Comments

Ronald Fischer: This paper touches on a subject usually ignored by Latin American economists, despite its importance. As Araujo and Funchal make clear, bankruptcy law is an essential ingredient of a well-designed economic system. The difference between the recoveries of Mexico and Chile after their respective crises in the early 1980s has been ascribed to changes in the Chilean bankruptcy law following the crisis.[1] A good bankruptcy law speeds the recovery after a crisis by freeing resources tied down in inefficient firms. It also lowers the cost of capital by ensuring that a large fraction of the assets in bankrupt firms is recovered, such that not all of the value of a loan is lost even in bad scenarios.

Bankruptcy legislation intervenes not only when debt contracts are not being serviced, but also when this is expected to occur in the near future, in which case reorganization is appropriate. Bankruptcy law tries to achieve several goals by making reasonable compromises among them. The first goal is to provide proper incentives to management. Management should ask for bankruptcy protection or for a period of protection in which to negotiate its obligations with creditors, in case the firm faces liquidity problems. Protection should not be used to protect inefficient management, however, which might use the breathing space to improve its bargaining position. The punishment to managers and owners cannot be so large that they decide to bet the firm in hopes of its survival, thus increasing the risk to creditors. Moreover, large punishments discourage entrepreneurship for fear of the consequences of failure.

As mentioned, another object of bankruptcy legislation is to improve the functioning of credit markets, by ensuring that lenders know they will receive as much as possible in case of liquidity problems in the firm. The absolute priority rule (APR) must also be respected, so lenders know what to expect when they sign a contract. In particular, collateral for loans (mortgages and

1. Bergoeing and others (2002).

other liens) should not be included among the firm's assets at bankruptcy. Araujo and Funchal clearly make all these points in the paper, which presents a simple but extremely effective model to illustrate these various effects; this is probably the best feature of the paper.

The paper mentions the issue of fraud associated with bankruptcy, but it is not given the importance it merits in the Latin American context. The inefficient civil procedures in our countries restrict the design of bankruptcy legislation, since the weakness of civil law means that rules that create incentives for fair negotiation can easily be co-opted.[2] For example, it appears that the original spirit of the *concordata* procedure in Brazil is similar to that of Chapter 11 in the U.S. bankruptcy code: namely, to provide an opportunity for a viable firm with liquidity problems to reorganize itself and avoid liquidation. The results were very different, however: while Chapter 11, despite its many flaws, is useful in reorganizing bankrupt firms, the *concordata* procedure appears to be used as a mechanism to stop the payment of loans through its excessive protection of managers and owners. The effect is to restrict the flow of credit.

In this area of law, small legislative changes can make a law inoperative or, alternatively, turn a law that does not work into one that is efficient. An example of this is the minor change in Chilean bankruptcy law in 1982 that introduced court-appointed private managers to direct, supervise, and manage the liquidation process. These officials had no more performance incentives than the previous judicial branch appointees, but the difference between private versus public administrators was significant.

Several Latin American countries have responded to dissatisfaction with the results of bankruptcy legislation and reformed their bankruptcy codes, as described in the paper. It is too early to determine which of the reforms have been successful, since the effects of this type of legislation affect fundamental economic relations that may affect performance in the long run. To proceed with my comments, I provide some details about Chile.

Until the recent legislative changes, Chilean bankruptcy procedures had as their sole object the repayment of loans—not, as in other countries, the survival of firms, even as a secondary objective. This is a primitive feature derived from the earliest bankruptcy codes. While the Chilean law is inefficient in an absolute sense, it appears relatively efficient in Latin America. The main explanation for the relative efficiency is the existence of private managers of the bankruptcy, which were introduced during the 1982 crisis at the

2. See La Porta and others (1998).

behest of multilateral agencies. Another reason is that bankruptcy proceedings can be initiated by any unpaid creditor that posts a bond of approximately U.S.$2,500, thus increasing the penalty to management for delaying bankruptcy and putting any creditor in a strong bargaining position.

