THE FINANCIAL CRISIS OF 2009 - HAVE REORGANIZATION PROCEEDINGS IN EMERGING MARKETS GONE BANKRUPT? ISRAEL AS A CASE STUDY

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Abstract

The financial crisis of 2009 affected markets all over the world, presenting an unprecedented challenge for international regulators. In emerging markets, firms began raising significant amounts of debt through corporate bonds only in recent years. When such markets crashed, and firms could no longer pay bondholders, regulators were forced to adopt innovative policies to cope with the problem.

This paper explores the possible regulatory responses to the crisis, by focusing on the actions taken by regulators in Israel. The paper outlines the various mechanisms that have been employed and offered to combat the crisis and highlights their shortcomings. It then points to one mechanism that was designed specifically for such crises, yet was dramatically underused, namely, formal bankruptcy. The paper elaborates on the prime reasons for the unfortunate neglect of bankruptcy proceedings in this context and proposes certain revisions in reorganization law that can lead to more widespread use of formal bankruptcy for resolving the financial crisis in the best interest of all parties involved.

I. Introduction

Much like ripples from a pebble radiating to distant shores, the meltdown of the U.S. market of subprime loans for home ownership in 2007¹ and the subsequent

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collapse of the real estate market\(^2\) transformed eventually in 2008 into a nationwide financial crisis and contaminated other economies around the world.\(^3\) The intertwined investments of private investors and institutional investors, such as financial institutions and public and private funds from all over the world in the U.S. financial market transported the crisis on to foreign markets in Europe,\(^4\) Asia\(^5\) and the Middle East.\(^6\) The economies that have been hit include both well developed economies and rapidly emerging markets. Emerging markets around the world have been transforming gradually from prototypically concentrated banking markets to more balanced markets, relying more than before on corporate bonds issuing.\(^7\) Thus, the current global economic crisis is a novel challenge for such markets. Economies hit by the crisis must address broadly the rights of bondholders as the issuing firms are facing financial distress.

Israel is a classic example of a rapidly growing emerging market, on the verge of acceptance to the OECD.\(^8\) As such, its dealing with the financial crisis can illustrate how the private sector and the government in emerging markets can overcome the global crisis through the utilization of traditional and novel mechanisms. Indeed, unlike the Biblical tenth plague, the plague of the current global economic crisis has

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2. But see Stan Liebowitz, New Evidence on the Foreclosure Crisis: Zero Money Down, Not Subprime Loans Led to the Mortgage Meltdown, WALL STREET JOURNAL, A13 (July 3\(^{rd}\), 2009) (showing that since Q4 of 2006 51% of foreclosures are on prime loans and that the foreclosure rate on prime loans has risen by 488% while the foreclosure on subprime loans has risen by only 200%, and arguing accordingly that the single most important factor in the mortgage foreclosure crisis is the negative equity that homeowners have in their houses).
not passed over Israel.\textsuperscript{9} The crisis has caught Israel at a crossroads. In the last decade its economy has gradually changed from a concentrated debt market towards a more balanced market where issues of corporate bonds have become a practical and friendly alternative to bank lending for raising corporate debt.\textsuperscript{10}

The diffuse holdings of bonds by the public as well as bulk holdings thereof by institutional investors introduced new players to the traditional arena of corporate creditors and changed its landscape. The prototypical group of creditors of a corporation in a concentrated debt environment is traditionally comprised of banks, commercial suppliers and service providers, tax authorities and employees.\textsuperscript{11} The change in Israel's credit market added an important new actor to the mix – the bondholders.

Most series of bonds that have been issued by Israeli firms are unsecured. Many investors invested in bonds with little regard to the legal rights attached to the bonds and the investment risks associated therewith. Protecting the bondholders' rights upon a financial distress of the borrowing firm is unfamiliar territory for the Israeli investors.\textsuperscript{12} Thus, in the current crisis the institutional investors and other bondholders are debating among themselves and with the issuing firms (\textit{i.e.} the borrowers) what can be done in order to minimize their losses and save their investments in the distressed firms.

The fear of massive defaults on commercial bonds has drawn the full attention of the government as well. Given that institutional investors, who aggregate the public's long term savings, are invested heavily in the bonds market, the government became concerned about the public's money. In responding to this concern, the government explored and discussed publicly various alternatives for its active

\begin{verbatim}
\textsuperscript{9} See Exodus 12: 29-30.
\textsuperscript{10} On the importance of corporate bonds as a financing alternative to bank lending see Meir Sokoler, \textit{The Importance of a Well Developed Bonds Market: An Israeli Perspective}, BANK OF ISRAEL (Jan. 28\textsuperscript{th}, 2002), available at http://www.bankisrael.gov.il/deptdata/neumim/neum085e.htm.
\textsuperscript{11} This is particularly typical in the financing of SMEs, even in developed economies. Berger and Udell find that in the U.S. approximately 70\% of the financing of small businesses comes from the principal equity holder, financial institutions (primarily commercial banks) and trade creditors. Allen N. Berger \& Gregory F. Udell, \textit{The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle}, 22 J. BANK. \& FIN. 613 (1998).
\textsuperscript{12} For the relative disadvantages of dispersed creditors in reacting to a management's initiative for a restructuring plan see Arturo Bris \& Ivo Welch, \textit{The Optimal Concentration of Creditors}, 60 J. FIN. 2193 (2005).
\end{verbatim}
intervention in the bonds crisis. As shall be elaborated henceforth, these plans included government guarantees, insurance, the founding of credit funds and more.13

This paper highlights an available mechanism that in the current crisis has been sparsely used – formal reorganization proceedings under bankruptcy law. Reorganization proceedings are by no means the exclusive or necessarily the optimal mechanism for handling a financial crisis.14 Yet, they are a useful mechanism. The paper compares the relative advantages of formal reorganization proceedings and governmental intervention and outlines the underlying obstacles that currently impede the use of bankruptcy even when it is an adequate channel for handling the bonds crisis.

Moreover, the paper criticizes the current legal state of the domestic reorganization law and calls for certain revisions that would likely facilitate the use of formal reorganization as a viable and efficient mechanism for handling bondholders' rights upon the financial distress of a firm. The paper also argues that alongside any legal reform, the erroneous cultural perception of reorganization proceedings as an event of failure and as instigating a problem for the creditors must give way to a more balanced and businesswise understanding that such proceedings merely reflect a preexisting economic problem and that these proceedings may actually produce an opportunity for rescue where "conventional" treatments fail.

This article is organized as follows. Part II outlines the effects of the global crisis on the domestic Israeli market. It will show particularly how the bonds market has declined as a result of the crisis, cutting the value of long term savings of the general public and turning the crisis into a national concern. Part III then describes the various proposed and advanced initiatives to tackle the bonds crisis, both by the private sector and by the government. In the private sector the controlling shareholders of the issuing firms began negotiating haircuts of the bonds and repurchasing the bonds at a discount on the secondary market. On its side, the government proposed several financing channels to support the market and drafted a bill that would facilitate out-of-court workouts.

13 See Part III.B infra.
Part IV then turns the focus to bankruptcy law. It shows empirically that the parties hardly use bankruptcy proceedings for resolving the firms' financial distress. It then analyzes the reasons for this low use of bankruptcy, some of which are legal impediments and some of which are psychological-cultural barriers. In Part V the paper discusses the relative advantages of a governmental intervention in favor of the private sector on one hand and the advantages of a case-by-case bankruptcy resolution for financial distress. This discussion concludes that no approach clearly outweighs the alternative.

Given the importance of the alternative of formal bankruptcy, Part VI then calls for a change in the cultural attitude and the adoption of formal reorganization as a legitimate and useful means for resolving a firm's financial distress. To encourage this change of heart in the business sector, I propose several legal revisions including a partial adoption of a debtor-in-possession (DIP) controlled reorganization regime, the carving of floating charges in favor of unsecured creditors, facilitating the continuance of executory contracts and the enactment of a cramdown provision for confirming a reorganization plan. A brief conclusion follows.

II. The Global Crisis and the Domestic Market

A. Israel's Changing Capital Market

Israel's three largest banks, Bank Leumi, Bank Hapoalim and Bank Discount, have suffered a significant loss in 2008 as a result of their investments in structured investment vehicles in the U.S. Fortunately, and thanks to early intervention and action by the Bank of Israel, these losses are far from threatening the overall financial stability of these banks. Nonetheless, the operating loss has trimmed the
banks' net worth to a level that, until recently, made it extremely difficult for them to comply with the central bank's requirement that they meet the capital adequacy standards of Basel II by the end of 2009. As a result, by the end of 2008 the availability of credit to the business sector has shrunk significantly.

Since the rise of Israel's high-tech corporations, the global activity and investments of large Israeli conglomerates and financial institutions, and the country's general subsequent economic growth, the operation costs of the fast growing Israeli businesses increased consistently. As a result, alongside the banking system new channels of financing, such as venture capital, were utilized as well. One of the most significant developments in Israel's capital market in the past decade was the shift to raising capital through the issuing of corporate bonds. While the capital market has been active for many years, the main vehicle for raising capital was traditionally corporate stock. Until the new millennium, corporate bond offerings were relatively negligible. But in recent years corporations have discovered the promise of raising capital through the issuing of bonds. Bonds issuing quickly became the main channel of raising capital in the market in the current decade, surpassing the amount of capital raised through stock offerings. Year 2007 marked the peak in bonds issuing, as over 20 billion U.S. dollars ($20,000,000,000) were raised, before the eventual sharp decline of 2008-2009. As of March 2009, there were 638 listed corporations in the

18 As of late, Bank Hapoalim was successful in raising fresh capital, and even enjoyed oversubscription. As a result thereof the bank has met the requisite adequacy of capital standard. See Adi Ben-Israel & Erez Wohlberg, Bank Ha-Poalim Raised 1.7 Billion Shekels (June 30th, 2009), available at http://www.globes.co.il/news/article.aspx?did=1000476143&fid=585 (as visited on July 5th, 2009) (Hebrew).

19 Ms. Rakefet Rosek-Aminah, Head of the Business Division of Bank Leumi, stated however that the credit crunch is specifically in the non-bank credit (i.e. the decline of the bonds market), while the banks are stable, adequately capitalized and offering credit to their business customers at the same level as in the past. See Globes Capital Market Summit (May 13th, 2009), http://www.globes.co.il/news/article.aspx?did=1000449533&fid=2 (as visited on May 13th, 2009) (Hebrew).


21 In contrast to the private sector, the government made use of the capital market to offer government bonds for financing many years earlier. See Asher A. Blass & Oved Yosha, Reform in the Israeli Financial System and the Flow of Funds of Publicly Traded Manufacturing Firms, in THE ISRAELI ECONOMY, 1985-1998 — FROM GOVERNMENT INTERVENTION TO MARKET ECONOMICS 189, 191, Table 6.1 (Avi Ben-Bassat ed. 2002).

