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Draft legislative guide on insolvency law

Note by Secretariat

1. This note sets forth the structure of the draft legislative guide as contained in A/CN.9/WG.V/WP/63/Add.1-17. The list of contents shows the scope of the issues addressed by the draft legislative guide and its responsiveness to the mandate given to the Working Group. The final structure will require some revisions as to the numbering of chapters and recommendations; inclusion of the existing Chapter IV. D, Institutional framework, in the opening chapters of Part One; and relocation of Addendum 17 should the Working Group recommend that the material on applicable law governing in insolvency proceedings be retained in the legislative guide.

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Draft legislative guide on insolvency law

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[Part One, Chapters I and II of the Guide appear in document A/CN.9/WG.V/WP.63/Add.2; Part Two of the Guide appears in documents A/CN.9/WG.V/WP.63/Add.3-17]

Glossary

A. Notes on the terminology used in the Guide

1. The following terms are intended to provide orientation to the reader of the Guide—many terms such as "secured creditor", "liquidation" and "reorganization" may have fundamentally different meanings in different jurisdictions and the inclusion of a definition in the Guide may assist in ensuring that the concepts as discussed in the Guide are clear and widely understood.

- *References in the Guide to the "court"*

2. The Guide assumes that there is reliance on court supervision throughout the insolvency proceedings which may include the power to commence insolvency proceedings, to appoint the insolvency representative, to supervise its activities and to take decisions in the course of the proceedings. Although this reliance may be appropriate as a general principle, alternatives may be considered where, for example, the courts are unable to handle insolvency work (whether for reasons of lack of resources or lack of requisite experience) or supervision by an administrative agency is preferred (see Part two, chapter IV.D Institutions).

3. For the purposes of simplicity the Guide uses the word "court" in the same way as article 2(e) of the UNCITRAL Model Law on Cross-Border Insolvency to refer to a judicial or other authority competent to control or supervise an insolvency proceeding.

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B. Terms and definitions

Term	Definition
Administrative claim	Claims that are generally accorded priority over unsecured claims and which relate to costs and expenses of the proceedings such as remuneration of the insolvency representative and any professionals employed by the insolvency representative, debts arising from the proper exercise of the insolvency representative's functions and powers, costs arising from continuing contractual obligations, and costs of proceedings [see para. 426, A/CN.9/WG.V/WP.63/Add.14].
Appropriate protection	Measures directed at maintaining the economic value of a security interest during the insolvency proceedings (in some jurisdictions referred to as "adequate protection"). This protection may be particularly relevant where the value of the secured claim is greater than the value of the secured asset or even where the value of the secured asset exceeds the value of the secured claim, but the value of the secured asset is diminishing and ultimately may be insufficient to satisfy the secured claim. Such diminution in value may be affected by the application of the stay to secured creditors and by the use of the secured asset in the insolvency proceedings (see recommendation (42)). Appropriate protection may be provided by way of cash payments, provision of alternative or additional security or by other means as determined by a court to provide the necessary protection.
Avoidance action	Action which allows transactions [occurring prior to the application for commencement of insolvency proceedings or commencement of insolvency proceedings] to be cancelled or otherwise rendered ineffective. Transactions that may be avoided include [*terms of recommendation (70) to be added*].
Centre of main interests	The place where the debtor conducts the administration of its interests on a regular basis and that is therefore ascertainable by third parties [EC Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings, recital (13)].
Claim	Enforceable right to money or assets which may be based upon a judgement, may be liquidated or unliquidated, matured or unmatured, disputed or undisputed, secured or unsecured, fixed or contingent.
Close-out netting	See Netting

Term	Definition
Commencement of proceedings	Date as of which the effects of insolvency are applicable or [date as of which the judicial decision to commence insolvency proceedings becomes effective, whether it is a final decision or not], in some jurisdictions referred to as “opening” of proceedings.
[Composition	[In the context of reorganization,] an agreement between the debtor and the [majority of] creditors where the creditors agree with the debtor and between themselves to accept from the debtor payment of less than the amount due to them in full satisfaction of their claims or to a reduction or postponement of debts or the redefinition of payment terms]
Court	A judicial or other authority competent to control or supervise an insolvency proceeding [UNCITRAL Model Law on Cross-Border Insolvency, art. 2(e)].
Cram-down provision	A mechanism that will enable the support of one class of creditors for a reorganization plan to be used to make the plan binding on other classes without their consent.
Creditor committee	Representative body appointed by [the court] [the insolvency representative] [creditors as a whole] to act on behalf and in the interests of the general body of creditors and having consultative and other powers as specified in the insolvency law.
Debtor	A person or entity, engaged in a business, which meets the criteria for commencement of insolvency proceedings; or [an individual or legal entity that is indebted to a creditor].
Discharge	A court order releasing a debtor from all liabilities that were, or could have been, addressed in the insolvency proceedings, including contracts that were modified as part of a reorganization.
Establishment	Any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services [UNCITRAL Model Law on Cross-Border Insolvency art. 2(f)].
Financial contract	Means any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above [UNCITRAL Convention on the Assignment of Receivables in International Trade (2002) art. 5(k)].
Formal insolvency proceedings	Insolvency proceedings commenced under the insolvency law and governed by that law, generally including both a liquidation and a reorganization process.

