The Draft Law, if implemented, would completely change the framework for and structure of insolvency procedures in Mozambique, as well as the roles and responsibilities of judges, insolvency administrators, lawyers, debtor businesses, secured creditors and unsecured creditors. The Draft Law:

- Increases the participation of creditors in the insolvency process, increases the responsibilities of the insolvency administrator and reduces the role of the court; also gives secured creditors significantly greater rights;
- Replaces the ineffective *concordata* or debt restructuring procedure with modern, US-inspired court supervised reorganization procedure, *Recuperacao Judicial*;
- Completely revises the outdated liquidation procedures and changes the priority of creditor claims, notably placing tax creditors below secured creditors;
- Introduces mechanisms to encourage out of court negotiations resulting in a "pre-packaged" reorganization plan (*Recuperacao Extrajudicial*) that becomes binding provided the plan is approved by the requisite percentage of creditors and approved by the court.

The Draft Law is closely modeled on the new Brazilian Insolvency Law (Law No. 11,101--Lei de Falencias e Recuperacao de Empresas, 2005) (Brazilian Insolvency Law). As such, the Draft law is a so-called "legal transplant" and many if not most of the provisions of the Draft Law are for all intents and purposes identical to the Brazilian Insolvency Law. As set out below, we believe this approach to be appropriate for the Mozambican context, and it is typical for insolvency reforms in developing country contexts. However, the legal transplantation approach carries certain risks, such as the risk of insufficiently adapting the model to local contexts, or selecting an inappropriate model.

POSITIVE AND NEGATIVE FACTORS

PROVIDING NEW INCENTIVES TO STAKEHOLDERS

Perhaps the most significant improvement of the Draft Law over existing legislation is that it introduces the appropriate incentives to the secured creditors, unsecured creditors, the debtor, the debtor's managers and employees and other stakeholders to participate in good faith from the start and to negotiate and complete insolvency procedures promptly.

THE DRAFT LAW IS CLEARLY DRAFTED AND REFLECTS INTERNATIONAL BEST PRACTICES

The Draft Law meets most the legal framework guidelines set out in the UNCITRAL Legislative Guide. It is important to note that these guidelines do not constitute a model law, but rather guidelines on how to

develop a modern insolvency law; there is no consensus on the best model, and legal experts and economists continue to debate how best to resolve insolvency.[3] The World Bank Principles and ROSC were developed concurrently with the UNICTRAL Legislative Guide, and the Draft Law likewise meets these standards. Although the EBRD assessment methodology was not applied systematically to "grade" the Draft Law, the author found that the Draft Law would likely achieve a high score. Finally, only a small part of the BizCLIR assessment questionnaire applies to the legal framework alone, since BizCLIR seeks to assess implementing institutions as well; the Draft Law meets virtually all of the points highlighted by BizCLIR.

INTRODUCING OUT-OF-COURT WORKOUTS (*RECUPERACAO EXTRAJUDICIAL*)

International best practices, and the US experience in particular suggest that encouraging creditors and debtors to negotiate reorganizations out of court and then obtain court approval if needed is the most efficient approach. In this respect, the Brazilian model is excellent.

THE DRAFT LAW TAKES A BALANCED APPROACH: ENCOURAGE REORGANIZATION IF POSSIBLE, AND STRENGTHEN CREDITOR RIGHTS

The Draft Law encourages reorganization, which generally speaking favors the debtor and other stakeholders such as employees, while significantly increasing creditor rights and participation in liquidation (and in reorganization) over existing law. This moderately pro-creditor approach, similar to the US model, contrasts notably with the French law and OHADA approach of limiting the role of the creditors may also be the optimal one to take for a developing economy such as Mozambique. Several economists have argued that in countries where investor protections are weak and the judiciary is not strong and/or has relatively limited capacity to analyze the economic viability of insolvent companies, a creditor friendly law is optimal[4].

The World Bank considers reforms that strengthen the rights and participation of creditors as positive reforms which increase the recovery rate and consequently a country's raking on the Closing a Business indicator[5]. A major argument in favor of pro-creditor systems, where secured creditors enjoy legal protections, participate actively and are repaid promptly is that such systems foster the development of credit markets by lowering credit risks to lenders. Likewise the insolvency process tends to be more efficient where secured creditors are involved and defending their interests, since the banks will have considerable knowledge of the debtor's business and can help design and implement efficient reorganization plans or facilitate efficient sales of the business or its assets.

USING THE BRAZILIAN MODEL: PROS

- Brazil's old system was similar to Mozambique's current system, and the two countries share certain legal traditions. Brazilian legal and financial sector experts from the public and privates sectors spent over a decade developing and then enacting the 2005 Brazilian Insolvency Law, ensuring it reflected best international practices, including notably US Chapter 11 type reorganization mechanisms.

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[3] UNCITRAL does have a model law relating to cross-border insolvency, but that aspect is not addressed in the Draft Law and is probably not a priority for Mozambique at this point.

[4] Ayotte & Yun, Matching Bankruptcy Laws to Legal Environments, 10 Journal, Economics & Organization (2007), p. 1.

[5] See e.g. Djankov et al., Debt Enforcement Around the World (2007), p. 42.

- The "legal transplant" approach seems appropriate here—as opposed to attempting to reform the existing laws or developing an entirely new framework-- given the limited resources and limited insolvency practice today. Many scholars and legal reform experts agree that in smaller jurisdictions using a larger country's legal framework as a model is a rational choice[6].
- Brazil's reforms resulted in the significant shortening of insolvency procedures almost immediately and a dramatic drop in the average time for resolving insolvency cases, from ten to four as measured by the World Bank's Doing Business; the recovery rate also increased in the years following the implementation of Brazil's new law[7]. Another study conducted in 2008, just three years after the law was passed, found a 22% reduction on average in firm's cost of debt, an increase of 39% in the aggregated level of credit and of 79% in long term credit. These results are explained by the higher level of creditor protection following the reforms.[8] However, Brazil's old insolvency system and courts were notoriously ineffective and slow, even by Latin American standards, and Brazil's ranking in Closing a Business remains low despite these improvements following the implementation of the 2005 Insolvency Law.