22 Tel-Aviv Stock Exchange, Corporate Fact Sheet (March 2009), http://www.tase.co.il/TASEEng/AboutTASE/Overview/CorporateFactSheet (as visited on May 12, 2009).
Tel-Aviv Stock Market, 546 issued and outstanding series of bonds, and the overall market capitalization was comprised of 140 billion U.S. dollars worth of equity instruments and 160 billion U.S. dollars worth of bonds.\(^23\)

The widespread public debt offerings of the new millennium slowly changed the landscape of the domestic financial market in several aspects. First, with respect to its public corporations, Israel is gradually shifting from a typical concentrated banking market to a more balanced market, where the holding of corporate debt is split between the banks and bondholders.\(^24\) Secondly, a large portion of the corporate bonds issued has been purchased by institutional investors, such as pension funds, mutual funds and insurance companies.\(^25\) As a result, negotiations between an ailing firm and its creditors now involve these investors alongside the banks. The number of key players in any arrangement that the firm may wish to orchestrate has risen and reaching a consensual compromise has become more complicated.\(^26\) Third, the magnitude of debt and the debt to equity ratio that firms undertake are significantly higher than in the past. Since firms have been able to sidestep the banks and offer unsecured debt to the public the relatively rigid banking limitations on a firm's borrowing potential have been relaxed and overridden.\(^27\) Finally, due to the development of bonds issues, much of the corporate debt is not held throughout the

\(^{23}\) Id.

\(^{24}\) The market share of Israel’s commercial banks in the overall outstanding credit to the private sector (consumers and businesses combined) has dropped from 79.7% in 2003 to 67.12% in 2008. More specifically, the banks’ share in the outstanding credit to commercial businesses has dropped from 71.91% in 2003 to 55.28% in 2008. \textit{See BANK OF ISRAEL, OUTSTANDING CREDIT IN THE ECONOMY, available at http://www.bankisrael.gov.il/deptdata/stability/indic/03h.xls (as visited on May 12, 2009)} (Hebrew).

\(^{25}\) As of the end of 2008, the general public held 50.9% of all outstanding corporate bonds, the foreign investors held 0.3%, and institutional investors held 48.8%. The institutional investors’ holdings were as follows: mutual funds – 21.9% (of the overall bonds); insurance companies – 10.7%; pension funds – 7.5%; trust funds – 6.1%; and banks - 2.5%. \textit{See Bank of Israel, The Division of Holdings of Traded Non-Governmental Bonds 2005-2009, http://www.bankisrael.gov.il/deptdata/monetat/assets/tnc12_h.xls (as visited on May 12, 2009)} (Hebrew). Corporate bonds comprise approximately 32% of the institutional investors’ overall portfolio, with bonds rated AA- or higher accounting for 78.3% of the overall bonds held by these investors. \textit{See: Ministry of Finance, Capital Markets, Insurance and Savings Division, ”Increasing the Involvement of Institutional Investors in Debt Arrangements and Taking Actions of Collection” (February 2009) http://www.finance.gov.il/hon/2001/general/memos/mosdyim2009.pps#3 (as visited on May 14\(^4\), 2009)} (Hebrew).


\(^{27}\) \textit{See Shane A. Johnson, The Effect of Bank Debt on Optimal Capital Structure, 26 FIN. MAN. 47 (1997).}
term of the loan by the original investor but is being traded on the secondary market. This facilitates liquidity for the original investors-lenders and allows them to pass on the credit risks to speculative investors. It also facilitates a relatively simple exit for original lenders, who wish to fix their losses at a certain level and avoid any potential additional decline of their investments outside or inside formal insolvency proceedings.

B. Importation of the Global Crisis

1. Real Estate Corporations

The most significant direct effect of the global crisis on the Israeli market is the operation and investment losses suffered by the country's largest public conglomerates that manage large commercial real estate development projects around the globe. Israeli corporations act today from India in the Orient, through various countries in Eastern and Central Europe, to North America. A classic example of this foreign real estate activity is the 2007 launching of the Las Vegas Plaza Hotel grand project, undertaken as a joint venture by IDB and Delek, two of the largest non-bank conglomerates in Israel. In conjunction with broadening the scope of their real activity, these corporations have also diversified their financing sources. In addition to traditional financing by Israeli banks, part of the investments in foreign real estate was financed by foreign banks. Domestic banks in the target countries enjoy superiority in enforcing financial obligations, especially through foreclosure on the real estate to the extent it has been collateralized by the borrower corporation. Indeed, many bank loans, the purpose of which was the financing of such projects, were secured by the developing real estate on a non-recourse basis.

The loss of value in foreign real estate investments contaminated domestic investments in the Israeli capital market as well. The real estate crisis in North America and Europe adversely affected the economic value of Israeli corporate bonds. Once the value of real estate in those economic markets depreciated and was marked

29 Non-recourse financing is common for real estate development projects. See Jeffrey Delmon, PROJECT FINANCE, BOT PROJECTS AND RISK, Ch. 4 (2005).
down in the firms' financial statements, it no longer covered the non-recourse bank loans. The banks became undersecured and, consequently, no surplus remained for satisfying the unsecured claims of the bondholders. The firms' credit ratings declined and raising new capital to service current debt payments became overly expensive.

Also, the general downturn in the foreign economies slowed down the sales and leases of completed projects and thus further constrained the Israeli firms' cash-flow. Thus, periodical interest payments on domestic bonds were exposed to a substantial risk of default. As a result, along 2008 the Tel-Bonds 20 and the Tel-Bonds 40 indices dropped 3% and 22%, respectively.

In May 2009, the ISA studied the payments due by listed corporations to their creditors during the first half of 2009. Of 258 corporations with due payments during the surveyed period, the ISA took a sample of 141 corporations. Of the 141 sampled corporations, the debt of 114 corporations was primarily non-bank debt (that is, primarily bonds debt). The total debt payments due by the sampled corporations by the end of June 2009 aggregates to 3 billion dollars, of which real estate corporations are due 1.25 billion dollars (approximately 42% of the total sampled debt). The ISA estimated that about 0.3 billion dollars, or 11% of the total debt of the sampled corporations, will not be paid by the end of June 2009 due to insolvency of the issuing firms.

2009 may be just the first in a series of years where the Israel's capital market will face the challenge of financially distressed corporations meeting their bonds payments. The aggregate payments on issued and outstanding bonds traded on the TASE due in the period of years 2010-2013 is 22.5 billion dollars. Of this amount, approximately 5 billion dollars, or 22.2%, are due on bonds that, as of the end of April

31 The Israel Securities Authority (ISA) demanded as of late 2007 that all firms investing in and operating real estate projects in Europe and the USA must disclose in a special report the possible effect of the subprime crisis on their operations.
34 Id, at p.8
35 Id, at p.2.
36 Id, at p.3.
37 Id, at p.5.
2009, were traded on the market at a discount of 25% or more off their par value, an indicator calling into question the solvency of the issuing corporations. Although the bonds market has somewhat recovered in July and August 2009, nonetheless one should not overlook the severity of the crisis and its potential adverse effect on the entire ex-bank credit market. Indeed, the recent announcement of Africa-Israel, a real estate giant conglomerate, that it will not be able to meet its future bonds payments may be just the first sign of a dim future.

2. Shrinkage of Export

Real estate firms are by no means the sole business sector exposed to the global crisis. In the global investment atmosphere, the country's largest banks invested large amounts in U.S. SIVs and suffered severe losses at the second half of 2008, once Wall Street and the entire U.S. financial system were hit. Moreover, even commercial and industrial firms who do not maintain operations and investments abroad suffered from the global crisis. Given the slowdown of the European and American economies and the decrease in demand for products and services, the commercial export from Israeli firms to these major markets has correspondingly shrunk. The decline in sales has strangled the cash-flow of these firms and impeded their ability to fulfill their debt obligations.

C. Transformation into a Macro Crisis

The wide scope of the bonds' crisis has turned this crisis from an isolated and micro crisis of certain distressed firms to a macro crisis that threatened the stability and integrity of the entire capital market. Too much money of too many investors was at stake. Institutional investors have become a viable alternative to bank lending only

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39 Id. For payments due in any given quarter of the years 2009-2011, real estate corporations account for anywhere between 50%-70% of the bonds that have been traded at a discount of 25% or more off their par value. Id., at p.4
42 See supra text accompanying n.15.
in recent years. Should these investors suffer too large a loss in the current crisis, it may effectively drive them out of the credit market and cause them to restructure their portfolios concentrating on the stock market. As a result, the main achievement of the reform spearheaded by the Bachar Banking Reform Committee, that is, altering the supply of credit to businesses, creating a competitive credit environment and negating the banks' absolute control of this market, would be missed. Thus, maintaining the ex-bank credit market merits safety measures of the institutional investors' investments.

Moreover, the institutional investors invest in the capital market with money raised from and managed on behalf of laymen who manage their long term savings through those institutions. Pension funds, mutual funds and insurance companies manage hundreds of billions of Israeli Shekels of employees and individual entrepreneurs who save for their retirement. The investment of these savings in the capital market has been approved by the government in order to enhance the returns on these savings, on one hand, and inject fresh financing to the rising and demanding capital market, on the other. The grand losses that the institutional investors were likely to suffer as a result of the corporate bonds crisis were losses of lifelong savings of the general population. The general understanding was that the government would not likely sit still while such dramatic outcomes that touch upon the foundations of the labor and capital basis of the country's economy unravel in reality. The government, through the Ministry of Finance, indeed was not indifferent to these macro ramifications of the bonds' crisis and searched for certain protective and stimulus measures to address the crisis and its negative impact. The exact form of intervention was to be determined by the newly elected government following the general elections that took place in February 2009. Nonetheless, even in the months preceding the swearing in of the new government, the expectation for an imminent governmental move has fixed the parties in their positions at the time and delayed any initiatives to settle the crisis of any particular firm separately as long as it had not actually defaulted on a payment.

44 For an outline of the Bachar Committee and its subsequent transpiring, see Bachar Reform, http://bacharreform.com.
45 The value of the total assets managed by the mutual funds alone, as of the end of 2008, was approximately 54 billion dollars. See MOF, Capital Markets, Insurance and Savings Division, Mutual Funds – 2008 Annual Summary, available at http://147.237.72.127/kupot_gemel/kg_sikum_main.htm, (as visited on July 20th, 2009) (Hebrew).
46 The Bachar Committee, supra n.44.
The names of the firms that suffered from cash distress, their size in Israel's economy, and the identity of their controlling shareholders is yet another factor that painted this crisis in a dramatic fashion. Among the firms whose bonds were traded in the second half of 2008 at significant discounts are some of the country's largest conglomerates,\textsuperscript{47} including 10 corporations whose bonds are included in the blue chip Tel-Bond 20 index.\textsuperscript{48} These giants are considered the backbone of Israel's economy and its bridges to the global market. On top of this, the controlling shareholders of these conglomerates are the most powerful and influential persons in Israel', who enjoy close relationships with the politicians and regulators. Whether justified or not, their personal precarious position in this crisis became an issue that quickly turned out to be an independent public concern. Using their access to the government and the media these tycoons publicly portrayed the financial crisis of their business groups as a large and general crisis of Israel's economy as a whole.\textsuperscript{49} Turning their personal business crises into a national one helped their cause and allowed them to lobby for a wide-range, government brokered, solution that would save the corporations, and would also preserve their control and holdings in those business groups.

III. Response to the Crisis

A, The Private Sector

1. Negotiating for Haircuts

The imminent risk of default, coupled with the shortage of cash in the financial sector, limit the firms' options. Successful negotiated settlements that would eventually result in refinancing of the corporate bonds depend on the ability of the firms to unify their bondholders and convince them that this is their best option to eventually collect their claims. Haircuts of bonds, that is, relieving the corporate

\textsuperscript{47} On the financial distress of the real estate giant Africa-Israel see, e.g., Yuval Maoz, Africa-Israel Bonds Dropped 20%; Delek Real Estate Dropped 11.1% to a Discount of 38%, HAARETZ (Oct. 3\textsuperscript{rd}, 2008), available at http://www.haaretz.co.il/hasite/pages/ShArtPE.jhtml?itemNo=1026053&contrassID=2&subContrassID =17&sbSubContrassID=0 (Hebrew); Michael Rochvarger, Can Leviev Repay NIS 23 Billion?, HAARETZ (Oct. 30\textsuperscript{th}, 2008), available at http://www.haaretz.com/hasen/spages/1032847.html.