Nevertheless, the Chilean bankruptcy law has several deficiencies.[3] First, the lack of incentives for the court-appointed administrators has led to accusations of corruption and inefficiency.[4] Second, there is no contractual priority, even for mortgages and liens: the statutory set of priorities takes precedence, which creates the efficiency problems noted in the present article. Several procedural problems lead to a slow resolution of the bankruptcy process and accusations of corruption. Finally, nearly all bankruptcies include separate criminal proceedings for fraud, which means that controllers may delay the bankruptcy petition excessively. Bonilla and others examine the payouts and procedures in thirty-two bankruptcy cases worth more than U.S.$250,000 for the period between 1992 and 2002.[5] They show that the average bankruptcy process takes forty-one months, with the following loan recovery rates: court costs, 94 percent; posted bonds, 99 percent; debts to workers, 91 percent; taxes, 58 percent; mortgages and liens, 43 percent; unsecured loans, 3 percent; and total, 39 percent. Bankruptcy costs equal 11 percent of total revenue from liquidation.

In another study, Bonilla and Fischer use a sample of almost three hundred bankruptcies (without size restrictions).[6] Their findings on the dependency between the costs of bankruptcy and the revenues at bankruptcy are given in figure 8. Although the figure seems to show that the system is efficient, this is not necessarily so in the sense of returning a large proportion of total revenues to larger firms, because it is possible that the liquidation revenues could be much smaller than the revenues under an efficient liquidation procedure.

Chilean procedures are so costly that troubled firms try to avoid them, with the result that bankrupt firms are usually beyond recovery. Recent legislation attempts to solve this problem by facilitating prebankruptcy arrangements and introducing the possibility of a mediator that will attempt to reach an agreement between a troubled firm and its creditors to avoid bankruptcy.

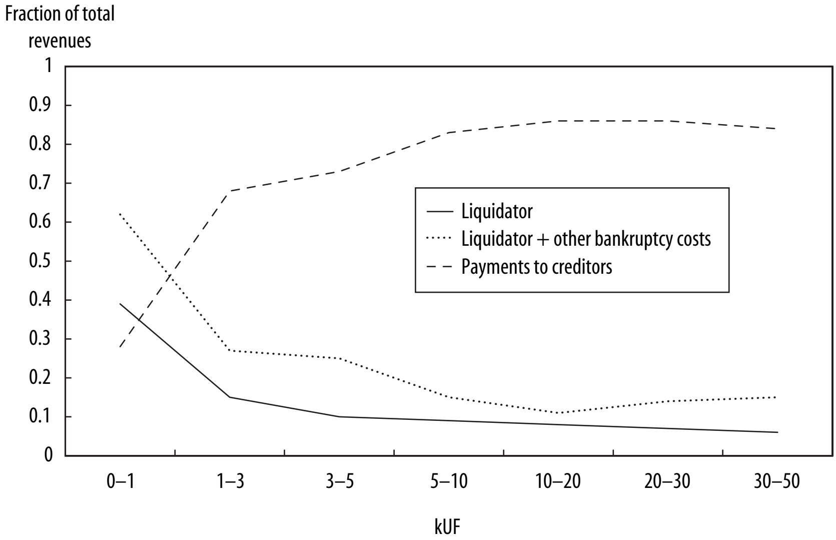
3. See Bonilla and others (2004) for more details.

4. A recent change to the bankruptcy legislation allows the firm's largest creditors to select the bankruptcy administrator. This should solve the incentives problem, at least with regard to these creditors.

5. Bonilla and others (2004).

6. Bonilla and Fischer (2004).

FIGURE 8. Assignment of Liquidation Revenues



Moreover, this mediator will have the capability to decree immediate bankruptcy if he or she believes that the failing firm is acting in bad faith.

Efficient bankruptcy procedures are a vital part of an economic system. The authors provide us with a comprehensive theoretical model of the effects of inefficient procedures, as well as a bird's-eye view of bankruptcy procedures in Latin America, with a special focus on the new bankruptcy law in Brazil. It is a welcome change to have economists researching an area previously dominated by lawyers.

Sara G. Castellanos: The paper by Araujo and Funchal represents a timely and significant input to a topic that has been considered a paramount economic policy issue in the Latin American region at least since the past

I thank Eduardo Engel for the invitation to comment on this article for *Economía.* I am grateful to the authorities of the Bank of Mexico and the Ministry of Finance and Public Credit who coordinated the effort to design, write, and lobby for the approval of the Commercial Reorganization Act (LCM) and the creation of the Federal Institute of Reorganization and Bankruptcy Specialists (IFECOM), between September 1998 and April 2000. During that project, I benefited greatly from discussions with many economists and lawyers. They all deserve my most sincere gratitude, especially Rafael Del Villar.

decade.[1] Besides, the economic theory and databases used to understand bankruptcy are recent and constantly revised. In this context, the paper makes three major contributions. First, it provides an elegant theoretical framework that uses nine propositions to describe the main questions and trade-offs involved in choosing an optimal bankruptcy system. Second, it presents an empirical section that evaluates the impact of the key characteristics of a bankruptcy regime on private creditors' lending and provides an overview of the status of bankruptcy reform in Latin America, with emphasis on Brazil's experience. Third, it includes the personal account of one of the authors regarding the context and decisionmaking of the Brazilian bankruptcy law reform that became effective on June of 2005.