USING THE BRAZILIAN MODEL: CONS

- While certain legal traditions may be shared, from an economic, social and judicial perspective, Brazil is obviously quite different from Mozambique, and had more resources to implement the insolvency reforms and strengthen implementing institutions. Many scholars would argue that transplanting a law from such a different context, rather than developing a law specific to Mozambique, will result in difficulties in implementation[9]. As noted above however, it seems clear that due to limited resources using a model from another jurisdiction was necessary, in that respect the choice of Brazilian law is appropriate. As set out below, some of the possible improvements to the draft involve adjustments to the Mozambican context.
- While Brazil's new insolvency law resulted in significant improvements to the insolvency system, and aspects of the reform are presented as best practices by the World Bank, Brazil's ranking on the Closing a Business Indicator remains extremely low—in fact Brazil's 2011 ranking of 132nd overall is actually lower than Mozambique's ranking of 129th. As discussed below, this ranking reflects both serious methodological flaws in how the survey is conducted, but also the fact that the main challenges of insolvency reform relate more to implementation than to legal drafting—or to put in other words, it is not enough to have a good insolvency law. Notwithstanding this, Brazil's low ranking is a concern to be considered by Mozambique policy makers seeking to improve Mozambique's Doing Business rankings.
- Brazil has had to follow up on the 2005 reforms to the insolvency legal framework with additional reforms in a number of other related areas, including reforms to the Code of Civil Procedure in 2007

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[6] See e.g. Kevin Davis, *Law Making in Small Jurisdictions*, 56 Univ. of Toronto L.J. 151 (2006).

[7] Standard & Poors, Ratings Direct, Debt Recovery for Creditors and the Law of Insolvency in Brazil (2008).

[8] Bruno Funchal, The Effects of the 2005 Bankruptcy Reform in Brazil, Elsevier Economics Letter 101 (2008) 84-86.

[9] See e.g. Ann Seidman and Robert Seidman, *Using Reason and Experience to Draft Country-Specific Laws*, in Making Development Work: Legislative Reform for Institutional Transformation and Good Governance (Ann Seidman et al, Eds., 1999).

order to strengthen creditor rights and streamline the enforcement of judgments[10]; Mozambique will likely need to consider reforms to other related laws which support insolvency.

AREAS FOR POTENTIAL IMPROVEMENT / FURTHER DISCUSSION

GENERAL COMMENTS APPLICABLE TO ENTIRE DRAFT

Terminology: Risk of Confusion Regarding the Terms "Insolvency" / "Liquidation".

The term *falencia*, or liquidation was replaced with the term *insolvencia* in the Draft Law to denote the liquidation procedure set out in Articles 69-157. The rationale for this is set out in the Sal & Caldeira Final Memorandum, namely that the term *falencia* carries strong negative connotations (Final Memo, p. 11). If it is indeed advisable to stop using the term *falencia*[11] in Mozambique, it is strongly recommended that the term liquidation / *liquidacao* be used instead.

Using "insolvency" to denote the liquidation procedure will likely result in confusion. Most countries[12], international organizations and multilateral development banks[13] use "insolvency" to denote the state of financial difficulty (such as the inability to pay debts as they come due), and use the term "insolvency procedures" for the procedures that are available to resolve the insolvency, including both "liquidation" and "reorganization".[14]

COMMENTS RELATING TO INTRODUCTORY PROVISIONS AND PROVISIONS THAT APPLY TO BOTH REORGANIZATION AND LIQUIDATION (ARTS. 1- 45)

Preamble.

The Preamble (*Fundamentacao*) states that the Draft Law moves from "a situation where one basically protected the interests of the creditors towards a system that intends to safeguard stability and social peace and quiet". We recommend deleting or perhaps toning down this statement, as it sets high expectations and is arguably not entirely accurate. It is true that unlike Mozambique's current law, the Draft Law encourages reorganization of troubled businesses, which in theory should safeguard social stability by saving jobs and takes into consideration interests other than those of creditors. However, in practice the majority of insolvency cases around the world end up in liquidation, and successful reorganizations can be rare in developing countries, particularly where there is little previous practice. The liquidation

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[10] Standard & Poors, Ratings Direct, Debt Recovery for Creditors and the Law of Insolvency in Brazil (2008), at p. 7.

[11] In Brazil the legislator opted to continue using the term *falencia* for liquidation.

[12] Including notably Portugal (*insolvencia, processos de insolvencia*, and *liquidacao*), Spain and South Africa. While some countries use other terms for insolvency in general, such as the term bankruptcy in the US or the term *procedures collectives* in France, the use of the term liquidation is almost universal around the world, with the notable exception of Brazil.

[13] Including the United Nations (UNCITRAL), EBRD, the European Union, and the World Bank.

[14] The fact that a country's ranking in the Doing Business survey is largely determined by responses from practitioners to questionnaires circulated by the World Bank, is a compelling reason in itself to use internationally accepted terms.

procedures provided for in the Draft Law are arguably rather pro creditor, although labor claims remain the first priority before secured creditors and are not capped (see discussion below).

Debtors Covered by Insolvency Law (Art. 2).

The Draft law applies to *empresarios comerciais* (or commercial entrepreneurs), a term which is defined in Art. 1 of the Commercial Code. Per the Commercial Code the term covers both legal entities and natural persons who are engaged in commercial activities. For the sake of clarity we recommend that the Commercial Code definition be incorporated into the Draft Law at Art. 2, so that there is no confusion, particularly for non-lawyers or foreign investors, for whom the term commercial entrepreneurs may seem to cover only natural persons and not legal entities such as corporations. Art. 2 of the Brazilian text lists both: "do empresario e da sociedade empresaria" and is accordingly clearer.

We also note that state-owned enterprises (SOEs) and mixed enterprises are excluded from insolvency proceedings, even if they are commercial entities and/or the state only holds a minority stake. While there are likely underlying policy issues, this exclusion in contrary to international best practices, which encourage inclusion of SOEs provided they are commercial entities (obviously the state, sub national government and municipalities are not covered by business insolvency legislation). See UNCITRAL Legislative Guide on Insolvency Law at p. 40, and World Bank Principles for Effective Creditor Rights and Insolvency Systems, Principle C.3 (Commencement), USAID BIZCLIR Closing a Business, Item 2 (p. 125).

Notification of the Public Prosecutor (Art. 4).

This clause requires notification to the Public Prosecutor and gives the office the right to intervene in insolvency cases. We understand that this involvement of the Public Prosecution is mandated by law and is intended to ensure that fraud is investigated and prosecuted. However, Art. 4 may be over-broad when it allows the Public Prosecutor to intervene in any insolvency case involving the "public interest." We suggest that this point be discussed further, particularly in light of one of the stated goals of the Draft Law, which is to minimize state involvement in business insolvencies, encourage the parties to negotiate among themselves and remove the out-dated and ineffective "punitive" approach to business insolvency.

The Automatic Stay and Adequate Protection for Secured Creditors (Art. 6).