\textsuperscript{48} The most notable drops of market value of bonds in 2008 were those of Africa-Israel (70%), Gazit Globe (30%) and Amot (15%) – all real estate centered businesses. Other notable conglomerate bonds plunges were of IDB Development and Discount Investments (10%). See TASE, supra n.32.

issuer from paying back a certain percentage of the bonds’ par value, is an idea that
was thrown into the public discourse but received critically by the investors. The
general understanding was that such mitigations of the corporate debt are simply
unfair and run afoul of the fundamental principles of loan agreements and corporate
governance. To turn down part of the creditors’ claims without requiring the
abdication of the shareholders is at odds with the principles of risk and return in
investments.

2. Repurchase of Bonds

Another practice adopted to combat the bonds’ free fall in the market and the
imminent risk of default that controlling shareholders have been utilizing since the
outburst of the current crisis is the repurchase of bonds in the market at their updated,
discounted, market price. Bondholders who wished to cut their losses and avoid
further decline to their portfolio disposed of their bonds and were glad to meet
purchasers in the market, regardless of their identity. According to the ISA’s data, in
the six months between December 2008 and May 2009 1,715 repurchase transactions
took place, pertaining to 239 series of bonds that were issued by 161 corporations.
The repurchases generated to the selling bondholders an aggregate amount of 0.475
billion dollars, on bonds the par value of which was 0.975 billion dollars, representing
an average discount of 52%. Approximately 57% of the repurchases were completed
by the controlling shareholder, usually a parent corporation, or a subsidiary of the
issuing corporation, and 43% of the repurchases were completed by the issuing

50 See, e.g., Michael Rochvarger and Etti Aflalo, Steinmetz Tries to Give his BSG Bondholders a
51 See, e.g., Etti Aflalo, Ocif Backs Down from Giving Bondholders a Haircut (Jan. 7th, 2009),
52 The repurchases were through the open market. Another potential alternative for debt
      repurchase is via a tender offer. See Timothy Kruse, Tom Nohel & Steven K. Todd, The Decision to
      For adverse effects of such initiatives on bonholders’ rights, see John C. Coffee, Jr. & William A.
      Klein, Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and
      Recapitalizations, 58 U. CHI. L. REV. 1207 (1991); Victor Brudney, Corporate Bondholders and
      Debtor Opportunism: In Bad Times and Good, 105 HARV. L. REV. 1821 (1992)
53 ISA, Economic Department, The 2007/2009 Credit Crisis, The Corporate Bonds Market – Self
54 Id. In the year 2008 the volume of repurchases was even greater and totaled 0.775 billion
dollars. TASE, Research Department, Repurchases of Corporate Bonds in 2008, available at
http://www.tase.co.il/NR/rdonlyres/6B1292EA-1CCD-4D4F-80E4-
corporation itself.\textsuperscript{55} Since the real estate corporations are the ones suffering the most from the current bonds crisis,\textsuperscript{56} it is no surprise that approximately 56\% of the aggregate repurchases of bonds in the market was in connection with this industry.\textsuperscript{57}

B. Governmental Financial Initiatives

Several governmental agencies proposed various channels of assistance in the current crisis. Five channels are worth mentioning: (a) the establishment and enlargement of government supported funds for advancing credit to SMEs; (b) a government guarantee for raising additional capital by the banks; (c) a government insurance of new issues of corporate bonds; (d) the establishment of lever funds; and (e) a government financing of prepackaged reorganization plans. Each channel is described below. Channels (a), (b) and (d) have been adopted and actually launched, while channels (c) and (e) remained merely as proposals and were not carried forward. Each of the channels is described summarily below.

1. Credit Funds for SMEs

Prior to the current crisis, the government, through the Ministry of Finance (MOF), in a joint venture with 3 medium sized banks, maintained a fund for advancing credit to small businesses who experienced difficulties in obtaining credit from the banks. 1/6 of the fund has been financed by the MOF and 5/6s by the participating banks. The fund advances credit to eligible small businesses and the government provides collateral for 70\% of the amount of each specific loan.\textsuperscript{58} This allows small businesses to obtain financing at reasonable rates while limiting the collateral they would be required to provide to a maximum of 30\% of the loan. During the current crisis, the MOF offered to enlarge the fund by injecting an additional 10 million dollars on its part and an additional 50 million dollars from the banks.\textsuperscript{59}

\textsuperscript{55} ISA, supra n.53 at p.4; TASE, supra n.54, Graph 1.
\textsuperscript{56} See supra Part II.B.1.
\textsuperscript{57} ISA, supra n.53 at p.5; TASE, supra n. 54, Graph 2.
\textsuperscript{58} Eligible businesses for this fund are businesses whose annual turnover does not exceed 5.5 million dollars.
Eventually this fund received a fresh infusion of 110 million dollars from its participants.

In addition, the MOF has established in January 2009 a new fund for advancing loans to eligible medium sized businesses, as a joint venture with participating banks. The fund raised 325 million dollars, 20% of which - from the MOF and 80% of which – from the participating banks. Any eligible business may obtain a loan from this fund that shall not exceed 8% of the business' annual turnover. The annual interest rate shall not exceed the prime rate + 2.9%, the maximum term of the loan is 5 years, and the government provides collateral for 70% of the amount of each specific loan. Recently, the MOF has expressed some dissatisfaction with the low extent of bank lending to the business sector and as a result started to explore the possibility of establishing in a joint venture with institutional investors joint funds that will raise 250 million dollars in order to provide ex-bank credit to private corporations. The primary beneficiaries of these funds would be corporations whose primary assets are intellectual property and corporations from the agricultural industry.

2. Guaranteeing the Banks' Raising of Capital

In a somewhat similar manner to other countries, the Israeli government wished to stabilize the banking industry, given its primary role in the credit market and out of concern for the public's deposits. For that purpose, the government provided a 1.5 billion dollars guarantee for raising fresh subordinated debt by the banks. The raising of this money is expected to further stabilize the banks and allow

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60 Eligible businesses for this fund are businesses whose annual turnover is between 5.5 million dollars and 25 million dollars.

61 Ministry of Finance, Spokesman Department, Press Release, "Within the Framework of the Acceleration Plan – The Loans for Medium Sized Businesses Governmental Fund in the Amount of 1.3 Billion Shekels has been Launched" (Jan. 9, 2009), http://www.mof.gov.il/Lists/List19/Attachments/14/2009-12.doc (as visited on May 14, 2009) (Hebrew).


64 Ministry of Finance, Spokesman Department, Press Release, "The MOF Provided the Banking System a 6 Billion Shekel Government Guarantee for Raising Capital" (Jan. 19, 2009),
them to extend credit to the business sector without risking the exhaustion of the banks' capital surplus and pushing it to the limits of Basel II.

3. Insurance of Issues of New Bonds

The Chair of the ISA, Professor Zohar Goshen, proposed that the government provide insurance to the issuing of new bonds in the following manner: The government would sponsor a mechanism that shall operate for four years. Newly issued bonds by eligible firms would be placed in a general basket, and the institutional investors would invest and purchase units in the collective basket. 80% of the aggregate value of the bonds in the basket would be insured by the government. In exchange, all issuing firms participating in the basket would pay a premium to the government or share with it their profits at the end of the four years period. Eligible firms would be firms whose main operations are in Israel. Firms whose bonds would be included in the government insured basket would be subject to limitations pertaining to distribution of dividends, executive compensation and self-dealings between the firms and their controlling shareholders.

4. Lever Funds

The MOF initiated the founding of Lever Funds. These funds are funds in which the government invests an aggregate amount of 1.2 billion US dollars (approximately 50-60 billion per fund) and the institutional investors will lever the fund by a significant investment on their part. The fund shall incorporate as a limited partner with the manager of the fund investing at least 1% of its total capital investments and serving as its unlimited partner and the government and institutional investors constituting its limited partners.

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66 Also, holding firms would be ineligible for this proposal.

Lever funds shall invest their money in eligible firms\(^{68}\) for a single purpose: to recycle corporate bonds and finance voluntary arrangements between the firms and their bondholders.\(^{69}\) Distributions to the partners in the fund shall be made pro rata. However, in order to encourage the institutional investors to participate in the funds, the government shall assume most of the losses upon the funds' liquidations and limit its part in the liquidation distribution should there exist a surplus.\(^{70}\)

The first fund has been actually launched in March 2009 and raised 0.5 billion US dollars.\(^{71}\) As of late April 2009 two additional groups are on the verge of winning bids to manage additional funds.\(^{72}\) However, as of August 2009 only 10 corporations explored the possibility of obtaining financing from the lever funds since the bonds market is starting to show some positive signs of recovery.\(^{73}\)

5. Government Financing of Reorganization Workouts

The Official Receiver proposed a plan as follows:\(^{74}\) Within a designated period of two months any small or medium sized firm which feels it is facing financial distress may apply for a governmental loan to pay off its current debt. A general moratorium shall be statutorily imposed for this designated period. An applying firm shall submit a general business plan to the recommending committee, outlining its general plans for reorganization. All applications will be reviewed by ad hoc committees comprised of lawyers, economists and accountants with adequate

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\(^{68}\) Eligible firms are firms that (a) issued corporate bonds; (b) are not banks, issuer of financial instruments or government controlled corporations; (c) at least 50% of its income (excluding financing income) are generated in Israel and 50% of its assets are located in Israel; and (d) the aggregate value of its holdings in securities of other firms does not exceed 50% of the value of its total assets. Id, slide 15.

\(^{69}\) The ISA emphasized that while the lever funds were founded for recycling existing debt of the firms, the primary goal of the ISA's insurance for bonds issuing plan was aimed at stimulating the bonds market and regaining the investors' confidence in the capital market.

\(^{70}\) Upon liquidation, in case of a deficit the government shall pay the institutional investors the lower of 90% of a 4% return on their investment or the total distributions the government had previously received from the fund. In case of a surplus that exceeds 4%, the government shall limit its part in the distribution to the mean of the actual return and 4%. MOF, supra n. 67, slides 21-22.


\(^{73}\) Most notable among these 10 corporations is the real estate giant Africa-Israel. See Aflalo, supra n.63.

\(^{74}\) This proposal has been submitted to the Minister of Finance in the Official Receiver's letter of April 20\(^{th}\), 2009 and is on file with the author.
background in insolvency. These committees shall recommend to a steering committee, whose members shall be representatives of the Official Receiver, the MOF, the ISA and the General Federation of Labor, the amount of loan that should be provided to each firm and outline the terms that the firm must comply with for being eligible for the loan. The steering committee will allocate among the various applying firms a relative portion of a total sum the government shall set for assistance to all firms, based on priority criteria the committee shall set. In exchange, the government shall receive first priority as a creditor of the firm. In addition, the firm shall amend its bylaws and issue a golden share to the government, which shall entitle the government to replace its management should the firm fail to meet the projected goals in its plan within specified time periods. This plan obviates the need to initiate official reorganization proceedings in court.