In a nutshell, business bankruptcy law deals with a situation in which a debtor firm cannot meet its payment obligations toward its creditors. The generalized default of private debt contracts is one of the most complex conflicts in the business sector, particularly when the defaulting firm has many creditors. The legal infrastructure ideally should resolve this conflict in a simple, predictable, and expeditious manner that ensures that the parties' rights will be respected and permits resources to be allocated to their most valuable uses. Not having such an infrastructure is very costly to society because it causes credit to become more expensive and resource allocation to be inefficient. An inadequate infrastructure for enforcing the law may diminish the government's credibility in solving these conflicts, thus encouraging debtors to not fulfill their payment obligations.

While most practitioners of law, business, and economics agree on this characterization of what bankruptcy law should do, agreement diminishes dramatically when the discussion moves to how the law should achieve all that.[2] This is reflected in strong cross-country variations in bankruptcy procedures, even across industrial countries.[3] In the world of incomplete contracts that a bankruptcy law aims to remedy, the devil is in the details: opinions diverge widely on when to declare that a firm is insolvent and which payment priority the multiple recognizable creditors should have, as well as on whether to attempt reorganization before liquidation, to have public or private bankruptcy officials, to use rules or discretion, or to provide incentives through carrots or sticks.

1. See, for instance, López-de-Silanes (2002).
2. See, for instance, IMF (1999).
3. Common comparisons involve France, Germany (even before the new insolvency statute became operational last year), Japan, the United Kingdom, and the United States. See, for instance, Bhandari and Weiss (1996).

Araujo and Funchal present an economic model that brings together previous theoretical work developed in finance, law, economics, uncertainty and information economics, and general equilibrium theory to address various micro- and macroeconomic aspects of bankruptcy. This framework permits a novice with general training in economics to grasp those basic principles and trade-offs behind any regime's design. Careful readers can compare the key model assumptions with their own priors and incorporate them into a potent toolkit. For instance, two aspects of bankruptcy law commonly under debate, as Araujo and Funchal point out, have to do with APRs. What conditions make it desirable to grant tax claims a lower statutory priority than the claims of capital market creditors (such as bank lending)? What other conditions make it desirable to grant labor claims a lower statutory priority than the claims of capital market creditors? How should the APR change to emphasize the importance of risk tolerance?

Regarding fiscal claims, this model suggests that governments that rely on proportional taxes would tend to prefer a lower priority for tax claims than governments that rely on indirect taxes, because efficiency and revenue collection would move more closely together. In practice, however, reform proponents in countries where tax collection is relatively low could have a difficult time convincing the tax authorities to forgo interests and fines accrued for late payments. If other revenue sources cannot be adjusted to compensate for that revenue loss, then government expenditure will have to fall to maintain a constant deficit (and in the recent past the financial authorities of several Latin American countries have been under constant pressure to reduce government deficits). Expenditures would have to be cut at least until the benefits of the enhanced credit conditions achieved by this measure materialize. When legislators fear that the first expenditure cuts may be on social programs, for instance, it will be difficult to sell the idea that this cost should be incurred for the benefit of lower interest rates.

The authors present a good case against placing labor claims above those of competitive capital market lenders when the lenders anticipate low repayments in the event of default. Assuming that capital is relatively scarcer than labor strengthens this conclusion, as does assuming that capital is more flexible than labor. In practice, however, reform proponents may have difficulty convincing worker representatives to set wage claims below capital claims, especially when banks and large businesses (which are among the main beneficiaries of a good bankruptcy regime) have access to more instruments for diversifying risks than workers have. Reformers may need to implement a good unemployment insurance system before they can move labor claims below capital claims. Lastly, labor representatives may be skeptical about credit markets being sufficiently competitive to boost liquidity and job creation enough to compensate for this modification of the APRs.