A major change to Mozambique's insolvency system under the Draft Law will be the imposition of a US Chapter 11-style automatic stay which at the start of insolvency procedures suspends all legal actions and claims against the debtor, including notably those of secured creditors. This 180-day stay provides "breathing room" for the debtor to attempt reorganization, or if reorganization fails, for the insolvency administrator to liquidate the debtor. Under current Mozambique law, it appears that while the concordata process does include a stay, secured creditors are exempted from the stay, and thus can continue litigation against the debtor even during insolvency proceedings. The change to an automatic stay that applies to all claims reflects international best practices, as reflected in the UNICTRAL Legislative Guide (pp. 83-99), the World Bank (Principle C5.3) and BizClir (Closing a Business, Item 4H).

However, it is not clear that the Draft Law provides adequate protection for secured creditors, i.e. that the secured creditor's rights in the encumbered assets will be protected by the insolvency administrator during insolvency. This is extremely important, as secured creditors by definition have higher rights than unsecured creditors. We recommend that this issue be studied by financial sector and legal experts before the law is finalized, as it is of significant importance to secured creditors such as banks and could affect access to credit.

We also note that while Brazil implemented the same type of automatic stay that applies to secured creditors, Brazilian law also provides that certain types of secured creditors, including financial lessors, creditors that take security by means of a fiduciary sale or assignment, and certain types of real estate creditors, are completely exempt from the insolvency process, including the 180-automatic stay. These creditors have the ability to foreclose on an expedited basis out of court. Not surprisingly this type of secured lending has grown significantly in importance in Brazil as a result[15]. It appears that this exemption is not in the Brazilian Insolvency Law, but in other legislation; we recommend that this issue also be examined further.

Verification and Filing of Creditor Claims (Arts. 7-15).

The Draft Law provides that the Insolvency Administrator, and not the judge, is responsible for receiving and verifying creditor claims. There is no international consensus on whether the verification of claims should be done by the court or by the insolvency administrators. It will be extremely important to ensure that the professionals who will be acting as administrators have been adequately trained and that appropriate supervisory mechanisms (beyond the judges in the particular case) are established. This is especially important given the finding discussed above that as of today there is very little experience with insolvency in Mozambique, which suggests that there are few insolvency professionals.

While the initial verification of claims can be done by the administrator, we believe that appeals regarding such verification should be done by the court having jurisdiction over the case. However, Article 13 of the Draft Law provides that appeals from the initial verification of the claim by the administrator are also heard by the administrator.[16]

The final review and approval of all creditor claims is made by the judge (Arts. 14-15)

We suggest that Art. 13 be reviewed and the question of who hears appeals from decisions by the administrator be discussed further. On the one hand we understand the stated goal of minimizing the role of the judge and reducing appeals. On the other hand we believe that there are serious due process and transparency concerns raised by having the administrator hear appeals from his own decisions.

Verification of the validity of creditor claims is a very important step in the insolvency process, and due process and transparency concerns seem paramount.

Role and Regulation of the Insolvency Administrator (Arts. 21-25, 29-33)

The text of the articles relating to the insolvency administrator, who is to be a private sector professional, reflect international best practices, and implement the drafters' goal set out in the preamble of limiting the role of the courts in insolvency. Accordingly, the administrator is given significant responsibilities and an active role throughout both reorganization and liquidation. In fact, the administrator will be in the driver's seat in both liquidations and reorganizations, which will represent a major change from the current out-dated system.

The administrator is appointed by the judge (Art. 21) and reports to both the judge and the creditors and can be removed by the judge. Notwithstanding this supervision by the court in a particular case, real-

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[15] Standard & Poors, Ratings Direct, Debt Recovery for Creditors and the Law of Insolvency in Brazil (2008), p.3.

[16] Note that Brazilian Insolvency Law differs from the Draft Law in this respect, as it is the judge that hears appeals regarding the verification of claims. (See Brazilian Insolvency Law Art. 13

world experience in a number of countries around the world suggests that additional safeguards are necessary to ensure that insolvency administrators are qualified, properly trained, supervised, compensated and disciplined. Under the Draft Law, and assuming that no other regulations are issued regarding insolvency administrators, almost anyone with five years of work experience as a “manager” can theoretically be appointed by a judge to serve as administrator in any insolvency case, including someone with a criminal record, no education, and no knowledge of law, accounting or the debtor’s business. Given the absence of experience with insolvency cases in Mozambique, which likely has resulted in there being few professionals with experience implementing insolvency cases, this concern is especially significant and we recommend that this issue be examined before the law is enacted.

Industrialized and developing countries have experienced problems with incompetence and corruption by administrators, and international best practices suggest that (1) the requirements to be administrator be far more rigorous than those set out in Art. 21; and (2) that other self-regulatory or state licensing mechanisms be established to train, support, supervise and discipline administrators. The latter mechanisms can be established in regulations or decrees separate from the insolvency law itself, and will of course require additional resources to implement.[17]

Drafters may also consider the possibility of giving the creditors (through either the Creditor’s Committee or the General Assembly of Creditors) the power to select and appoint the insolvency administrator (see Art. 21).

See UNCITRAL Legislative Guide on Insolvency Law (pp. 174-189); BizClir Closing a Business / Implementing Institutions Item 1; European Bank for Reconstruction and Development (EBRD) Insolvency Office Holders Standards (Insolvency Law Assessment Project 2009 / Questions 24-35); and the World Bank’s Creditor Rights and Insolvency Assessment Methodology (ROSC) (Criteria D7-D8). See also INSOL International, Insolvency Practitioners: Qualifications and Appointment Around the World (2009).

COMMENTS RELATING TO JUDICIAL REORGANIZATION (ARTS 46 – 66)

Overview of Judicial Reorganization Procedure

As noted above, the Draft Law provides for a court-supervised reorganization procedure under which the debtor proposes a reorganization plan to save its business, which must be approved by a vote of the creditors and approved by the court. This approach is clearly modeled on US Chapter 11 reorganization procedures, which is generally recognized as the most successful model, and has served as a model in recent reforms throughout the world, including in civil law countries. The debtor, whose management usually will remain in place during the procedure, must present a two-year reorganization plan, get it approved by the creditors and implement it under strict time frames, or risk liquidation.