C. Government Legal Initiatives: Credit Officers

Aside from proposals for financial support by the government, the ISA, as the government agency regulating the disclosure of information by securities issuing firms, has attempted to promulgate emergency rules that may facilitate consensual workouts between the issuing firms and their bondholders. The primary legal obstacles that the parties must overcome are: (a) the strict disclosure rules of securities law that mandate public disclosure of any material development, which hinders the quiet and confidential negotiations between the parties; (b) informal communication between parties regarding a possible reorganization plan that may implicate the bondholders in the use of inside information; and (c) the possibility that coordination between the institutional investors regarding their position as creditors vis-a'-vis the firm may violate antitrust law.  

Aside from overcoming the impediments to reaching a consensual arrangement between an issuing firm and its bondholders, the ISA concluded that in order to lower the probability of similar future crises the protection of bondholders' rights should be fortified through legislation and regulation. It found that the indenture trustees have thus far performed relatively poorly in protecting the bondholders' rights because of the trustees' dependence on the issuing firm. As a result, in June 2009 the ISA released a draft bill amending the Securities Act and its rules, so that they empower the indenture trustees with wider authorities and subject the trustees to the superiority of the bondholders' meeting and to explicit statutory fiduciary duties. See Draft Bill and Rules pertaining to Bonds (June 1st, 2009), available at http://www.isa.gov.il/Download/IsaFile_3618.pdf (as visited on July 20th, 2009) (Hebrew). An analysis of the current operation of indenture trustees in Israel and the proposed amendments is beyond the scope of this article.
To assist the parties to overcome the aforementioned legal obstacles the ISA adopted a resolution establishing the function of bondholders' committees and credit officers.\textsuperscript{76} This resolution allows an indenture trustee to appoint a bondholders' committee for any series of issued and outstanding bonds. The committee shall be comprised of representatives of the three largest bondholders of that series. The bondholder's committee may appoint a credit officer who shall serve as its representative. The creditor officer may engage in quiet and informal negotiations with the firm regarding a restructuring of the bondholders' rights. The credit officer shall report to the bondholders' committee, consult with it and update it with respect to all the developments in the negotiations with the firm. The appointment of a bondholders' committee and of a credit officer, as well as information obtained by the creditor officer from the firm and reported to the bondholders' committee, shall be exempt from disclosure as an immediate report under the standard rules of securities laws. Also, the mere introduction by the firm of undisclosed information to the credit officer and the bondholders' committee shall not subject the disclosing persons to liability for violation of the prohibition against the use of inside information, to the extent that the disclosing person has no reasonable ground to assume that the recipients of this information shall use it and trade on it.\textsuperscript{77}

The Antitrust Authority has complemented the ISA by promulgating an ad-hoc rule for 2009, under which communication and cooperation between members of a bondholders' committee with respect to the modification of the payment terms of the bonds shall not constitute an anti-competitive measure in violation of antitrust laws.\textsuperscript{78}


\textsuperscript{77} On June 1st, 2009 the ISA released for the public's comments a draft of a bill amending the Securities Act, that would vest the authority of the credit officer and the bondholders' committee in the indenture trustee. See ISA, Draft Bill and Rules Pertaining to Certificates of Obligation, available at http://www.isa.gov.il/Download/IsaFile_3618.pdf (as visited on June 30th, 2009) (Hebrew).

IV. Low Use of Reorganization Proceedings

A. Empirical Data

One interesting phenomenon in the current bonds crisis is the relatively low use of formal bankruptcy proceedings in the attempts to resolve specific financial difficulties of bond issuing firms. Based on official filings with the ISA, as of May 2009 only 28 issuing firms have commenced some form of negotiation, workout or official reorganization in order to approve a plan (or arrangement) between the corporation and its bondholders.\(^{79}\) Of these reporting firms, 4 firms were at the time of negotiations in liquidation, 2 were in official reorganization in court, and 22 were negotiating out of court.\(^{80}\) In the case of 11 of the reporting firms the parties have eventually filed a motion with the court under section 350 of the Companies Act,\(^{81}\) seeking the official approval of their plan in creditors' meetings and confirmation by the court.\(^{82}\) 12 of these firms were real estate corporations.\(^{83}\) In 13 of these cases the plans included delay of payments or specifying installment payments; in 8 cases the plans designated a collateral to secure the bondholders' rights; in 7 cases the plans provided for the issuing of new equity to the bondholders; and in 4 cases the plans called for an infusion of fresh capital by the shareholders.\(^{84}\)

It appears that both the distressed firms and their bondholders prefer to avoid a formal bankruptcy resolution.\(^{85}\) Bankruptcy is widely regarded as a means of last


\(^{80}\) From an informal inquiry with the ISA I have learned that only in the case of 2 firms the parties have employed the ISA's new credit officer scheme.

\(^{81}\) Section 350 of the Companies Act is the general provision of this Act, which facilitates any compromise or arrangement between a corporation and its shareholders or creditors, regardless of the corporation's financial state. To the extent the firm is ailing financially and is seeking temporary relief from its creditors' collection rights, it may file, under section 350(b) of this Act, a motion for a moratorium against the creditors. Cases where the court has ordered a moratorium are regarded as official reorganization cases. Accordingly, the 11 cases where section 350 has been utilized include the 2 official reorganization cases.

\(^{82}\) ISA, supra n.79, at p.11. An alternative mechanism for a majoritarian approval of the modification of the bondholders' rights, as specified in the indenture, is through a bondholders' vote on such a modification under section 35G of the Securities Act.

\(^{83}\) Id.

\(^{84}\) Id, at p.12. Some of the plans contain a combination of several of the above listed treatments.

\(^{85}\) The total number of firms entering negotiations leading to a reorganization plan, within bankruptcy or outside thereof (28, as of May 2009) is less than 18% of the number of firms that employed bonds repurchases to balance the decline in their bonds' market value and the looming financial distress it signaled (161 firms). The number of firms that entered formal bankruptcy (6, as of May 2009) is less than 4% of the number of firms repurchasing their bonds. See text accompanying n.53 supra.
resort. The following paragraph offers several possible reasons for the low use of formal reorganization proceedings to resolve the financial distress of issuing firms.

B. Reasons for Avoiding Reorganization

Several factors may affect, separately or cumulatively, a firm's decision-makers and its creditors to not use formal reorganization proceedings or at the very least to try to postpone adoption of these proceedings as long as possible. These factors are: (a) the loss of control shareholders and management experience in reorganization; (b) uncertainty concerning the actual rules of Israel's reorganization law; (c) covenant light bonds pose a filing obstacle; (d) a general preference of quiet and consensual workouts; (e) a traditional, cultural, aversion to bankruptcy with its associated negative stigma; and (f) underestimation of the judiciary's competence to handle sophisticated financial matters. These factors are discussed below in detail.

1. Shareholders' and Management's Loss of Control

The most likely candidate to file a bankruptcy petition is the debtor. The debtor enjoys superior access to the accurate data concerning its own financial state. Thus, it may move for legal action at the earliest possible stage, when a reorganization of the firm is still a viable option. Indeed, in practice most reorganization cases are initiated by debtors. However, upon the initiation of a formal insolvency proceeding, the courts appoint a trustee to control and manage the debtor's property and business affairs. In a liquidation case the appointment is explicitly provided by the statute. In reorganization, while not mandated by the legislature, the courts have nonetheless implemented the practice of appointing a trustee to a firm undergoing

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86 In the case of a corporate debtor the legal action for salvaging the firm is initiated primarily by the board of directors. See Brian M. Hunt & Rish Handa, A Critical Comparison between Australian and Canadian Creditor Protection Regimes: Voluntary Administration and CCAA, p. 9, n.41 (June 2005), available at http://ssrn.com/abstract=888411.


88 Companies Ordinance §300.
reorganization. The trustee displaces the reigning management and board of
directors and takes over the business of the firm with a primary goal of maximizing
the payments for the creditors. The change of personnel at the helm resonates through
the corporate investors. Shareholders, and especially the controlling shareholders, lose
control of the firms business and their influence evaporates almost instantaneously.
The new sheriff in town, that is, the trustee, takes orders from and reports to the court,
in the name of the creditors. It owes no favors to the shareholders and acts
accordingly.

As has been documented and proven empirically, the loss of control upon
initiation of formal insolvency proceedings discourages the management from filing.
For the classic decisionmakers in a firm, the managers and the board of directors, their
disposition upon the filing makes such proceedings a course of last resort. Indeed, no
person volunteers to vacate her seat in favor of a newcomer. Entrenchment, to the
extent possible, is more likely. This impedes the probability of a successful
reorganization. Alongside the management stand the controlling shareholders who
fear for their control over the firm and as a result push the management to hold and
delay any filing for a formal insolvency proceeding. Thus, as long as the relevant
financial crisis has not led the creditors to seriously consider filing for liquidation or
receivership, firms in Israel rarely initiate formal reorganization proceedings. It is an
unfriendly option for the incumbent decisionmakers. As a result, this alternative for
resolving financial crises is pushed away even if objectively it may be the appropriate
tool for salvaging the firm.

2. The Uncertain State of Israel’s Insolvency Law

In Israel, a financially distressed firm can choose between two main
bankruptcy proceedings. It can either enter liquidation or reorganization. A distressed

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89 Subsequently, the regulator provided for the appointment of a trustee in reorganization. Rule
14 of the Companies Rules (Application for Compromise or Arrangement), 2002.
90 This has been documented empirically in Barry E. Adler, Vedran Capkun & Lawrence A.
Weiss, Theory and Evidence on the Bankruptcy Initiation Problem (September 2005), available at
91 Arturo Bris, Ivo Welch & Ning Zhu, The Costs of Bankruptcy: Chapter 7 Liquidation v.
Chapter 11 Reorganization, 61 J. Fin. 1253 (2006). The delay in initiation is exacerbated when the
concentrated ownership is complemented by a large secured claim. William J. Donoher, To File or Not
firm may also be subjected to receivership by one or more of its secured creditors. Liquidation proceedings are specified in the Companies Ordinance. The ordinance sets forth many of the traditional aspects that characterize insolvency cases, namely: a stay of all outstanding proceedings against the debtor, appointment of a trustee to the debtor's property, filing of proofs of claims, avoidance of pre-commencement preferences, and orderly distribution of the proceeds of the debtor's property among its creditors based on the absolute priority rule. The reorganization statute is more limited in scope. It basically covers only two aspects of the reorganization proceedings. First, it provides for a moratorium on all proceedings against the debtor or its property. Unlike in liquidation, this moratorium suspends the collection rights of all creditors, including the secured ones. Secondly, the statute authorizes the court to convene a creditors' meetings to vote on a proposed arrangement or settlement. Originally, this statute addressed only the procedural aspect of allowing the creditors' or shareholders' meetings to approve a proposed arrangement or settlement with a corporation. It was not related to financial distress. Such arrangements were a means to modify existing rights vis-a-vis the corporation whenever changing business circumstances required such modifications. To advance reorganization initiatives and block individual grab of corporate property by a creditor that would frustrate any reorganization plan, however, the statute was hastily amended in 1995 authorizing the courts to impose a general moratorium once a proposal for an arrangement or a settlement has been submitted.