With regard to risk tolerance or equity considerations, country attitudes are only one of many factors that may shape particular bankruptcy regimes, inasmuch as they shape other institutions. This model goes far in explaining a complex and important problem through a simple but powerful tool, especially considering how these other aspects can be incorporated into the analysis and balanced correctly. Lobbying for bankruptcy reform sometimes requires giving up or modifying the original plan to accommodate many interest groups, so understanding how all the elements combine is crucial for preserving the original proposal's aims.

Empirical evidence is a necessary complement to basic principles as policymakers advance through the design stage, especially when the gist is the absence of a single rule that fits all circumstances. For the early bankruptcy law reformers of Latin America, the most immediate references were the laws and data of the industrial countries. The applicability of these sources is questionable, however, given such factors as limited law enforcement capabilities, underdeveloped financial markets, poor public registries, and a lack of specialized courts. Since adaptation results in a loss of comparability, this situation of scant empirical evidence persisted well into the 1990s, despite the increased number of bankruptcy reform drafts.[4] Bankruptcy reform became a common prescription from the international financial institutions in Mexico and several Asian countries that endured economic crises, as well as in the European countries and former Soviet provinces in transition toward market-oriented institutions. In this context, these authors' effort to empirically measure the degree of creditor protection and the goals of the insolvency regime addresses a very present need for systematic evidence.

While this paper's findings are suggestive of the benefits associated with strengthening creditor protection and efficiency, causality interpretations remain subject to concerns regarding the adequacy of the specification and the estimation methods. The literature cited by the authors on the connection between financial market development and growth provides a good illustration of why a cautious interpretation is desirable, namely, because it has

4. For example, in Mexico at least three competing proposals were on the table with the Commercial Reorganization Act, including one based on sequential auctions of reorganization rights among creditors, which was also discarded in Brazil.

advanced so quickly in recent years. Moreover, the sections describing the intricacy of the problem and the theoretical framework, showing the complex interaction between the micro- and macroeconomic trade-offs involved, lead the reader to wonder whether the analysis based on microeconomic data rather than on aggregated perception indexes would be more fruitful.[5] This is particularly relevant given that a very common aim of reform, at least among Latin American countries, is to create better case records, increase the general public's access to them, and improve the accountability of the officials involved in the bankruptcy process.[6]

The section that reports Araujo's personal experience on the Brazilian bankruptcy reform reinforces this perception. Other Latin American countries' efforts to improve their business liquidation and restructuring regime started with very similar diagnoses (as the values of the aggregated indexes used in this paper suggest) and the laws aimed at very similar objectives (as declared by both those who proposed the reforms and those who approved them). Nonetheless, the differences in the various new laws are more obvious than the similarities. While many elements of the Brazilian experience are present, country-specific idiosyncrasies push the reformers to use different carrots and sticks in different combinations.

Mexico's experience provides a good comparison. Mexico's Bankruptcy and Payment Suspension Law (LQSP, by its Spanish acronym) dated from 1943. This law had several problems that made it quite unworkable in practice. It generated bankruptcy proceedings that were excessively bureaucratic, long, uncertain, and costly, and it did not provide adequate incentives for

5. Although the *Doing Business* variables are probably the best available for this kind of study at present, they have limitations. For example, *Doing Business* studies the time and cost of insolvency proceedings involving domestic entities using data derived from survey responses by local law firms, all of which are members of the International Bar Association. Answers are provided by a senior partner at each firm, in cooperation with one or two junior associates. To make the data comparable across countries, several specific assumptions about the business and the case are employed. Answers may thus be based on very educated guesses rather than on hard facts or actual experience. For more detail, see *Doing Business* 2003. Studies that employ microeconomic information from bankruptcy or restructuring files include Franks and Sussman (2003); Franks, Nyborg, and Torous (1996); Lambert-Mogiliansky, Sonin, and Zhuravskaya (2000); Eisenberg and LoPucki (1999); Bris, Welch, and Zhu (2004); White (1994); and Charvel (1998). The last one uses data on Mexico.