Like US law, the Draft Law provides for an automatic stay of all claims and actions against the debtor, including secured creditor claims, to give the debtor business “breathing space” and facilitate the reorganization. This is a major improvement over the old *concordata* procedure, which does not appear

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[17] The S&C Final Report indicates that the consultants provided support in preparing articles of incorporation for a future association of insolvency administrators. The author was not provided with this document. While such an association can be important in training and supporting the development of the profession, we believe that stronger regulatory or self-regulatory measures will be needed.

not provide for a stay against secured creditors. The Draft Law provides for voting by three classes of creditors: labor, secured creditors and all other creditors, and like in US Chapter 11 proceedings, under certain circumstances a plan can be approved despite the dissent of a class of creditors. In conclusion, we believe that this approach to reorganization provides for the most effective set of incentives and should, if effectively applied, be far more effective in avoiding liquidation than the current *concordata* procedure. That being said, implementing effective reorganization procedures is extremely challenging and requires a body of experienced and trained accounting, management and legal professionals as well as competent, efficient and honest judges.

Possibility of Involuntary Reorganization (Art. 47).

The Draft Law only allows the debtor to file for judicial reorganization. We suggest that the possibility be considered of permitting creditor(s) to make such filings as well, rather than only giving creditors the option of filing for liquidation (both the debtor or creditor(s) can file for liquidation). Note that this revision would require a number of changes in the text.

Appeals of Judgments Approving Reorganization (Art. 57)

Art. 57 grants the Public Prosecutor standing to appeal a court approval of a reorganization. Please refer to the comments on Art. 4 above, which also relate to the role of the Public Prosecutor in business insolvencies.

Debtor-in-Possession Financing or "New Money"

One of the key lessons learned from US Chapter 11 reorganization practice is that it is almost impossible to successfully reorganize a business without the infusion of new credit. However, for obvious reasons, convincing an existing creditor or an outside creditor such as a bank to lend to a company that is in reorganization is usually quite difficult—the business is already struggling and has already defaulted. For this reason, many jurisdictions accord a so-called "super priority" to new creditors who bring new funding to a business undergoing reorganization, which provides an incentive for the new loan: that new creditor is to be paid first. We recommend that this issue be studied, as it is not clear that the Draft Law provides such a super priority.

Tax Liabilities Cannot Be Restructured (Art. 48)

As in Brazil, certain types of debt are not subject to judicial reorganization or out of court work-outs, including tax claims. The inability to restructure tax claims in reorganization procedures has been criticized in Brazil by the private sector, since insolvent businesses there typically have large tax liabilities. This is again a matter of policy, but the possibility of restructuring tax liabilities should be discussed.

Notice to Creditors (Art. 51(e)).

It is not clear whether the notice to creditors in Art. 51(e) is sufficient. For example, what if the debtor inadvertently or on purpose omits a creditor? Such a creditor would then be excluded from participating in the procedure. Perhaps some additional incentive should be provided to the creditor to provide a complete list (e.g. in the US, the claims of such an omitted creditor would survive insolvency, so the debtor has an incentive to provide a complete list). In many French law countries, such as Morocco, debtor companies sometimes deliberately "forget" about a creditor, and later use this omission as delaying tactic later on in the procedure.

COMMENTS RELATING TO LIQUIDATION (ARTS. 67 – 157)

Overview of Liquidation

Under the Draft law, the liquidation procedure (*falencia* in Brazil) will be applied where the debtor cannot be saved; the goal is to distribute the remaining assets or insolvency estate to the creditors in an orderly and equitable manner. The debtor will be liquidated (i) following the failure of a reorganization procedure (Arts. 67-68), at the request of the debtor (Arts. 91-104) or upon filing by one or more creditors, provided that certain conditions are met (Arts. 89-97). After liquidation is declared, an insolvency administrator is appointed to administer the liquidation, by collecting, disposing of and liquidating the debtor's assets and distributing them in priority order (Art. 77). When the debtor has been liquidated the administrator files a final report with the court and the case is concluded.

When Can Creditors Request the Declaration of Liquidation of the Debtor (Art. 89)

Article 89 is a key provision of the law, as it sets out the conditions where one or more creditors can petition a court to declare that a debtor is to be liquidated. Based on the experience in other countries, there may be considerable litigation on this point. Briefly, under the Draft law, a debtor will be liquidated at the request of one or more creditors if it meets any one of the following conditions:

(i) Does not pay, when due and without good cause, the amount represented in a valid bond or document; or

(ii) If in a collection lawsuit against the debtor does not pay or proffer for attachment sufficient assets; or

(iii) Liquidates or sells assets in a wasteful or fraudulent manner; or

(iv) Seeks to defraud creditors or delay payments through fraud; or

(v) Transfers the business to a third party without the creditor's consent; or

(vi) Does not fulfill the requirements of a reorganization plan.

While this article, like much of the Draft Law, is based on the Brazilian Insolvency Law, it is important to note that the Brazilian Law at Art. 94 provides that the unpaid bond referred to above in (i) must be for at least forty times the minimum monthly salary, in order to avoid a situation where a default on a minor debt obligation could be used to force a business into liquidation. We recommend that this issue be further discussed.

While there is no set international standard for the commencement of liquidation procedures (the standards must be appropriate for the local conditions), considerable guidance is provided by the UNICITRAL Legislative Guide on Insolvency Law, pp. 45-67. As a general matter, the text of the Draft Law meets those standards, and the fact that the Draft Law sets standards specific to liquidation (rather than establishing a general test of insolvency prior at the beginning of insolvency) is to be commended.

Priorities of Claims (Art. 77).

After all claims have been processed and the assets of the debtor have been consolidated, payment of creditor claims in liquidation follow the following priorities:

(1) Labor (employee) claims,

(2) Secured Claims,

(3) Tax Claims, and

(4) Ordinary or Unsecured claims.

This order of priorities of claims is a major change from the old legislation, as it puts secured creditors ahead of tax creditors. This is one of the major innovations of the Brazilian model and is considered to be one of the features that makes the law business oriented and successful in increasing access to credit and lending to businesses in Brazil.

Note however, that the Draft Law does not include a cap or limitation on labor claims, which the Brazilian model does include (Art. 83 of the Brazilian Insolvency Law caps each labor claim at 15 times the minimum wage per employee, or about $15,000) and which is considered one of the key pro-creditor provisions. This cap was included in Brazil because under the old Brazilian law, business managers engaged in a particular type of insolvency fraud: prior to insolvency they "hired" large numbers of acquaintances and family members as highly paid "employees", who were then paid their labor "claims" upon liquidation (and they were paid before legitimate creditors). Perhaps not surprisingly when large amounts of money are involved, this cap was the subject of considerable debate in Brazil.[18]

The question of prioritization of claims in liquidation and the priority of labor creditors in particular, is an extremely important and politically sensitive one, which should be determined with input from all stakeholders. We recommend that this provision be debated, to ensure that the competing interests are adequately balanced. In this case the absence of a cap on employee claims makes the law less creditor-friendly and could potentially limit the positive effects on lending of the new law. At the same time the claims of employees who have not been paid for their services (and may be losing their jobs) are also important, although the lack of caps may encourage fraud. This is a matter of economic and social policy, there are no international standards or guidelines, other than the importance of clarity in the order in which claims are to be fulfilled from the insolvency estate during liquidation and the prevention of fraud.