The important contribution of the statutory moratorium notwithstanding, the current reorganization legislation in Israel remains deficient. The statute currently fails to address many operational and financial issues. Three notable issues that the legislature is yet to address are (a) the extension of security interests to property acquired within the reorganization case; (b) the state of executory contracts in

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92 Receivership is subject to the Execution Act. A creditor secured by a floating charge may file a motion for the appointment of a receiver under section 194 of the Companies Ordinance.
93 The stay does not preclude secured creditors from foreclosing on their collateral. Thus, the initiation of a liquidation case notwithstanding, secured creditors may separately continue or initiate receivership proceedings for collection of their secured claims. Bankruptcy Ordinance §20(b), which has been applied to corporate liquidations in C.A. 5821/92 Houri v. Fischler, 49(5) P.D. 833 (1996).
94 Companies Act §350(b), (f).
95 Id §350(a).
96 For a general account of the legislative history of Israel's reorganization law see David Hahn, The Formative Decade of Israel's Reorganization Law: 1995-2004, 14 INT'L INSOLVENCY REV. 121 (2005).
reorganization; and (c) the confirmation of a reorganization plan over the objection of a class of creditors.

a. Collaterlizing Reorganization-Acquired Property

In Israel, like in the UK, creditors may secure their claim against a corporation by taking a floating charge in all its present and future acquired assets. This security interest is most common among bank lenders. If the loan documents include a contractual provision that limits the corporation from subjecting any of its property to subsequent security interests without advance consent of the creditor secured by the floating charge, and this provision is among the details of the charge filed by the companies registrar, the floating charge gains priority over any subsequent claims, secured and unsecured alike, except for a purchase money security interest. The reorganization statute is silent with respect to the question whether newly acquired property during the reorganization proceedings is subject to a pre-reorganization floating charge or not. Thus, it is unclear whether a potential lender, who has been asked and is contemplating advancing credit to finance a firm's operations while undergoing reorganization can enjoy the priority of a senior security interest in any of the firm's assets free and clear of the floating charge. The Supreme Court has addressed this matter only twice, and reached unclear conclusions. In the first case, the Court assumed, without discussing the matter in depth, that the floating charge extends to post-filing acquired property. Based on this premise, it held that a new lender enjoys priority over the floating charge but only with respect to any existing going-concern surplus value in the property. The creditor secured by the floating charge enjoys seniority in the property's liquidation value, as of the date of filing. Nonetheless, in a later case the court held that the floating charge ranked lower than the claim of contractors who were owed payment for completing the construction of a real estate project during the reorganization proceedings of the debtor firm. The court did not elaborate whether this priority was limited to the going-concern surplus of the project. This unclear state of the law is puzzling for unsecured bondholders as

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97 Companies Ordinance §169(b).
98 Id §169(d).
99 In the U.S., except for proceedings of the original collateral, property newly acquired in bankruptcy is free from prepetition security interests. Bankruptcy Code §552.
well. To the extent the bondholders are asked to consider the delay of payments in exchange for receiving a security interest in property of the debtor, the apparently unlimited scope of the floating charge becomes a serious hurdle the parties must overcome. Case law has not contributed to any clarity here.

b. Executory Contracts

A major tool of bankruptcy law that facilitates reorganization is the ability of a trustee, subject to the approval of the court, to assume or reject executory contracts to which the debtor is a party. Various executory contracts may be of essential importance for the debtor's business. A favorable lease or real property, a license to use certain intellectual property or an uncompleted construction contract, are small examples of strategically important contracts for the continuation of a firm's business as a going-concern. Any interruption of the flow of the business as a result of the termination of such a contract may, under the dire circumstances, cause irreparable damage to the firm's business operations. Thus, continuation of existing executory contracts is of extreme practical importance to a reorganizing firm.

Israeli law addresses primarily a trustee's power to reject an executory contract in liquidation. The reorganization statute contains no similar provision. More importantly, a trustee's power to assume an executory contract, and if so – under what terms, is left unanswered by the legislature. As a result, courts have been reluctant to allow trustees to assume executory contracts in circumstances where the contract has been breached prior to the commencement of the formal insolvency case and invariably respect the non-breaching party's right to rescind the contract. Thus, the future of contracts that were breached because of the debtor's inability to pay as a result of its financial distress is completely dependent on the good will of the non-breaching party to overlook the breach. Similarly, absent any statutory limitation to

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102 Executory contract is widely understood as a contract where "the obligations of both parties are so unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other". *Griffel v. Murphy* (*In re Wegner*), 839 F.2d 533, 536 (9th Cir. 1988). This builds on the definition initially suggested by Countryman. Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 MINS. L. REV. 439, 460 (1973).


104 Companies Ordinance §§360-365.

the contrary, the courts enforce insolvency *ipso facto* termination clauses. Given the wide practice of including such clauses in business contracts, the prospect of assuming executory contracts and preserving the going-concern value they generate is meager. The risk of losing important executory contracts is thus another concern that deters the corporate management and their creditors from turning to formal bankruptcy proceedings.

c. Inter-Class Holdouts

To approve a proposed reorganization plan the creditors must convene and vote on its terms. For this purpose, the creditors are classified into separate meetings. Creditors sharing homogeneous interests are classified together. Within each class the proposed plan must achieve a requisite majority. The problem arises though when one or more of the classes voted against the plan. This creates a challenge as it impedes the practical ability to confirm the plan. This problem is exacerbated as the number of classes increases and with it the risk of holdout. By requiring the unanimous consent of all voting classes, Israel fails to provide workable tools for the confirmation of reorganization plans in circumstances of inter-class disagreements or conflicts of interests.

3. Covenant Light Bonds

Management and shareholders wish to delay the filing for reorganization of their firm as long as possible in order not to lose their control over the firm. Consequently, the task of filing for formal proceedings is thus one left for the creditors. Yet in the current bonds crisis bondholders of some of the firms suddenly discovered that despite the financial deterioration of the issuing firm their legal options are limited. The debenture, under the terms of which their bonds were issued, lacks common financial covenants that demand the maintaining of certain financial

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106 See, e.g., Motion (D. Tlv.) 6483/97 *In re Home Mart* (unpublished opinion, 1997).


108 Under section 350(i) of the Companies Act the requisite majority is a majority in person of the actually voting creditors, sans abstainers, who hold 75% or more of the claims voted in the meeting.

109 Any increase of the total number of individuals whose personal consent is required for approving a proposed decision exacerbates the cost of holdout. Lloyd Cohen, *Holdouts and Freeriders*, 20 J. LEGAL STUD. 351 (1991).
ratios and provide that failure to oblige constitutes an event of default and acceleration of their entire claim.\textsuperscript{110} As mentioned earlier, the issuing of commercial bonds in Israel is a relatively young practice. In this novice practice the negotiations between issuing firms and the indenture trustee (on behalf of the investors) were yet to achieve perfection and standard contractual rights commonly found in loan agreements were left out.\textsuperscript{111} As a result, as long as the issuing firm has not reached a date of payment of interest to the bondholders, the latter were in no legal position to declare a default by the firm. Subsequently, the path to initiating formal bankruptcy proceedings appeared blocked for the time being.

4. Preference of Unofficial Workouts

Regardless of the legal details and mechanisms of formal insolvency proceedings bondholders are generally reluctant to enter these proceedings. Their general preference is to negotiate with the issuing firm quietly and informally in search of a consensual restructuring for the terms of the bonds.\textsuperscript{112} The out of court workout has been further facilitated by the ISA in its adoption of the credit officer mechanism.\textsuperscript{113} The bondholders feel that they may receive their goals without the need to utilize official reorganization proceedings. The official reorganization proceedings may nonetheless be used by the parties, in a light format, upon reaching a consensual path. In order to simplify the confirmation of the negotiated solution and have it binding all dissenting creditors, the parties may seek the voting rules and court approval provided for under section 350 of the Companies Act, the section that also

\textsuperscript{110} The phenomenon of covenant-light loans is common practice even in sophisticated and developed financial market as the U.S. The leniency there was, \textit{inter alia}, a result of the desire of managers of hedge funds and private equity to close as many deals as possible and get paid their bonuses as a result thereof. See Harvey R. Miller, \textit{Chapter 11 in Transition - From Boom to Bust and into the Future}, 81 AM. BANKR. L.J. 375, 380-383 (2007).

\textsuperscript{111} A recent study of the financing of LBOs between 2001 to 2006 confirms that covenant-light loans were typical for loans originated by institutional investors and were accompanied with higher interest spreads. See Joseph R. Mason, Wei-Ling Song & Jerry Cao, \textit{Business Aggression, Institutional Loans, and Credit Crisis: Evidence from Lending Practices in Leveraged Buyouts} (March 2009), available for download at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1362421&download=yes. See also Adam Gallagher, \textit{Covenant Lite: The High-Water Mark of the LBO Market?}, 26-6 AM. BANKR. INST. J. 30 (2007).

\textsuperscript{112} For empirical data on out of court workouts compared to formal bankruptcy proceedings see Part IV.A \textit{supra}.

\textsuperscript{113} See Part III.C \textit{supra}.
constitutes the reorganization statute. Such a use of section 350 is essentially a prepackaged reorganization proceeding.

As for the risks of unilateral filings for reorganization by the issuing firms, the institutional investors count on their leverage as repeat players to reliably threaten the issuing firms from taking any such measures. Given that these investors are well organized and primary holders of corporate bonds in the Israeli market, the issuing firms will likely hesitate to upset the institutional investors and waste their good standing therewith. Any subsequent debt financing will backfire against the issuing firm, as it will be required to raise the interest rate on that debt instrument. The firms are thus wary of unilaterally initiating a formal reorganization proceeding and risking the ire of the institutional investors.

5. Cultural Rubicon

Another reason for the aversion of formal reorganization proceedings is a cultural barrier. The Israeli business world regards formal insolvency proceedings as the eleventh plague. Investors, controlling shareholders, accounting firms and creditors alike feel that entering a formal proceeding is always, under any circumstances, the last resort and the least desired alternative. In their eyes, the initiation of a formal insolvency proceeding itself is destructive. The formal proceedings can do no good for the firm. The very initiation of such proceedings is official evidence that the firm is insolvent and that her viability as a going-concern is

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114 See Part IV.A supra (empirical data on the use of section 350 for concluding the negotiations).
117 For the segmentation of the holdings of corporate bonds in Israel see supra n.25.
118 But see John C. Coffee, Jr. & William A. Klein, Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations, 58 U. Chi. L. Rev. 1207 (1991) (discussing the coercive forces that may lead bondholders, including institutional investors, to accept haircuts and other informal workouts proposed by a distressed issuing firm, when the firm's management may reliably threaten to file for bankruptcy). The concern raised by Coffee & Klein is strong in the U.S., because managers are less averse from turning to bankruptcy. See Part IV.B.1 supra.
119 See, Amir Helmer, How to Reorganize a Failing Real Estate Corporation (Oct. 10th, 2004), available at http://www.haaretz.com/hasite/pages/ShArtPE.jhtml?itemNo=486280&contrassID=2&subContrassID=10&sbSubContrassID=0 (Hebrew) (debtors file with the courts petitions for formal bankruptcy proceedings only after the banks make it clear to the controlling shareholders that the business can no longer be run as usual).
The filing for bankruptcy will only exacerbate the firm's delicate standing vis-a'-vis its suppliers, employees and customers, many of whom will seek doing business elsewhere. This dramatic event in the life of a firm marks the beginning of its end. The general understanding is that any formal bankruptcy case is the ultimate failure of a debtor. Correspondingly, the market reaction to an announcement that a formal insolvency proceeding has been commenced is a steep drop in the valuation of the firm's securities and a further loss to the investors. Thus, it is widely believed and accepted among the creditors that the longer formal proceedings can be avoided – the better. Accordingly, in the current bonds crisis the bondholders prefer any alternative, for example a consensual out-of-court workout with the firm, or an ad-hoc governmental bailout plan over formal bankruptcy proceedings. In short, no one wishes to come near bankruptcy because it is considered an illegitimate option for a functioning business.