6. Some encouraging evidence of these improvements can be found on the websites of Peru's National Institute for the Defense of Competition and Intellectual Property Protection (INDECOPI), at www.indecopi.gob.pe, and Mexico's Federal Institute of Reorganization and Bankruptcy Specialists (IFECOM), at www.ifecom.cjf.gob.mx.

debtors and creditors to reach mutually beneficial restructuring agreements. The LQSP provided two proceedings, payment suspension and bankruptcy. The law failed to establish credible deadlines for carrying out different actions of the proceedings, particularly in the case of payment suspension, which tended to delay its solution indefinitely, causing asset deterioration. In practice, creditors had no means to request switching from payment suspension to bankruptcy. The most notorious example is Altos Hornos de México S.A. (AHMSA), once Mexico's largest steelmaker. This firm was among the last to file for a payment suspension under the LQSP in 1999, when it defaulted on more than U.S.$1.8 billion in debt. As of late 2005, creditors have been unable to negotiate a restructuring plan that leads out of this proceeding. Another problem with the law was that judges were overburdened with administrative duties in these proceedings, and the court-appointed trustees did not have the appropriate incentives to provide high-quality administrative services on time.

On 27 April 2000, the Mexican congress unanimously approved the Commercial Reorganization Act (LCM), which recognized these problems.[7] The LCM's proposed primary objectives are to maximize the social value of financially distressed firms, to promote their viability, and, when possible, to maintain their operations and the jobs they generate. The new legal framework is intended to maintain a balance between firms and their creditors to protect the legal rights of both entities. This law seeks to establish a lineal, transparent, swift, and impartial process that generates greater legal certainty and security for the parties involved in the insolvency process through the following key features.

First, judges continue to be the main operators. Although one of the initial ideas was to establish a special bankruptcy court, it was abandoned as soon as the team of reformers concluded that this would require a constitutional amendment. However, the new law establishes the Federal Institute of Reorganization and Bankruptcy Specialists (IFECOM) to provide the judges with support in finance, accounting, and administrative matters so that they may concentrate on judiciary functions.

Second, IFECOM coordinates the provision of technical support in reorganization cases and has the following specific duties, among others: to authorize the specialists that are qualified to provide technical or administrative support in the proceedings, based on ethical and professional requirements; to manage

7. The full text of the 2000 *Ley de Concursos Mercantiles* is available at www.ifecom.cjf.gob.mx.

the central register of authorized specialists and establish the general dispositions to randomly designate them for each case; to supervise the specialists' performance in the proceedings and promote their training; and to elaborate and publish statistics about business reorganizations. The institute is an auxiliary body of the Federal Judiciary Counsel (CFJ), which is part of the judicial branch. Since the CFJ is itself a recent institution, the case for creating a body with similar functions within the judicial branch was severely undermined. However, the case for creating such a body outside the judicial branch was even weaker given the potential conflicts with the Mexican constitution.

Third, the LCM simplifies the business reorganization regime of the old law by introducing a unitary proceeding. This choice was inspired by the German insolvency statute of 1994. This proceeding has three sequential stages: visitation, conciliation, and liquidation. The purpose of the visitation stage is to verify, on the basis of objective criteria, whether the firm has ceased making payments to its creditors generally. While this stage is longer than the bankruptcy or payment suspension declaration stage of the LQSP, it serves to alleviate the filtering failure by allowing the IFECOM experts (trained in accounting, finance, or business administration) to support the judge's decision. The conciliation stage, which has a maximum duration of one year, aims to facilitate the firm's reorganization through an agreement between the firm and its creditors. This stage has an initial duration of 185 days, which can be extended for three months. In exceptional circumstances, this extension could be augmented for an additional three months. If a reorganization plan is not agreed on, the procedure moves into the liquidation stage. The objective of this stage is to preserve the firm's value through an orderly liquidation of its assets and to satisfy the claims of its different creditors and stockholders according to their respective rights. The modifications with respect to the LQSP bankruptcy procedure consist in setting clear deadlines and rules for selling the assets. Other important modifications aim to preclude sales based on insider information. Auction is the baseline sales method.

Fourth, the law provides that the debtor will retain management of the firm during the conciliation stage, except in certain established cases in which the specialist (conciliator) can request that the judge remove the debtor from management, basically for interfering with the proceedings. Inspectors designated by individual creditors or groups of creditors can play the role of a creditors' committee that supervises the debtor and the specialists while the firm is kept under normal operations. This last aspect is crucial because one of the main creditors' complaints about the former payment suspension procedure was that the debtor kept full control of its assets. In the absence of proper supervision mechanisms, this allowed asset dilution.[8]

Fifth, although the conciliation and liquidation stages are sequential, the LCM allows the reorganization plans to be as flexible as the parties agree, in order to preserve the law's aim of maximizing social value. Reorganization plans are voted on by the creditors and the law contains clauses that protect dissenting creditors.