COMMENTS RELATING TO RECUPERACAO EXTRAJUDICIAL / OUT OF COURT WORKOUTS (ARTS. 158-166)

Debtors may initiate an out-of-court reorganization by first negotiating a reorganization plan with some or all of its creditors, which if approved by the requisite percentage of 3/5 of the claims (by value of the claims) of creditors (excluding tax and labor claims) and then approved by the court, will become binding on all the creditors, as would a normal reorganization plan. In the US, this type of procedure is called a "pre-packaged" reorganization plan, since all the negotiations take place out of court, and the court is presented with a complete package that has already been approved by the creditors. The advantage of this mechanism is that it can take place quickly and uses minimal court resources. Of course, in some cases the debtor and creditors engage in entirely informal negotiations that make even the out of court reorganization unnecessary; however, if there are too many creditors with conflicting interests, such an informal work out can be impossible. The availability of such out of court mechanisms is considered a positive feature under international best practices, including UNCITRAL Legislative Guide, the World Bank ROSC and BizCLIR.

[18] Aloiso Araujo and Bruno Funchal, Past and Future of the Bankruptcy law in Brazil and Latin America, Fundacao Getulio Vargas, Escola de Pos-Graduacao em Economia (2005).

The major disadvantages of the out of court reorganization procedure in the Draft Law include the fact that that the debtor is not afforded the 180 day automatic stay stopping all lawsuits and debt enforcement actions, so the debtor does not have the "breathing space" it has under the judicial reorganization procedure. As noted above, another disadvantage is that tax and labor claims cannot be restructured through such a procedure (Art. 162).

In Brazil, there have been relatively few out-of-court workouts: for example, in the first two years after the Brazilian Insolvency Law came into effect, there were over 500 insolvency cases entering judicial reorganization, but only a few cases where reorganization plans negotiated out of court have been approved by courts. This is explained by a number of factors, including the fact that such out of court procedures generally require a body of highly experienced and specialized "workout professionals" who work with the banks and the debtor companies to facilitate the negotiations. Accordingly this innovation may take longer to implement.

POTENTIAL IMPACT OF 2009 DRAFT LAW ON WORLD BANK DOING BUSINESS SURVEY/"CLOSING A BUSINESS" INDICATOR

The World Bank's Doing Business Survey (WB DB), which investigates the regulatory framework for business activity in 183 countries around the world, includes an indicator on business insolvency entitled "Closing a Business". Information regarding the WB DB survey is available at www.doingbusiness.org. Mozambique currently ranks 126th out of 183 economies according to the World Bank's global Doing Business ranking. Performance measured as per the "Closing a Business" procedure has stagnated[19] since 2004 , with an indicator-level ranking of 129. According to the 2011 Doing Business report, insolvency proceedings in Mozambique last 5 years, cost 9% of the estate value and enable the recovery of only 17.7 cents on the dollar.

TABLE 1: MOZAMBIQUE'S PERFORMANCE ON THE "CLOSING A BUSINESS" INDICATOR

Measure	2004	2005	2006	2007	2008	2009	2010	2011
Recovery rate (cents/dollar)	11.9	11.9	13.3	15.0	13.9	15.2	15.2	17.7
Time (years)	5	5	5	5	5	5	5	5
Cost (% of assets)	9	9	9	9	9	9	9	9

PREDICTING THE POTENTIAL IMPACT OF THE 2009 DRAFT LAW ON THE WORLD BANK DOING BUSINESS SURVEY / "CLOSING A BUSINESS"

Enacting and then successfully implementing the Draft Law should result in a significant improvement to Mozambique's score on the "Closing a Business" indicator. However, for the reasons set out below, it is

[19] Direct comparisons are not entirely accurate because the methodology for this indicator has been slightly adjusted.

not possible quantify the potential increase both because the law has not yet been implemented and because a country's ranking will always depend on what other countries are doing.

Limitations in data obtained from questionnaires in some countries can sometimes result in unexpected rankings. For example, respondents are asked to estimate the total duration of an insolvency case based on the hypothetical case. Responses to this question can be subjective and particularly where there is little insolvency practice, are often not accurate. So there is always the risk that following a reform and improved understanding and experience by practitioners that a country's ranking actually drop despite successful reforms—only because the process is better understood and the answers to the questionnaire more accurate.

Reporting New Reforms

First, the Doing Business Survey asks for and recognizes any new reforms made in a country, and broad reforms of this nature should improve the score, notwithstanding the answers to the questionnaire (see below). In fact, the Draft Law would implement nearly every major reform recommended by the World Bank in recent years. For example Doing Business 2011 highlights the following reforms, which would all be included in the Draft Law:

- Introducing a new out-of-court procedure (Latvia, Spain);
- Reforms aimed at promoting reorganization (Brazil, Estonia);
- Adopting a new insolvency act (Rwanda, Mauritius, Czech Republic) and/or new reorganization procedures (Colombia, Mexico, Uruguay);
- Adopting reorganization procedures modeled on the US Chapter 11 procedures (Sweden, Belgium, Germany, France, Italy, Finland);
- Empowering creditors and increasing their participation through creditor committees (Over half of the 183 countries surveyed for Doing Business).

The World Bank also highlights related institutional reforms that are recommended, including training programs for insolvency judges (Poland), improving regulation of insolvency administrators (South Africa), requiring more stringent professional and education requirements for insolvency administrators (Botswana).

Figure 1 below, from Doing Business 2010, shows the top five reforms between 2005-2010; again the Draft Law would include all of these.

FIGURE 1: TOP FIVE REFORM FEATURES IN CLOSING A BUSINESS

Table reproduced from Simeon Djankov, Bankruptcy Regimes during Financial Distress (World Bank 2009)

UNDERSTANDING THE CLOSING A BUSINESS INDICATOR: THE "MIRAGE HOTEL" FACT PATTERN

Below we have reproduced the World Bank's detailed information regarding the Closing a Business indicator (Doing Business 2010), notably the fact pattern used in the questionnaire which is sent out to experts in each country.

Closing a Business

Doing Business studies the time, cost and outcomes of bankruptcy proceedings involving domestic entities. The data are derived from survey responses by local insolvency practitioners and verified through a study of laws and regulations as well as public information on bankruptcy systems. To make the data comparable across economies, several assumptions about the business and the case are used.