This approach, although widely accepted and relied upon in practice, represents a culturally erroneous perception of bankruptcy and its essence. The popular approach, shared even by many lawyers, is that the initiation of bankruptcy is the drawing of a line between two periods in the life of a debtor firm. Before the commencement of the proceedings the firm may have been ailing but nonetheless an operating business. Upon the filing for bankruptcy, the firm loses its good standing as it publicly proclaims its failure. Unfortunately, this approach overlooks the detailed legal mechanism of bankruptcy and the fundamental values it is intended to promote. Regardless of the legal functions of bankruptcy proceedings, in the business world, much like the consumer context, the term "bankruptcy" connotes failure and financial disaster. The roots for this popular view may be historic and may have lost legal

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120 In the Globes-PWC joint research, the only two alternatives of action for bondholders analyzed were an out of court workout or formal liquidation. GLOBES RESEARCHES & PRICEWATERHOUSECOOPERS, supra n.40, at pp. 22-23. This indicates that even the most sophisticated and respectable accounting firms in Israel fail to fully comprehend the legal option of formal reorganization and its positive potential.

121 Id, at p. 22.

122 The current general resentment of insolvency proceedings in Israel is reminiscent of the public atmosphere in the U.S. in the 1960s. See Miller, supra n.110, at 376 ("[I]n the 1960s, bankruptcy was a small, arcane, undesired practice area. After the Second World War, the volume of bankruptcies and particularly old Chapter XI cases was very minor. Credit was relatively tight. Major law firms and accounting firms shunned the area of bankruptcy. The stigma of bankruptcy was very much to be avoided.")

ground over the years. Nonetheless, in the eyes of a layperson bankruptcy is a predicament one should avoid. Because the business world has not changed its traditional hostility and suspicion towards bankruptcy, any firm and its creditors who wish to resolve the firm's financial difficulties successfully should distance the firm from such proceedings. Thus far, this popular attitude, regardless of its merit, has indeed kept the bondholders away from the bankruptcy courts.

6. Underestimation of the Courts' Competence

The parties involved in the bonds crisis, debtors and creditors alike, generally display skepticism regarding the courts’ competence to handle acute economic matters and reach optimal decisions. The general concern is that judges who lack expertise in evaluating firms, analyzing their financial statements and dissecting their periodical performances will be called upon to decide the overall fate of such firms. Any initiation of formal insolvency proceedings moves the court to the front and vests in the judge the authority to make all the critical calls, whether operational, investment or financing. The business parties resent the thought of a court de facto running the business and perceive this alternative inferior to others. Obviously, the preferred

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124 For the influence of moral norms on the social psychology pertaining to bankruptcy see Gordon Bermant, Bankruptcy by the Numbers: What's Stigma Got to Do with It?, 22-6 AM. BANKR. INST. J. 22 (2003).
125 American non-legal professionals exhibit a similar misunderstanding of Chapter 11 and its virtues. The (erroneous) general belief among non-legal persons is that the filing for Chapter 11 doomed Lehman Brothers and that major distressed businesses should stay away from bankruptcy as long as they can. Stephen J. Lubben, Systemic Risk & Chapter 11 (May 2009), available at http://ssrn.com/abstract=1399015.
127 This concern is found worldwide. See, e.g., Alan Bancaud & Anne Boigeol, A New Judge for a New System of Economic Justice, in PROFESSIONAL COMPETITION AND PROFESSIONAL POWER 104 (Yves Dezalay & David Sugarman ed. 1995). See also Patricia M. Wald, Judicial Review of Economic Analyses, 1 YALE J. ON REG. 43 (1983).
128 In enacting chapter 11 of the U.S. Bankruptcy Code Congress' original intention was actually to relegate the bankruptcy courts to the role of mere adjudicators of controversies while leaving the operational aspects of the case to the professional parties. In practice, however, this intent has not worked out. See Harvey R. Miller, The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play, 69 AM. BANKR. L.J. 431 (1995).
method for resolving their financial issues is through a consensual negotiated plan of payment. Yet, the second best alternative in the eyes of the market is a government brokered plan, such as the establishment of lever funds or guaranteeing the value of newly issued bonds whose proceeds will retire the outstanding debt on the old (and payable) bonds. The common denominator of these plans is that they are orchestrated and planned to be managed or supervised by branches of the government. These plans are traceable to the Ministry of Finance. The common view is that the persons behind the designing of these plans and their execution are ranking officers in the Ministry of Finance, whose economic grasp is far superior to that of any judge in the judicial system. The MOF employs some of the brighter economic minds in Israel’s market. Thus, any financial crisis that the major firms are experiencing would likely be treated more efficiently by the MOF or the ISA and their staffs than by the courts. Also, the government addresses the crisis from a macro point of view, while courts always focus on the specific case at hand and miss the larger picture of the economy as a whole. Thus, a systemic bailout program launched by the government is perceived a preferable alternative to a case by case attempt to salvage the ailing firms and the investment of the bondholders (and directly of all the public who invest their long term savings in funds managed by the institutional investors).

A testament to both the cultural barrier and the underestimation of the courts' competence is the Official Receiver's initiative for a government financing of reorganization workouts. The parameters of the Official Receiver's proposal effectively emulate main elements of a formal reorganization proceeding (moratorium, priority financing), but without the actual resort to the court's jurisdiction. This proposal is a surrogate to the path the Official Receiver understands that the parties do not like to take.

V. The Benefits and Costs of Government Intervention

The preceding part outlined various explanations for the avoidance of formal insolvency proceedings by firms and their bondholders. These explanations may be

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130 See GLOBES RESEARCHES & PRICEWATERHOUSECOOPERS, supra n.40.
summarized under two general categories: legal reasons and extra-legal reasons. The legal reasons include the uncertainty of the current state of insolvency law in Israel and the personal cost for managements and controlling shareholders once official proceedings have commenced. The extra legal reasons include the general expectation for a wide scale governmental intervention in the crisis, a cultural aversion from the stigma of bankruptcy, and holding face by the institutional investors who fear that setting a precedent of writing off significant debt while allowing the survival of their debtor firm will saddle them in future cases.

All parties are well aware that paying off the bonds of many firms is currently impossible and thus some modifications must be made. The question then is what type of modifications and whose supervision would best serve the firms and their creditors. Should the government launch an ad-hoc plan for backing the firms or is a case-by-case approach through bankruptcy proceedings preferable? I believe there is no solution that is clearly and convincingly superior to all others. This part will outline the relative advantages and costs of each approach. Given the positive potential of both channels the following part will recommend certain improvements and a change of attitude so that firms and their creditors can benefit from the relative advantages of a (case-by-case) bankruptcy resolution for the firms' financial distress.  

A. The Advantages of Government Intervention

All variations of government intervention across the border to rescue ailing firms from defaulting on their issued and payable bonds enjoy certain advantages over the resolution of the crisis through the bankruptcy judicial system. These advantages are (a) the presence and involvement of a strong and able financial guarantor; (b) reduction in administrative costs due to streamlining of payable corporate debt; (c) an inter-firm consistent treatment of creditors; (d) a quick implementation of the rescue initiative; and (e) the move is likely to stimulate the economy.

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1. Governmental Financial Backing

Governmental financial support, either through an insurance of new bonds issues or through subsidized funds that infuse fresh capital to the distressed firms intervention includes some form of a financial backing for the corporate debts, alleviates the burdensome debt. The government's support lowers the firms' cost of capital and allows them to continue their operations undisturbed.\footnote{But see id (arguing that a government financial support for distressed firms should be deliberately supplied at a significant cost to those firms). For a proposal to lower the cost of banks’ recapitalization through finance supplied by the private sector see John C. Coates, IV & David S. Scharfstein, \textit{Lowering the Cost of Bank Recapitalization}, 26 YALE J. REG. \textit{pp} (2009).} In contrast, when a firm resorts to court supervised bankruptcy, as a practical matter it must obtain financing from a financial lender. The availability of such financing during a general financial crisis is limited. Also, such financing is more expensive than the government's subsidy.\footnote{On the other hand, the amount of financing a firm would need in a bankruptcy case is smaller because, unlike in the case of a governmental support, it needs the cash only for its operations and not for paying off its outstanding debts. \textit{See} Skeel & Ayotte, \textit{supra} n.131.}

2. Saving Administrative Costs

A wide scope government intervention spares the firm and its creditors the need to litigate the specific financial crisis of the firm in court. This removes the need for a particular judicial measurement of the concrete financial position of each firm. Administering a wide-scale crisis on a case-by-case basis clogs the judicial pipeline and increases the administrative costs since it requires retaining the services of lawyers, accountants and financial advisors on behalf of the litigating parties. A government plan for all firms suffering the crisis is a general and unified treatment that bypasses the microscope examination of each particular firm.

3. Inter-Firm Consistent Treatment of Creditors

A wide scale government plan of relief for distressed firms allows the creditors to enjoy the same treatment and grants them an opportunity to save their sunken investments in a consistent manner.\footnote{In contrast, bankruptcy cases are governed on a case-by-case basis, by potentially different judges across the country, which makes it difficult to apply a coordinated reply to a wide scale economic crisis. \textit{See} Lubben, \textit{supra} n.125.} Many creditors, and particularly institutional investors, invest in bonds of various firms. Such creditors look at their
overall portfolio of bonds and measure the returns or losses on the portfolio. The consistent and unified approach afforded by government intervention ensures these creditors the salvation of their investments (and indirectly those of all employees who invest their retirement savings in the institutional investors). In contrast, judicial resolution of financial distress varies across different judges.\textsuperscript{137} Moreover, the judicial system, treating the creditors’ claims on a case-by-case basis is prone to error in certain cases and thus decreases the overall return on the public’s investments.\textsuperscript{138} Thus, per-crisis in the market, a government plan enjoys the upper hand in its clarity and predictability.\textsuperscript{139}

4. Quick Implementation

Once adopted formally, a governmental rescue plan may be implemented rather quickly. Either the governmental support will apply automatically to any eligible firm or the firm will contact the governmental agency that is in charge of implementing the plan and prove its eligibility. Because a governmental bailout applies evenly to all ailing firms it is less threatening from a debtor firm’s perspective. Such a plan is less stigmatizing than an official judicial bankruptcy proceeding and it does not require, \textit{per se}, any change of control of the firm.\textsuperscript{140} Thus, the timely initiation of the governmental rescue plan appears more promising than the initiation of a judicial bankruptcy proceeding. Moreover, the terms of a governmental rescue are predetermined by the government and are not negotiated with any specific firm.


\textsuperscript{138} Even where creditors hold a portfolio of bonds the losses of errant judicial decisions in particular cases do not necessarily balance by the positive results generated in the cases adjudicated correctly and effectively, due to a general bias of the judicial system. See Nicola Gennaioli and Stefano Rossi, \textit{Judicial Discretion in Corporate Bankruptcy} (Jan. 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1051441.

\textsuperscript{139} The government’s per-crisis intervention is nonetheless susceptible to the costs of \textit{ad-hoc} legislation, when comparing the treatment of creditors in different economic crises. See Part V.B.3 \textit{infra}.