Term	Definition
Going concern	The sale of a business as a "going concern" is where the business is continued after commencement of insolvency proceedings and sold as a working whole, as opposed to a piecemeal sale of individual assets of the business.
Informal insolvency proceedings	Insolvency processes that are not regulated by the insolvency law and will generally involve negotiation between the debtor and some or all of its creditors. Often these processes have been developed through the banking and commercial sectors and typically provide for some form of reorganization of the insolvent debtor. Whilst not regulated by an insolvency law, these informal reorganization processes nevertheless depend for their effectiveness upon the existence of an insolvency law which can provide some indirect incentive or persuasive force to achieve a reorganization.
Initiation of proceedings	The making of an application for commencement of insolvency proceedings by the debtor; one or more creditors; and in rare cases by a public authority. Such an application may affect the legal rights of the debtor and creditors before commencement of the insolvency proceedings.
Insolvency	When the debtor is unable [or is likely to be unable] to pay its debts and other liabilities as they fall due or when the value of debts and liabilities of the debtor exceeds the value of assets.
Insolvency estate	Assets and rights of the debtor that are controlled by the insolvency representative and subject to the insolvency proceedings.
Insolvency proceedings	Collective judicial or administrative proceedings, including an interim proceeding, for the benefit of creditors and others conducted according to the insolvency law [in which the assets and affairs of the debtor are subject to control or supervision by a court or other competent authority] [which involve the [partial or total] divestment of the debtor and the appointment of an insolvency representative] for the purpose of either liquidation or reorganization of the business.
Insolvency representative	A person or body including one appointed on an interim basis, authorized in an insolvency proceeding to administer the reorganization or liquidation of the debtor's assets or affairs [UNCITRAL Model Law on Cross Border Insolvency, art. 2(d)] (see also "interim insolvency representative").
Insolvency decision	Decision of the court to commence an insolvency proceeding [and to appoint an insolvency representative] (see also "commencement of proceedings").

Interim insolvency representative	Person or entity appointed by the insolvency court in case of a serious crisis of the debtor which prevents the normal operation of its business, and is required to ensure, temporarily, the further operation of the business in connection with suspension of the debtor or of the debtor's management (possibly in connection with reorganization) (see also "insolvency representative").
Involuntary proceedings	Insolvency proceedings commenced on the application of a party other than the debtor such as creditors or a public authority.
Liquidation	Process of assembling and selling a debtor's assets in an orderly and expeditious fashion in order to distribute the proceeds of sale to creditors according to established law and dissolve (where the debtor is a corporate or other legal entity) or discharge (where the debtor is an individual) the debtor either by way of a piecemeal sale or a sale of all or most of the debtor's assets in productive operating units or as a going concern [see World Bank Principles and Guidelines, 2001] Other terms for this type of proceeding include winding up, bankruptcy, *faillite, quiebra*, and *Konkursverfahren*.
Netting	In one form it can consist of set-off (see "set-off") of non-monetary fungibles (such as securities or commodities deliverable on the same day, known as settlement netting) and in its more important form it consists of a cancellation by a counterparty of open contracts with the debtor, followed by a set-off of losses and gains either way (close-out netting).
Netting agreement	An agreement between two or more parties that provides for one or more of the following: (i) The net settlement of payments due in the same currency on the same date whether by novation or otherwise; (ii) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other; or (iii) The set-off of amounts calculated as set forth in subparagraph (ii) of this definition under two or more netting agreements. [UNCITRAL Convention on the Assignment of Receivables in International Trade (2002) art. 5(l)].
Ordinary course of business	[*Note: is a definition required in the Guide?*]