ASSUMPTIONS ABOUT THE BUSINESS

The business ("Mirage"):

- Is a limited liability company.
- Operates in the economy's largest business city.
- Is 100% domestically owned, with the founder, who is also the chairman of the supervisory board, owning 51% (no other shareholder holds more than 5% of shares).
- Has downtown real estate, where it runs a hotel, as its major asset. The hotel is valued at 100 times income per capita or $200,000, whichever is larger.
- Has a professional general manager.
- Has 201 employees and 50 suppliers, each of which is owed money for the last delivery.
- Borrowed from a domestic bank ("Bizbank") 5 years ago (the loan has 10 years to full repayment) and bought real estate (the hotel building), using it as security for the bank loan.
- Has observed the payment schedule and all other conditions of the loan up to now.
- Has a mortgage, with the value of the mortgage principal being exactly equal to the market value of the hotel.

ASSUMPTIONS ABOUT THE CASE

- The business is experiencing liquidity problems. The company's loss in 2008 reduced its net worth to a negative figure.
- There is no cash to pay the bank interest or principal in full, due tomorrow. The business therefore defaults on its loan.
- Management believes that losses will be incurred in 2009 and 2010 as well.
- The bank holds a floating charge against the hotel in economies where floating charges are possible. If the law does not permit a floating charge but contracts commonly use some other provision to that effect, this provision is specified in the lending contract.
- The business has too many creditors to negotiate an informal out-of-court workout.
- It has the following options:
- a judicial procedure aimed at the rehabilitation or reorganization of the business to permit its continued operation;
- a judicial procedure aimed at the liquidation or winding-up of the company; or

- a debt enforcement or foreclosure procedure aimed at selling the hotel either piecemeal or as a going concern, enforced either in court (or through a government authority like a debt collection agency) or out of court (for example, by appointing a receiver).

If an economy has had fewer than 5 cases a year over the past 5 years involving a judicial reorganization, judicial liquidation or debt enforcement procedure, the economy receives a "no practice" mark. This means that creditors are unlikely to recover their debt through the legal process (in or out of court).

TIME

Time for creditors to recover their debt is recorded in calendar years. Information is collected on the sequence of procedures and on whether any procedures can be carried out simultaneously. Potential delay tactics by the parties, such as the filing of dilatory appeals or requests for extension, are taken into consideration (table 14.12).

COST

The cost of the proceedings is recorded as a percentage of the estate's value. The cost is calculated on the basis of survey responses by insolvency practitioners and includes court fees as well as fees of insolvency practitioners, independent assessors, lawyers and accountants. Respondents provide cost estimates from among the following options: less than 2%, 2–5%, 5–8%, 8–11%, 11–18%, 18–25%, 25–33%, 33–50%, 50–75% and more than 75% of the value of the business estate.

RECOVERY RATE

The recovery rate is recorded as cents on the dollar recouped by creditors through the bankruptcy, insolvency or debt enforcement proceedings. The calculation takes into account whether the business emerges from the proceedings as a going concern as well as costs and the loss in value due to the time spent closing down. If the business keeps operating, no value is lost on the initial claim, set at 100 cents on the dollar. If it does not, the initial 100 cents on the dollar are reduced to 70 cents on the dollar. Then the official costs of the insolvency procedure are deducted (1 cent for each percentage of the initial value). Finally, the value lost as a result of the time the money remains tied up in insolvency proceedings is taken into account, including the loss of value due to depreciation of the hotel furniture.

Consistent with international accounting practice, the depreciation rate for furniture is taken to be 20%. The furniture is assumed to account for a quarter of the total value of assets. The recovery rate is the present value of the remaining proceeds, based on end-2007 lending rates from the International Monetary Fund's International Financial Statistics, supplemented with data from central banks.

The recovery rate for economies with "no practice" is zero. For Doing Business 2010, 2007 lending rates are used to avoid effects of the global financial and economic crisis on data comparability over time.

This methodology was developed in Djankov, Hart, McLiesh and Shleifer (2008).

What does closing a business measure?

Time required to recover debt (years)

- Measured in calendar years
- Appeals and requests for extension are included

Cost required to recover debt (% of estate)

- Measured as percentage of estate value
- Court fees
- Lawyers' fees
- Independent assessors' fees
- Accountants' fees

Recovery rate for creditors (cents on the dollar)

- Measures the cents on the dollar recovered by creditors
- Present value of debt recovered
- Official costs of the insolvency proceedings are deducted
- Depreciation of assets is taken into account
- Outcome for the business affects the maximum value that can be recovered

Source: Doing Business database.

KEY QUESTIONS AND INFORMATION NEEDED TO ACCURATELY CALCULATE "RECOVERY RATE"

There are four key questions to accurately complete the Closing a Business questionnaire: (A) Most Likely Procedure, (B) Outcome, (C) Time and (D) Cost. Because the Draft Law is neither enacted or implemented, and because the new legal framework is completely different from the existing one, at this point in time it would be difficult to calculate items (C) (Time) or (D) (Cost); even where the questionnaire is being applied to an existing legal framework, it usually takes a local expert with considerable experience to evaluate all of these items.

However, a review of the Draft Law suggests that the likely answers to items A and B can be estimated, and with access to current survey data from the World Bank (completed questionnaire with the consensus answers and/or a "procedures list") and following consultation with local legal, financial and business experts, it may be possible to get an idea of the possible impact of the reforms on the ranking. This exercise was not undertaken and would require significant time and consultation with local legal and business experts.

Like all comparative indicators, a country's ranking in Doing Business depends on the reforms taking place in other countries as well. The author is scheduled to speak on July 6 with the World Bank experts responsible for compiling the Closing a Business indicator for Mozambique. This will be an opportunity to both advise the World Bank of ongoing reforms and to ask questions of the staff.

A. Most Likely Procedure for the Case Study

The first question in the WB Questionnaire for Closing a Business is "what is the most likely initial insolvency procedure for Mirage?" The answer is important, since the time needed for the procedure is part of the formula for calculating the recovery rate by the WB. The four choices are as follows:

(i) Debt Enforcement / Foreclosure (i.e. non-insolvency, individual court action or out of court action by Bizbank against Mirage);

(ii) Single Reorganization Procedure that leads to a reorganization attempt;

(iii) Reorganization Procedure that fails and leads to a liquidation; or

(iv) Liquidation Procedure.

Subject to further research and consultation with Mozambican legal experts, we believe that the most likely answer will be a reorganization procedure (ii). This should result in an improved score.