\textsuperscript{140} However, a sponsoring government may press for change of personnel at the corporate helm, as was the case recently with GM. See Mike Allen & Josh Gerstein, \textit{GM’s CEO Resigns at Obama’s Behest}, POLITICO, March 29\textsuperscript{th} 2009, available at http://www.politico.com/news/stories/0309/20625.html. Unlike in Israel and many other countries, in the U.S. Chapter 11 negates this consideration as it provides for the preservation of the debtor’s management as debtor-in-possession. See Bankruptcy Code §1107.
This may expedite the implementation of the plan and eliminate the need for lengthy negotiations between the parties entailed by a formal bankruptcy resolution.141

5. Stimulating the Economy

A governmental rescue intervention typically draws the full attention of the domestic media. All the players in the capital market rely on the terms of the government's plan and are inspired by it. A wide scale governmental support revives the confidence of investors in the economic activity and reenergizes the capital markets.142 In this sense, a constructive contribution of the government's intervention lies in the stimulation of a cash constrained economy.143 The panic effect that is exacerbated once an economic crisis escalates to a national level is best squelched by a government pacifier.

B. Costs and Limitations of Intervention

Part III has shown that the government considered various economic and legal measures of intervention in light of the bonds crisis. A broad brushed financial intervention bears the following costs: (a) it uses taxpayers' money to subsidize losses in the private sector; and (b) it amplifies management's moral hazard of risk taking. In addition, the new legal alternative advocated by the ISA, pursuant to which the bonds crisis will be resolved through consensual workouts via the credit officer mechanism, is a poor substitute for formal bankruptcy as it is shorthanded in comparison to bankruptcy. These shortfalls are discussed below.

1. Use of Taxpayers’ Money

The most obvious cost of a government bailout is the immediate burden it places on the country's treasury. Taxpayer money is relied upon to remedy the

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143 But see Luigi Zingales, Plan B, 5(6) THE ECONOMISTS' VOICE (2008), available at http://www.bepress.com/ev/vol5/iss6/art4 (arguing that the vast majority of the government's rescue money is being used by the rescued financial institutions to pay off their existing debts rather than vitalizing the economy through the supply of fresh financing to the markets).
mistakes of the private sector. While this current burden may pay off in the future, if and when it stabilizes the economy and reenergizes it, it is nonetheless questionable whether, as a matter of principle and as a philosophical matter, the general public should serve, after the fact, as a general guarantor of players in the private sector.

Moreover, on a practical basis, there is a limit to the amounts the government can allow itself to spend on the rescuing of distressed businesses.

2. Moral Hazard

Ken Ayotte and David Skeel are among the latest commentators to elaborate on the moral hazard problem that a governmental bailout would produce. Ex ante, the expectation for a general bailout in a wide economic distress encourages managers of the largest firms to overinvest and take excessive risks in belief that eventually the government will not let their firms fall. Managers and directors of such firms adopt the mantra that their firms are simply "too big to fail". This risk is magnified by the managers' modern days' inclination to overly risk the firms' operation in expectation of reaping increased executive compensation calculated on the basis of (shortsighted)

144 See Zingales, supra n.141.
145 Altman & Philippon advocate the use of taxpayer's money, through a government DIP loan to GM inside Chapter 11, but only because of the collapse of the DIP-finance market as a result of the general financial crisis. Edward I. Altman & Thomas Philippon, Where Should the Bailout Stop, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 353 (Viral V. Acharya & Matthew Richardson eds. 2009).
146 This may explain recent hesitations in the U.S. from bailing out additional faltering firms. See Dean Foust & Theo Francis, CIT: Not Too Big to Fail, BUSINESSWEEK, Jul. 13th 2009, available at http://www.businessweek.com/bwdaily/dnflash/content/jul2009/db20090713_500893.htm (also citing sources who call for utilizing a prepackaged bankruptcy in lieu of a bailout)
147 Ayotte, & Skeel, supra n.131. The problem discussed in the main text is a debtor's moral hazard problem. In a somewhat different context the International Monetary Fund's sovereign-debt bailouts have raised the concern of investors' moral hazard. See, e.g., Jong-Wha Lee & Kwanho Shin, IMF Bailouts and Moral Hazard, 27 J. INT'L MONEY & FIN. 816 (2008). For a historical (and skeptic) account of general bailouts and their adverse effect on managements of the railroad industry see Joseph R. Mason & Daniel A. Schiffman, Too Big to Fail, Government Bailouts and Managerial Incentives: The Case of the Reconstruction Finance Corporation Assistance to the Railroad Industry during the Great Depression, in TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 49 (Benton E. Gup ed. 2004)
high returns. Moreover, as Ayotte and Skeel argue, *ex post* the managers and directors may exacerbate the moral hazard problem by deliberately allowing the firm to deteriorate further, in order to paradoxically enhance its chances of receiving the government aid it seeks. That is, the firm races itself to distress to pass the dubious "poor firm in need of government bailout" threshold. This behavior only worsens the firm's position at a time where quick reconstructive actions of its managers and directors could have righted the ship.

3. The Limits of Consensual Workouts

As a legal response to the current bonds crisis the ISA regulated the operation of credit officers. The wide perception in the market is that this legal arrangement is superior to official reorganization proceedings. The scheme of credit officers facilitates a quiet workout between a firm and its bondholders without resorting to judicial intervention and the disruption of the normal course of the firm's business. Much like any consensual workout, the scheme of credit officers is indeed a constructive contribution to the successful resolution of payment crises in public corporations. However, this scheme and any other form of workout fall short once coordination problems and conflicts of interest between the bondholders and other creditors, such as bank lenders, or between the bondholders *inter-se* abound. In such circumstances classes of creditors that oppose the proposal negotiated between the firm and (a class of) its bondholders may effectively impede the proposal by

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151 Ayotte, & Skeel, *supra* n.131.
152 See *supra* Part II.C.
asserting their own collection rights. In such situations, which are common in practice, the scheme of credit officers fails to solve the crisis and save the firm.

In addition, bankruptcy equips the parties with the constructive benefits of a wide moratorium. Thus, while the negotiations between the parties take place no single creditor whose claim is due and payable may disrupt the negotiations by creating a run at the debtor's assets. The consensual workout alternative does not provide such a safety net and is thus wholly dependent on the good will and restraint of each and every creditor of the debtor. Finally, bankruptcy laws benefit the financers of a distressed debtor by according them a high priority in the order of claims. No such benefits may be obtained, however, in an out-of-court workout.

VI. The Case for Using Reorganization Law

A. Reorganization Law: The Cure, Not the Plague

By and large, the Israeli business sector has practically rejected formal bankruptcy proceedings as a mechanism for resolving the financial distress of viable firms and promoting a reorganization plan for the benefit of the firm and its creditors. The popular, yet completely errant, perception is that official bankruptcy proceedings, of any kind, are a death writ for a debtor firm who shall enter such proceedings. The reasons for this perception have been discussed in Part IV. In the previous part I have shown that alternative mechanisms, like government intervention or out-of-court workouts, are far from being optimal solutions for business financial distress as they

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156 See, e.g., Michael Rochwerger, Polishek Holds Enough Cash to Pay Its Bondholders by the End of February – The Banks are Refusing to Release the Cash, The Marker (1.2.09), available at http://www.themarker.com/tmc/article.jhtml?log=tag&ElementId=mr20090201_111121 (as visited on June 1st, 2009) (Hebrew). It is a common understanding in the capital market that without the consent of the bank lenders any proposed workout between bondholders is liable to fail. See GLOBES RESEARCHES & PRICEWATERHOUSECOOPERS, supra n.40, at pp. 15, 35-37.

157 For a proposition that repeat workouts with various issuers decrease the concern of a bondholder holdout see Royce de R. Barondes, An Economic Analysis of the Potential for Coercion in Consent Solicitations for Bonds, 63 FORDHAM L. REV. 749 (1994).

158 In Israel, the moratorium is ordered by the court pursuant to section 350(b) of the Companies Act. In the U.S., once a bankruptcy petition has been filed the stay applies automatically under section 362(a) of the Bankruptcy Code.

159 See, e.g., in the U.S., Bankruptcy Code §364.
suffer from numerous shortcomings. In my eyes, ruling out the use of bankruptcy proceedings for resolving the bonds crisis is erroneous as it unjustifiably narrows the available channels for resolving the crisis and abandons the very mechanism that was designed specifically for such situations.

I believe that all players, the debtor firms, their creditors (institutional and non-institutional alike), the government agencies who regulate the capital market and the Ministry of Finance in its capacity as the treasurer of the taxpayers' money, should realize that there are legal tools designed specifically for resolving the financial distress of debtor firms and facilitating the payment to their creditors, without losing the viability of the firms. Those tools are found in bankruptcy law. Once Israel's law has adopted a reorganization regime, bankruptcy should no longer be treated as a terminal disease that ought to be avoided as long as possible. Quite the contrary is true. Reorganization law was enacted explicitly as a mechanism for rescuing distressed firms and protecting their going-concern value for the benefit of their creditors. A firm who is experiencing a payment crisis can steady itself and reach a workable solution with its creditors through the reorganization proceedings. These proceedings often only simplify otherwise complex matters and procedures. The potential of reorganization proceedings is especially powerful when coupled with a prenegotiated or prepackaged reorganization plan. The creditors and the firm together can enter quiet and relatively peaceful negotiations pertaining to the modified terms of payment, the design and structure of the firm's future capital and its prospective business plan. During these negotiations the debtor continues to run its business, uninterrupted, in its ordinary course. Once the negotiations are ripe for finalization, the firm can enter bankruptcy and enjoy the automatic stay, new opportunities for financing and the advanced and flexible mechanism of approving the reorganization plan by classes of creditors. Thus, instead of avoiding bankruptcy law, all actors should embrace it as an available and useful, albeit by no means the sole, vehicle for rescuing firms. For that to happen, the most notable change that is required has to do

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160 For a similar argument concerning the positive role of Chapter 11 for U.S. businesses see Lubben, supra n.125.


162 However, sometimes a quick bankruptcy case is no more than a reflection of poor bankruptcy practice. For such an argument concerning the case of Chrysler's swift bankruptcy case see Mark J. Roe & David A. Skeel, Jr., Assessing the Chrysler Bankruptcy (Aug. 2009), U. PENN. INST. L. & ECON. RESEARCH PAPER NO. 09-22, available at http://ssrn.com/abstract=1426530.
with perception. The traditional bankruptcy phobia must make way to a modern constructive and unbiased understanding that bankruptcy law is not the terminal move in the game all should avoid as long as possible. Bankruptcy should not be a measure of last resort used only after all the (so-called) conventional attempts to solve a firm's financial distress have been exhausted. Bankruptcy law is a judicially prescribed treatment of financial distress. A reorganization case should be regarded as an opportunity, not as a black hole. While at the early stage of the case there exists uncertainty regarding the ultimate form of relief for the firm and the treatment of the creditors' claims, the same is true with respect to any negotiations oriented alternative. The ultimate outcome is unknown to the parties beforehand. Any out of court arrangement is similarly vulnerable to break down.