Sixth, the law simplifies judicial formalities and administrative procedures to make the procedure transparent and expeditious, reducing incentives for frivolous litigations. Credit recognition is significantly clarified and simplified, and credit recognition appeals no longer suspend the continuation of the proceedings. Specialists play a fundamental role in formulating the initial creditors' list based on the debtors' accounting books; this list is later presented to the creditors and to the judge for approval.

Seventh, the LCM includes several articles intended to safeguard creditors' information rights, since promoting the flow of information that allows the interested parties to participate constructively was a constant design concern. For example, it establishes sanctions for debtors that do not keep their accounting books in order, and specialists must produce bimonthly reports of their actions in the proceedings, which are available to the judge, the debtor, and the creditors. This has allowed the IFECOM to keep orderly files and case statistics.

Eighth, the law includes a chapter on cross-border insolvency, based on the UNCITRAL model of insolvency. This feature of the law facilitates international cooperation among Mexican and foreign judges and insolvency specialists.

Finally, with regard to fraudulent behavior, the LCM treats the insolvency proceedings and any applicable criminal proceedings separately. Furthermore, if the result of the visitation stage is that the reorganization is to proceed, then the IFECOM specialist scrutinizes the debtor firm's operations over the few months prior to this event, precisely to detect delay and gambling effects.

If the new Mexican and Brazilian bankruptcy regimes have such different features despite having similar objectives, then the next question is quite obvious: which combination of rules is most likely to succeed? At this point,

8. During the drafting of the law, it was considered that the term *inspector* sounded less threatening than *creditors' committee*. By the same token, the new bankruptcy and reorganization law is entitled the Commercial Reorganization Act.

TABLE 6. Bankruptcy Filings in Mexico

	LQSP			
Year	*Reorganization*	*Liquidation*	*LCM insolvency*	*Total filings*
1987	121	93	. . .	214
1988	17	32	. . .	49
1989	53	60	. . .	113
1990	38	38	. . .	76
1991	51	52	. . .	103
1992	53	45	. . .	98
1993	76	75	. . .	151
1994	55	57	. . .	112
1995	193	52	. . .	245
1996	70	51	. . .	121
1997	40	33	. . .	73
1998	26	45	. . .	71
1999	43	40	. . .	83
2000	14	10	5	29
2001	. . .	. . .	53	53
2002	. . .	. . .	41	41
2003	. . .	. . .	59	59
2004[a]	. . .	. . .	19	19

Source: Gamboa-Cavazos (2005).
. . . Not applicable.
a. January through July.

there is no answer. In Brazil's case, the reform is too recent to have had significant effects on the incidence of bankruptcy or the functioning of the credit market. In the case of Mexico, the law became operational more than five years ago, so an evaluation of the results should be feasible. Table 6 compares the caseloads under the LQSP and the LCM; it shows that the total number of filings after the reform dropped.[9] Based on the above description and assuming the same economic conditions, are more cases likely to be filed under a bankruptcy law that accomplishes its aims than under the previous, ineffective procedure?

An optimistic answer would be no. Actually, the reform view that prevailed during the LCM design process supported a harsher treatment of

9. In June 2004, the Bank of Mexico and IFECOM sponsored an ambitious research project to compare several attributes of the bankruptcy regime before and after this statute changed in Mexico, using the case files stored at IFECOM and at the Supreme Court of Justice of the Federal District of Mexico City. The project is not yet complete, but Gamboa-Cavazos (2005) presents preliminary results.

debtors, under the assumption that this would encourage fair out-of-court agreements (which would diminish the burden for the Mexican taxpayer, all things equal).[10] In addition, several reforms were passed in the 1990s to ease individual debt collection in Mexico; creditors are likely to prefer these methods because they are cheaper than the collective proceeding. This combination of reforms may be producing fewer cases under the LCM than before.[11]