B. Outcome (Going Concern v. Piecemeal Sale)

This question asks respondents to the Questionnaire to predict the ultimate outcome of the procedure: either Mirage continues as a business after the insolvency procedure is completed, or its assets are sold in pieces. It is important to understand that the choice of procedure (foreclosure v. reorganization v. liquidation) does not necessarily determine the outcome. Under most legal systems, reorganization may very well involve a sale of the business to a buyer, as may liquidation.

Subject to further research and consultation with Mozambican legal and financial experts, we believe that the most likely answer will be "Going Concern" under the Draft law, which will have an immediate positive impact on the Recovery Rate.

C. Time

As noted above, it is not possible to calculate this figure with any certainty, although local experts who have completed a "procedures list" and the questionnaire under the current (old) law might be able to provide an estimate of new law's potential impact)

D. Cost

The costs of insolvency procedure include:

a) Court fees

b) Remuneration and fees for administrator, if applicable.

c) Payment obligations that result from the administration, selling and distribution of the estate, including taxes, fees and other payments that relate to insolvency process.

As noted above, it is not possible to calculate this figure with any certainty, although local experts who have completed a "procedures list" and the questionnaire under the current (old) law might be able to provide an estimate of new law's potential impact on the cost).

DATA COLLECTION FOR THE CLOSING A BUSINESS INDICATOR

The World Bank's Doing Business Report has generated a great deal of research and reform initiatives around the world; at the same time it has engendered considerable controversy in recent years, and there

are literally hundreds of critical articles and books published around the world which question the methodology used and/or claim that the surveys are biased against Civil Law jurisdictions. It is beyond the scope of this report to address these academic and policy debates. In other countries where we have worked, we have noted some serious limitations in the way the Closing a Business questionnaire was administered. These include:

- Confusion regarding Legal Terminology. Compounding language limitations (the questionnaire is translated into only a few languages), a concern is the difficulty for respondents to interpret the legal terminology in the questionnaire.
- Targeted Respondents. The survey appears to have been sent to a limited number of international business law firms in Maputo which typically do not have insolvency practices, but it does not appear to have been sent to many lawyers specializing in insolvency, insolvency administrators, judges or academic experts. There are likely few such experts in Mozambique, but broader circulation would be beneficial.

PART II: RECOMMENDED STEPS FORWARD & POINTS TO TAKE INTO ACCOUNT DURING IMPLEMENTATION OF NEW LAW

GENERAL CONSIDERATIONS ON REFORM

It is vital to ensure that the reform process is participative, collaborative and transparent and that all private and public sector stakeholders are involved. All stakeholders should be involved in the reform process not only because they play a key role in implementation, but also because they have considerable understanding of the legal, financial and business issues involved. Stakeholder input should be sought both before the draft is presented to Parliament, during the parliamentary debates and enactment process and thereafter during implementation.

It will also be necessary to ensure that sufficient resources are available. Insolvency law is complex and reforming insolvency systems is challenging, controversial and involves important political and economic interests. The World Bank Doing Business indicator for insolvency measures the performance of the many institutions involved, and there are no "quick fixes."

TRANSITION PERIOD

While the Draft Law contains transitional provisions, covering insolvency cases that are pending at the time the new law is in force, we recommend that a plan and schedule for transitioning to the new insolvency framework be carefully developed. We believe that transitioning to the new reorganization procedure will pose the greatest challenges, as the process is completely different from the existing *concordata* procedure and it is also quite complex.

OUTREACH

Outreach to all public and private sector stakeholders in Mozambique will be essential to the successful implementation of the new insolvency law. Reference can be made to the outreach process that took place during the transition in Brazil to the new legal framework in 2005, since the Draft Law is quite similar to Brazil's new law. Presumably guides and other documents explaining the insolvency process were made available to both the financial sector and more broadly to the business community in Brazil; rather than preparing these from scratch, we recommend that the Brazilian materials be adapted to the Mozambican context.

TRAINING OF PRIVATE SECTOR LEGAL, ACCOUNTING AND INSOLVENCY ADMINSTRATION PROFESSIONALS

The desk study conducted for purposes of this Memorandum did not assess the capacity of commercial lawyers, accountants, management consultants, bankers or judges that will be implementing the new law.

However, we believe that there is likely to be a significant need to strengthen the legal, business, accounting and financial skills of these professionals, particularly where they have new responsibilities under the new legal framework. Insolvency professionals typically must not only master the law, but also must understand and be able to analyze financial statements and business management principles. Compounding the problem, there is likely a limited number of insolvency professionals in Mozambique, due to the very low number of insolvency in the country's courts.

IMPLEMENTING INSTITUTIONS

STRENGTHENING THE CAPACITY OF THE COURTS TO HANDLE INSOLVENCY CASES

Strengthening the implementing institutions will be a high priority. The courts play a key role in the insolvency systems of almost all legal systems, and strengthening the courts ability to manage and resolve insolvency cases will speed up the process and improve the chances of the business continuing as a going concern—all of which will result in higher recovery rates.

International best practices require judges hearing insolvency cases to have sufficient knowledge of basic accounting rules and the ability to interpret financial statements and understand banking documents, business plans and other complex business documents. This is because insolvency cases involve financial and business questions as much as they do legal ones.

The author was not able to ascertain whether special insolvency, financial or business training or skills are required of judges who currently hear insolvency cases in Mozambique. Likewise, the author did not see the training plan or materials which the S&C experts prepared. Some initial and ongoing training for judges is available at the judicial training institute (Centro de Formacao Juridica e Judiciaria) is available, but we recommend that specialized training be developed on the new procedures. The training modules should be designed not only to meet the needs expressed by judges, but also in compliance with modern adult education techniques and using participative, case study based exercises, as opposed to lectures. While the legal aspects of the training may need to be taught by sitting or retired judges, it is important to note that non-legal topics such as accounting, finance/banking, and business management topics should be taught by appropriate professionals. Judges may resist attending trainings taught by non-judges, so this is something to bear in mind. Training materials prepared in Brazil should be used to the extent they are available; adapting them to the Mozambican law should be relatively easy and inexpensive.

Best Practices Manuals and Other Guides / Bench Books

New manuals covering insolvency law and practice will need to be developed to support the implementation of the new law in Mozambique. Depending on for whom they are designed such manuals can contain the following kinds of information:

- Summary and analysis of existing laws and regulations applicable to insolvency cases;
- Summary of existing doctrine (academic research);
- Where the law is not clear and there is not any Mozambique case law yet, summaries of the law and case law in other jurisdictions with similar systems; an obvious place to look would be Brazil;
- Practical recommendations;
- Blank forms and checklists for all participants in the insolvency process; and
- Guidance on understanding financial statement and other accounting documents.