B. The Need for Modern Reorganization Law

Regional economic crises have led in the past to the reform of national insolvency laws and the legislation of reorganization schemes. Such legislation was intended to set a framework for salvaging domestic businesses. Indeed, crises are traditionally catalysts for improvement and reform. The current bonds crisis in Israel can, and in my eyes should, be a catalyst for revising its reorganization law. Revising the law and fine tuning it may contribute to a rational business environment that would be willing to use reorganization law wisely and efficiently. To the extent that the revised law will appeal to the parties and present a flexible platform for relieving a cash constrained debtor from the burden of due and payable claims, it is expected to assume its rightful place at the fore of the business legislation and complement its counter parts, namely contracts law, corporate law, securities regulation and the law of secured transactions. Such a revision would benefit the business world and fill a substantial hole that currently impedes the proper functioning of business entities, their investors and financers.

To make reorganization law appealing and a useful tool, the following revisions should be legislated:

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164 This vulnerability is exacerbated outside of bankruptcy by the lack of a moratorium. Thus, any solo action by a creditor to levy on the firm's property and collect notwithstanding the negotiated workout may turn to be the brick drawn out of the (eventually) collapsing wall.
(a) adopting a DIP regime for debtor firms, the control of whom is dispersed;
(b) carving the absolute priority of the floating charge;
(c) facilitating the continuance of executory contracts in general, and license and franchises in particular, during reorganization; and
(d) adopting the cramdown mechanism.

As explained above in Part IV.B, the current statutory law is deficient in that it has thus far failed to provide the debtor and its creditors with sufficient incentives to use reorganization and to address their mutual conflicts of interest through mitigating tools. The revisions I propose herein are intended to fill this legislative gap.

1. Adopting a DIP Regime

Any debtor enjoys information superiority over its creditors regarding the debtor's financial state. As a result, the debtor is the classic initiator of reorganization actions.165 Given the appropriate incentives, a debtor would use its informational advantage to take action for saving its business as early as necessary. In the corporate context it is thus essential to entice the main decision-makers of the debtor, namely its managers and directors, to timely resort to formal reorganization and take advantage of its constructive facets.166 A DIP regime is precisely the assuring measure necessary to neutralize the decision-makers' aversion to reorganization proceedings. From their perspective, it is their control of the firm more than any other factor that drives them away from official proceedings. A proceeding that leaves them at the helm is the antidote for their aversion. Adopting a DIP regime is the most significant legal reform aimed at turning reorganization from law in the books to law in action.

However, given the practical dependency of managers and directors of a firm on the controlling shareholder of that firm, a DIP regime would effectively entrench

the controlling shareholder at a time when the best interests of the creditors should prevail in the firm's decision-making.\textsuperscript{167} Outside formal bankruptcy, in the regular business environment, financial creditors are equipped with sophisticated contractual covenants to combat any externalization of risks from the controlling shareholder. Within bankruptcy, however, under the legal moratorium the contractual enforcement rights of the creditors are suspended. Thus, paradoxically, absent tight control by the presiding court, a controlling shareholder may enjoy a more lax business environment inside bankruptcy than outside and jeopardize the creditors' money within the formal framework. Therefore, converting reorganization law from a trustee-controlled regime to a DIP controlled regime should be done cautiously and conservatively. I believe that a shift to a DIP regime should be applied first only with respect to publicly traded firms whose stock is diffuse with no shareholder holding a controlling position. In such firms, the only decision-makers that matter are the managers and directors. Once they are encouraged to file for bankruptcy, they are also likely to read the map correctly and adopt the creditors' agenda as their own.\textsuperscript{168} The shadow of the shareholders is hardly threatening to the management. Diffuse stock is typical in large firms, whose financial distress affects severely many other actors and the economy at large. Thus encouraging a timely filing for bankruptcy for these firms is expected to be a positive legislative contribution to the successful handling of financial distress.

Another statutory provision that may simplify the reorganization initiation problem described above would be an amendment that would explicitly entitle creditors holding unliquidated or unmatured claims to file for reorganization.\textsuperscript{169} Should such an amendment be enacted, an indenture trustee, on behalf of the bondholders, would be entitled to file for reorganization of the distressed issuing firm once it has defaulted on any of its financial covenants even if the debenture lacks any acceleration clause. The mere deterioration in the debtor's financial stability and the heightened risk of default and insolvency as a result thereof shall suffice for collective actions initiated by the creditors. The fact that the specific payment to the petitioning creditor is not due at the time will not weaken that creditor's entitlement to take action

\textsuperscript{168} \textit{Id.}
\textsuperscript{169} \textit{Compare}, in the U.S., Bankruptcy Code §§ 101(5)(A) (definition of "claim"), 303(b)(1) (commencement of an involuntary case by holders of claims).
aimed at saving the debtor's going-concern value and preventing stalling tactics from the firm's management and board of directors. This amendment shall overcome the problem encountered by holders of covenant-light bonds.

Simplifying the conditions for a creditors' initiation of bankruptcy cannot serve as a proxy for a DIP regime, however. As explained above, given its information superiority, the debtor is the ultimate initiator of reorganization proceedings. Also, in a trustee controlled bankruptcy, even if it were initiated by creditors in a timely way, the case administration suffers inefficiencies due to the vulnerability of the newly appointed trustee and the confrontational atmosphere in which the trustee functions. Therefore, a legal regime would do better if it were to provide the firm's decision-makers the proper incentives to file for reorganization rather than circumventing them and turning its attention to creditors' initiated proceedings. Thus, adopting a DIP regime for diffused (shareholders') control firms is the preferable legal reform.

2. Carve-Out of Floating Charges

It has been mentioned above that pre-bankruptcy secured creditors, holding an encompassing floating charge on all the debtor firm's assets, enjoy an effective financing monopoly. No other creditor would voluntarily finance the firm as it is automatically junior to the holder of the floating charge. This leads to various inefficiencies, including over-lending by the holder of the floating charge, suboptimal monitoring by the fully secured creditor, and externalization of risks to the other creditors. In the context of negotiating a reorganization of capital arrangement with a firm's bondholders this absolute priority of the floating charge

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170 Alternatively, the legislature or regulator may demand the inclusion of an acceleration clause in any corporate bonds issuing as a mandatory prerequisite for public offering of the bonds. Such an initiative is currently discussed by the ISA.

171 However, this does not overcome the creditors' hesitation to initiate a collective bankruptcy case given the adverse effect of free riding by the other creditors. See Douglas G. Baird, The Initiation Problem in Bankruptcy, 11 INT'L REV. L. & ECON. 223 (1991).

172 Hahn, supra n.167.


over the entire firm's property, including property acquired during the reorganization case, frustrates the ability of the debtor firm to offer the bondholders delayed installment payments secured by a prime security interest in uncollateralized property. To overcome this problem, the legislature ought to amend the statute and to either provide that property acquired during the reorganization case is free of any pre-bankruptcy security interests, or to carve-out a certain percentage from the firm's property that is subject to the floating charge in favor of other creditors, as proposed some years ago in the U.S. by Bebchuk and Fried. Either alternative would facilitate the use of the firm's property in advancing a bondholders' arrangement.

3. Saving Executory Contracts

As stated earlier, in Israel the fate of executory contracts upon the filing for reorganization is extremely fragile. Any ipso facto clause may terminate the contract. Also, case law is unclear on the issue whether a pre-commencement payment default entitles the non-debtor party to rescind the contract. Such contracts may be a license obtained and used by the debtor firm, or a real estate lease in a primary and strategic location. Under current law, the filing for reorganization does not immune these contracts and may even be the official contractual trigger for their termination. The triggering events of ipso facto clauses cast dark shadows over any formal reorganization initiative. Wishing to preserve the business' substantial assets, distressed firms that are lessees or licensees attempt to avoid formal bankruptcy as long as possible and resolve their financial problems outside the courtroom. However, given the various obstacles outside formal bankruptcy, namely the lack of moratorium and the consent required from all creditors for any debt restructuring, it may be wise to reverse the legal factors that influence the actions of the parties. By enacting into law the invalidity of ipso facto clauses and facilitating the continuation of previously breached executory contracts formal reorganization would become the hospitable arena for salvaging financially ailing firms. Executory contracts would continue to run and generate the firm's core business while the parties enjoy the advantageous rules of

177 Compare, in the U.S., Bankruptcy Code § 552(a). Should such a provision be enacted in Israel, it ought to be conditioned on the safeguard of adequate protection for the rights of the holder of the floating charge in its secured claim.

178 Bebchuk & Fried, supra n.176.

179 See text accompanying notes 104-106 supra.

180 See Triantis, supra n.103.
reorganization law that facilitate their reaching a consensual reorganization plan. Saving the executory contract would remove a major tactical factor from the decision-makers’ aversion of bankruptcy. The veracity of this argument has been proven empirically.\textsuperscript{181} Israel should follow this path if it wishes to perfect its reorganization law.

4. Cramdown

The final revision that may enhance the efficacy of formal reorganization would be the enactment of a cramdown provision. That is, the reorganization statute should provide for the confirmation of a reorganization plan over the dissent of one or more of the voting classes of creditors or equityholders.\textsuperscript{182} Given the conflicts of interest among classes in general and among various series of bonds in particular, the dissent of a certain voting class is a very likely possibility. Enacting a cramdown provision would facilitate reorganization as it neutralizes the ability of any single class to hold out and veto the plan. This removes one of the major impediments en route to salvaging the firm and arranging a payment plan for its creditors. Moreover, by allowing the confirmation of plan over the dissent of a class the legislature would effectively encourage the various classes to display more flexibility at the bargaining table and reach a consensual arrangement and avoid the deep involvement on the part of the court that would be required in the case of cramdown.\textsuperscript{183} Thus, the legislation of a cramdown provision may even prove itself eventually as a catalyst for out-of-court workouts.

CONCLUSION

The global economic crisis of 2008-2009 has affected many emerging markets and slowed down their business activity. Israel is no exception. Many firms currently face financial distress and are struggling to keep their payment obligations and avoid default. The novel aspect of the current crisis is the wide exposure of holders of listed and traded bonds to default. Investors in the young Israeli bonds market treated these investments as solid and safe ones, only to discover during the crisis that they are

\textsuperscript{181} Simeon Djankov, Oliver Hart, Caralee McLiesh & Andrei Shleifer, \textit{Debt Enforcement Around the World} (December 2006116 J. POL. ECON. 1105 (2008).
\textsuperscript{182} The U.S. cramdown provision is Bankruptcy Code §1129(b).
subject to substantial losses resulting from the looming insolvency of the issuing firms. A large percentage of the bonds is held by institutional investors, who manage the long term savings of the public. This has drawn the public attention to search for satisfactory solutions to the bonds crisis.

Several government bailout proposals have been considered. However, the recent official announcement of the Minister of Finance that the government will not bail out even the largest firms from the private sector has put these initiatives to rest.\textsuperscript{184} Thus, the parties are necessarily drawn back to the negotiations table. Nonetheless, surprisingly, the path of formal reorganization proceedings under bankruptcy law has been largely overlooked if not deliberately and consciously avoided. Dodging reorganization may be explained as the result of several cumulative factors. One major factor is a general misconception of the constructive role reorganization law plays in salvaging ailing businesses. This misconception may be remedied only through a consistent and gradual cultural change towards insolvency and what its law stands for. Another major factor is the current poor state of Israeli reorganization law. Several aspects of current reorganization law deter the decisionmakers in a firm, as well as their creditors, from utilizing this channel.

This paper calls for using the crisis as a catalyst for reforming Israel's reorganization law, strengthening its current weak aspects and transforming it into an attractive, practical and workable channel for the satisfactory resolution of creditors' rights and saving viable businesses.