Pari passu	The principle according to which creditors of the same class are treated equally [and are paid proportionately out of the assets of the estate].
Post-commencement creditor	A creditor whose claim arises after commencement of the insolvency proceedings.
Preference	A payment or other transaction made by an insolvent debtor which places a creditor in a better position than it would have been otherwise to the detriment or prejudice of the general body of creditors [other than in the normal course of trade].
Priming lien	A priority given to lenders of post-commencement finance which ranks ahead of all creditors, including secured creditors.
Priority	The right of a person in preference to the right of another person and, to the extent relevant for such purpose, includes the determination of whether the right is a personal or a property right, whether or not it is a security right for indebtedness or other obligation and whether any requirements necessary to render the right effective against a competing claimant have been satisfied [UNCITRAL Convention on the Assignment of Receivables in International Trade art. 5].
Priority claim	A claim that will be paid out of available assets before payment of general unsecured creditors.
Priority rules	The rules by which distributions are ordered among creditors and equity interests.
Related person	A person who is or has been in a position of control of the debtor including a director or officer of a legal entity, a shareholder or member of such legal entity, a director or officer or shareholder of a legal entity that is related to the debtor, including any relative of such a person; a "relative" in relation to a related person means the spouse, parent, grandparent, son, daughter, brother or sister of the related person.
Reorganization	Process by which the financial well-being and viability of a debtor's business can be restored and the business continue to operate, using various means possibly including debt forgiveness, debt rescheduling, debt-equity conversions and sale of the business (or parts of it) as a going concern. Other terms for this type of proceeding include rescue, restructuring, turnaround, rehabilitation, arrangement, composition, *concordat préventif de faillite, suspensión de pagos, administración judicial de empresas*, and *Vergleichsverfahren*.

Reorganization plan	A plan by which the financial well-being and viability of the debtor's business can be restored. The insolvency law may provide for the plan to be submitted by various parties (the debtor, the creditors, the insolvency representative) and may require confirmation of the plan by the court following its approval by the requisite number of creditors. The plan may address issues such as timing of the process, commitments to be undertaken, terms of payment and securities to be offered to creditors, avoidance actions to be filed and treatment of pending contracts including employment contracts.
Retention of title (title financing)	Provision of a contract for the supply of goods which purports to reserve ownership of the goods with the supplier until payment of the purchase price.
Secured asset	An asset or property, movable or immovable, in respect of which a security interest has been granted to a creditor. If an obligation is not satisfied the asset or property subject to the security interest may be recovered or held, or the value realized by the creditor holding the security interest. Other terms include collateral and encumbered asset.
Secured claim	A claim assisted by a security interest taken as a guarantee for a debt enforceable in case of the debtor's default when the debt falls due.
Secured creditor	A creditor holding either a security interest covering all or part of the debtor's assets or a security interest in a specific asset entitling the creditor to priority ahead of other creditors with respect to the secured asset.
Secured debt	[Aggregate amount of secured claims] or [claims pertaining to secured creditors].
Security interest	A right or interest granted by a party committing the party to pay or perform an obligation. Whether established voluntarily by agreement or involuntarily by operation of law, a security interest generally includes, but is not necessarily limited to, mortgages, pledges, charges and liens [World Bank Principles and Guidelines, 2001].
Set-off	Where a claim for a sum of money owed to a person is "set-off" (balanced) against a claim by the other party for a sum of money owed by that first person. A set-off may operate as a defence in whole or part to a claim for a sum of money.
State-owned enterprise	[*Note: is a definition required in the Guide?*]
Stay of proceedings	A measure which prevents the commencement, or suspends the continuation, of judicial, administrative or other individual actions concerning the debtor's assets, rights, obligations or liabilities, including the perfection or enforcement of any security interest; and prevents execution

	against the assets of the insolvency estate, the termination of a contract with the debtor, and the transfer, encumbrance or other disposition of any assets or rights of the insolvency estate (recommendation (35)).
Superpriority	A priority that will result in claims to which the superpriority attaches being paid before administrative claims.
Unsecured creditor	Any creditor who does not hold security or any ordinary creditor who has no preferential rights.
Unsecured debt	Aggregate amount of claims not supported by security.
Voluntary proceeding	Insolvency proceedings commenced on the application of the debtor.

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[The Glossary to the Guide appears in A/CN.9/WG.V/WP.63/Add.1; Part Two of the Guide appears in documents A/CN.9/WG.V/WP.63/Adds.3-17]

Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.57, the previous version of this introductory chapter.

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* This document was submitted late because of the need to complete the twenty-seventh session of the Working Group (9-13 December 2002) and finalize revision of the document.