Again as noted above, materials already existing in Brazil can easily be leveraged and adapted.

COURT ADMINISTRATIVE STAFF

It may be useful to evaluate possible institutional strengthening initiatives targeting court staff, such as training, reviewing case management for insolvency cases and / or training.

STRENGTHENING & REGULATING INSOLVENCY ADMINISTRATORS

As discussed above in Part I, the Draft Law does not set sufficiently high standards for who can serve as insolvency administrator, and the draft likewise does not provide sufficiently detailed guidelines on the appointment, training, discipline, removal, or compensation of administrators. According to international best practices as summarized in the UNCITRAL Legislative Guide, insolvency administrators and liquidators play "a central role in the effective and efficient implementation of an insolvency law, with certain powers over debtor companies and their assets and a duty to protect those assets and their value, as well as the interests of creditors and employees, and to ensure that the law is applied effectively and impartially. Accordingly, it is essential that the insolvency [administrator] be appropriately qualified and possess the knowledge, experience and personal qualities that will ensure not only the effective and efficient conduct of the proceedings, but also that there is confidence in the insolvency system. (p.174)."

Selection and Training

We recommend that new initial and continuing training requirements for administrators be developed. In addition, some sort of internship with a practicing administrator might be considered. We also recommend that continuing training requirements for administrators be considered and implemented. It may also be useful to consider accrediting educational institutions to provide training to insolvency professionals, in order to have competitiveness and to maintain the high quality of training.

Professionalization, Self-Regulation and Discipline

As discussed above in Part I, the S&C experts provided assistance in establishing an association for insolvency administrators. Such an association will help develop the profession, and can help in the training process as well. However, we believe that far more will need to be done. For example, unlike attorneys and notaries, whose professional status is sanctioned by examinations and standards, and recognized by state agencies and third parties, insolvency administrators operate without a formal status.

The appointment, training, discipline, removal, and/or compensation of administrators can be ensured by governmental or public-private institution through regulations or the insolvency law itself. Many countries, including the US, have opted for this approach, particularly because of concerns for the potential for corruption and fraud by insolvency administrators.

In addition or instead of state regulation or licensing, there are self-regulatory arrangements in which a profession, with the approval of the state, regulates itself. Existing models include both the legal and notarial professions; in any case ethical and conflicts of interest rules would need to be developed, as would disciplinary mechanisms (in addition to the limited supervision by the court in a particular case). This question should be carefully examined with input from the administrator and judicial community.

As noted above, considerable guidance on these questions is available from international standards and research, such as the UNCITRAL Legislative Guide on Insolvency Law (Section III B and Recommendations 115-125, the World Bank, and the European Bank for Reconstruction & Development.

ADDRESSING OTHER POTENTIAL IMPLEMENTATION CHALLENGES

Experience from other countries implementing insolvency laws based on foreign models suggests that a number of unexpected challenges may appear during and after reforms to legal frameworks. Below are a few examples, presented as illustrations.

Mismatch between Legal Frameworks and Implementing Institutions

Morocco's insolvency legislation, passed in 1996, was almost entirely based on French laws from 1984 and 1985. The French framework was designed for specialized commercial law courts with lay judges, who are businesspeople elected by their peers, and not professional judges or jurists. Moroccan courts, however, are not specialized and have professional judges with no business or financial backgrounds or training. In practice, these judges have struggled to implement the insolvency law because it requires them to make business and financial decisions that they are not equipped to make. This illustrates the importance of understanding the donor country's institutional context when transplanting a law into another country.

Cultural and Historical Obstacles

Eastern European countries emerging from communism found that deep-seated cultural and historical biases against creditors and foreclosure in general considerably hindered the implementation of reforms in the areas of secured transactions, insolvency and enforcement in general. For example, in Bulgaria, a folk tale about the evil banker foreclosing on poor farmers is still in people's consciousness, and clearly affects how judges and other parties enforce certain obligations.

Incomplete Transplants and Missing Regulations

Legal transplants are often what the author has called "incomplete transplants". An example of this would be transplanting an insolvency law from another country, but failing to also transplant the regulations, laws, decrees and even case law that are essential to the donor country's insolvency system. A typical example would be the many countries that have no regulations or standards for insolvency administrators. Another example would apply to Common Law countries, where key precedent (in case law) is not part of the law and is sometimes "forgotten".

Winding Down vs. Insolvency: Unexpected Success

In Moldova, it is very difficult and time consuming to formally "wind down" a legal entity such as a corporation, because various government agencies impose meaningless red tape and the applicable laws are unclear. In contrast, the insolvency system is functioning. In order to wind down unused legal entities (which have no assets or liabilities but are just incurring expenses), some lawyers are advising their clients to "make up" an unpaid debt so that the shell company is technically insolvent, and then filing for liquidation. This process at least permits the closing down of the legal entity. Unfortunately, these "fake insolvencies" are now causing backlogs in the courts for real insolvencies, as more and more of them are filed.

Fraud and Abuse of Insolvency System

As noted above in Part I, dishonest business owners in Brazil have in the past created fraudulent employees, in order to take advantage of the labor priority in liquidation. In other countries, loopholes relating to insolvent businesses found in other legislation such as civil procedure codes have been abused by organized crime.

CONCLUSION

Because it is well-drafted and conforms to current international standards for insolvency legal frameworks, we recommend that the USAID SPEED program proceed with technical assistance in the area of insolvency reform in Mozambique on the basis of the Draft Law. Future technical assistance and training could be provided with respect to strengthening the Draft Law, obtaining input from stakeholders on the draft, and/or implementing it as a new law.

While the structure and technical content of the Draft Law is sound, we have identified a number of policy and legal drafting issues that warrant further discussion and input from private and public sector stakeholders. The fact that the Draft Law is largely based on a foreign model, while not a concern in itself, does suggest that careful consideration of local context and capacity will be needed throughout the reform process. Thus we recommend that, to the extent possible, further consultation and debate take place, both prior to submission to Parliament, and during the parliamentary process. We also recommend that the Brazilian experience in developing, finalizing and implementing the Brazilian Insolvency Law be leveraged as much as possible, for example by basing outreach and training materials on Brazilian materials.

Considerable work will be needed to prepare and strengthen the institutions and professionals responsible for implementing the new insolvency framework. The resources needed to effectively strengthen these institutions and prepare and train the professionals should not be underestimated; the importance of implementation to the success of the reforms and the improvement of the business enabling environment in Mozambique likewise cannot be overstated.