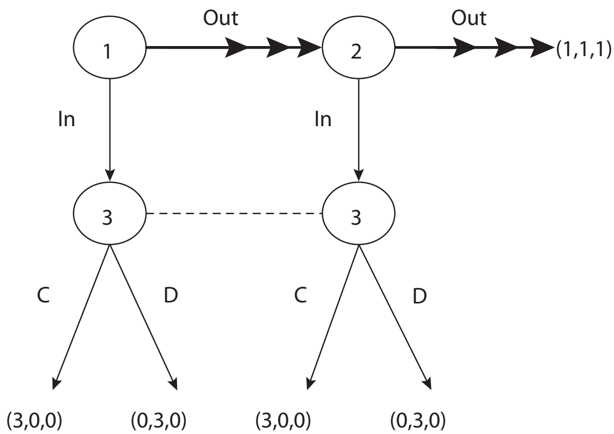
A more pessimistic view of the case filing reduction is simply that the reform was not as deep as it was intended to be. This perception is supported by the fact that, in contrast with Brazil, Mexico's LCM provides an APR ordering that closely resembles the prereform priority structure. That is, most labor and tax claims remain intact and have a higher payment priority than creditors' claims. Moreover, the administrative costs of the procedure are also credited against the debtor firm's estate (transparency and good case management come with a cost). While the LCM sets clear rules on voting on restructuring agreements and protecting dissenting creditors, the standard of protection for unsecured creditors may be weak; these provisions are certainly less protective than corresponding statutes in the United States or Argentina, for instance. The new scheme may thus be less attractive to debtors and creditors than the old one, leading to the fall in the number of cases.

Other factors may also explain the fall in the bankruptcy caseload. Transitory Article Nine of the LCM establishes that for the first five years of implementation (that is, until June 2005) this law would not apply to businesses whose nominal debt value as of June 2000 was less than 500,000 *Unidades de Inversion* (UDIs), reducing the law's scope. Even when the debtor firms qualify under the LCM, economic agents may be reluctant to experiment with the new procedure—both because of its de jure differences with the LQSP and because some of the de jure changes may end up being different de facto. Given this uncertainty, they may want to wait and see how other cases are solved before opting for this solution. If creditors do not know whether the new bankruptcy regime tends to favor creditors, they may prefer to reach an out-of-court agreement with the debtor, rather than using the court infrastructure to solve this problem. Likewise, if debtors do not know whether the new bankruptcy regime tends to favor debtors, they may prefer an out-of-court

10. Since the LCM provides no out-of-court procedure, the microeconomic data to evaluate whether this law indeed improves creditor protection would have to come from a specially designed survey or from aggregate credit market indicators.

11. See, for instance, the modifications to the 1996 Law of Credit Operations and Titles and the 2000 Amendments on Secured Lending, both of which are intended to make collateral seizure swifter and more certain.

FIGURE 9. Why Creditors and Debtors Are Reluctant to Use the LCM Court Infrastructure



Source: Fudenberg and Levine (2003).

agreement over using the court infrastructure.[12] To illustrate this possibility, figure 9 presents an extensive form game (specifically, a favorite game of Fudenberg and Kreps). If the creditor (player 1) and the debtor (player 2) always reach an agreement out of court (that is, each chooses action OUT), they will never learn whether the new bankruptcy regime's court (player 3) produces agreements that are more favorable to creditors than to debtors (that is, chooses action C with probability 1) or vice versa (that is, chooses action D with probability 1). If players 1 and 2 choose OUT, then this self-confirming equilibrium (in the weak sense of not being inconsistent with the evidence) may occur repeatedly, with no player ever observing a play that contradicts his or her beliefs.[13]

Therefore, it may be too soon to propose amendments to the LCM, except in one area: add an extrajudicial procedure. The current LCM proceeding

12. To some extent, this agent's reluctance to use the LCM runs against the idea that bankruptcy law has substantial economywide repercussions.

13. If either the creditor or the debtor ever chose to settle through the LCM, they would immediately find out whether the LCM is a creditor or debtor friendly. Hence, if they meet often or are impatient they may rather settle out of court to hide this information from the other one. In this case, (OUT, OUT) is a non-Nash self-confirming equilibrium that can result from a plausible learning process. For details, see Fudenberg and Levine (2003).

may be too costly for small firms that would benefit the most from a framework that reduces their credit costs, as the LCM aims to do.[14]

To conclude, many future tasks remain in connection with the evaluation of bankruptcy law reform, both in countries that have not yet undertaken this step and in those that already have. This paper about the past and future of bankruptcy reform represents a timely and significant contribution to understanding these complex and interesting problems.

14. The LCM establishes that the filing must be rejected if the specialist in charge of the visitation stage finds that the debtor firm's assets do not suffice to at least cover the administration costs of the proceedings.

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