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Part One

Designing the structure and key objectives of an effective and efficient insolvency regime

I. Introduction to insolvency procedures

1. [23] When a debtor is unable to pay its debts and liabilities as they become due, most legal systems provide a legal mechanism to address the collective satisfaction of the outstanding claims from all assets (whether tangible or intangible) of the debtor. A range of interests needs to be accommodated by that legal mechanism—firstly, the parties including the debtor, the owners and management of the debtor, the creditors who may be secured to varying degrees (including tax agencies and other government debtors), employees, guarantors of debt and suppliers of goods and services, as well as the legal, commercial and social institutions and practices that are relevant to the design of the insolvency law, including the institutional framework required for its operation. Generally, the mechanism must strike a balance not only between the different interests of these stakeholders but also between those interests and the relevant social, political and other policy considerations that impact upon the economic and legal goals of insolvency.

2. [23] Most legal systems contain rules on various types of proceedings (which are referred to in this Guide by the generic term “insolvency proceedings”) that can be initiated to resolve a debtor’s financial difficulties. While addressing that resolution as a common goal, these proceedings take a number of different forms, for which uniform terminology is not always used, and may include both “formal” and “informal” elements. Formal

insolvency proceedings are commenced under the insolvency law and governed by that law. They generally include both a liquidation and a reorganization process. Informal insolvency processes are not regulated by the insolvency law and will generally involve negotiation between the debtor and some or all of its creditors. Often these processes have been developed through the banking and commercial sectors and typically, provide for some form of reorganization of the insolvent debtor. Whilst not regulated by an insolvency law, these informal reorganization processes nevertheless depend for their effectiveness upon the existence of an insolvency law which can provide some indirect incentive or persuasive force to achieve a reorganization (discussed further below).

A. Key objectives of an effective and efficient insolvency regime

3. Although country approaches vary, there is broad agreement that effective and efficient insolvency regimes should aim to achieve the key objectives identified below. Whatever design is chosen for an insolvency law that will meet these key objectives, the insolvency law must be complementary to, and compatible with, the legal and value systems of the society in which it is based and which it must ultimately sustain. Although insolvency law generally forms a distinctive regime, it ought not to produce results that are fundamentally in conflict with the premises upon which the general law is based. Where the insolvency law does seek to achieve a result that differs or fundamentally departs from the general law (e.g. with respect to treatment of contracts, avoidance of antecedent acts and transactions or treatment of the rights of secured creditors) it is highly desirable that that result be the product of careful consideration and conscious policy in that direction.

1. Maximize value of assets

4. Participants in the insolvency process should have strong incentives to achieve maximum value for assets as this will facilitate higher distributions to creditors as a whole and reduce the burden of insolvency. The achievement of this goal is often furthered by achieving a balance between the risks allocated between the parties involved in an insolvency proceeding. The manner in which prior transactions are treated, for example, can ensure that creditors are treated equitably and enhance the value of the debtor’s assets by recovering value for the benefit of all creditors. At the same time, the treatment afforded those transactions can undermine the predictability of contractual relations that is critical to investment decisions, creating a tension between the different objectives of an insolvency regime. Similarly, a balance has to be struck between rapid liquidation and longer term efforts to reorganize the business which may generate more value for creditors, between the need for new investment to preserve or improve the value of assets and the implications and cost of that new investment on existing stakeholders, and between the different roles allocated to the different stakeholders, in particular the discretion that can be exercised by the insolvency representative and the extent to which creditors can monitor the exercise of that discretion to safeguard the process.

2. Strike a balance between liquidation and reorganization

5. The first objective of maximization of value is closely linked to the balance to be achieved in the insolvency regime between liquidation and reorganization. [16] An insolvency regime needs to balance the advantages of near-term debt collection through liquidation (often the preference of secured creditors) against maintaining the debtor as a viable business through reorganization (often the preference of unsecured creditors). Achieving that balance may implicate other social policy considerations such as

encouraging the development of an entrepreneurial class and protecting employment. [15] Insolvency law should provide for the possibility of reorganization of the debtor as an alternative to liquidation, where creditors would not involuntarily receive less than in liquidation and the value of the debtor to society and to creditors may be maximized by allowing it to continue. This is predicated on the basic economic theory that greater value may be obtained from keeping the essential components of a business organization together, rather than breaking them up and disposing of them in fragments. To ensure that the insolvency process is not abused by either creditors or the debtor, and that the procedure most appropriate to resolution of the debtor's financial difficulty is available, the insolvency law should also provide for conversion between the different types of proceedings in appropriate circumstances.

3. Ensure equitable treatment of similarly situated creditors

6. The objective of equitable treatment is based on the notion that in collective proceedings, creditors with similar legal rights should be treated equally, receiving a distribution on their claim in accordance with their relative priority and interests. [17] Equitable treatment recognizes that all creditors do not need to be treated equally, but in a manner that reflects the different bargains they have struck with the debtor, although this becomes less relevant as a defining factor where there is no specific debt contract with the debtor, such as in the case of damage claimants (e.g. for environmental damage). To the extent that equitable treatment is modified by social policy on claim priorities and should give way to the prerogatives pertaining to holders of claims or interests that arise, for example, by operation of law, the principle of equitable treatment retains its significance by ensuring that the priority accorded to the claims of a similar class affects all members of the class in the same manner. The policy of equitable treatment permeates many aspects of an insolvency law, including the application of the stay or suspension, provisions to set aside acts and transactions and recapture value for the insolvency estate, classification of claims, voting procedures in reorganization, and distribution mechanisms. [17] The insolvency regime should address problems of fraud and favouritism that may arise in cases of financial distress, by providing, for example, that acts and transactions detrimental to equitable treatment of creditors can be avoided.

4. Provide for timely, efficient and impartial resolution of insolvency

7. [18] Insolvency should be addressed and resolved in an orderly, quick and efficient manner, with a view to avoiding undue disruption to the business and the activities of the debtor and to minimizing the cost of the proceedings. Achieving timely and efficient administration will support the objective of maximizing asset value, while impartiality supports the goal of equitable treatment. The entire process needs to be carefully considered to ensure maximum efficiency without sacrificing flexibility. At the same time, it should be focussed on the goal of liquidating non-viable and inefficient businesses and the survival of efficient, potentially viable businesses.

8. [18] Quick and orderly resolution of a debtor's financial difficulties can be facilitated by an insolvency law that provides easy access to the insolvency process by reference to clear and objective criteria, provides a convenient means of identifying, collecting, preserving and recovering assets and rights that should be applied towards payment of the debts and liabilities of the debtor, facilitates participation of the debtor and its creditors with the least possible delay and expense, provides an appropriate structure for supervision and administration of the process (including both professionals and the institutions involved)

and provides, as an end result, effective relief to the financial obligations and liabilities of the debtor.

5. Prevent premature dismemberment of the debtor's assets

9. [19] An insolvency regime should prevent premature dismemberment of the debtor's assets by individual creditor actions to collect individual debts. Such activity often reduces the total value of the pool of assets available to settle all claims against the debtor and may preclude reorganization or the sale of the business as a going concern. A stay of creditor action provides a breathing space for debtors, enabling a proper examination of its financial situation and facilitating both maximization of the value of the estate and equitable treatment of creditors. Some mechanism may be required to ensure that the rights of secured creditors are not impaired by a stay.

6. Provide for a procedure that is transparent and predictable and contains incentives for gathering and dispensing information

10. [20] The insolvency law should be transparent and predictable. This will enable potential lenders and creditors to understand how the insolvency process operates and to assess the risk associated with their position as a creditor in the event of insolvency. This will promote stability in commercial relations and foster lending and investment at lower risk premiums. Transparency and predictability will also enable creditors to clarify priorities, prevent disputes by providing a backdrop against which relative rights and risks can be assessed, and help define the limits of any discretion. Unpredictable application of the insolvency law has the potential to undermine not only the confidence of all participants in insolvency proceedings, but also their willingness to make credit and other investment decisions. [20] As far as possible, an insolvency law should clearly indicate all provisions of other laws that may affect the conduct of the insolvency proceedings (e.g. labour law; commercial and contract law; tax law; laws affecting foreign exchange, netting and set-off, debt for equity swaps; and even family and matrimonial law).

11. [20] The insolvency law should ensure that adequate information is available in respect of the debtor's situation, providing incentives to encourage the debtor to reveal its positions or, where appropriate, sanctions for failure to do so. The availability of this information will enable those responsible for administering and supervising the insolvency process (courts or administrative agencies, the insolvency representative) and creditors to assess the financial situation of the debtor and determine the most appropriate solution.

7. Recognize existing creditor rights and establish clear rules for ranking of priority claims

12. [21] Recognition and enforcement within the insolvency process of the differing rights that creditors have outside of insolvency will create certainty in the market and facilitate the provision of credit, particularly with respect to the rights and priorities of secured creditors. Clear rules for the ranking of priorities of both existing and post-commencement creditor claims are important to provide clarity to lenders, to ensure that that the rules can be consistently applied, that there is confidence in the process and that all participants are able to adopt appropriate measures to manage risk. To the greatest extent possible, those priorities should be based upon commercial bargains and not reflect social and political concerns that have the potential to distort the outcome of insolvency. According priority to claims that are not based on commercial bargains should be avoided.

8. Establish a framework for cross-border insolvency

13. [22] To promote co-ordination among jurisdictions and facilitate the provision of assistance in the administration of an insolvency proceeding originating in a foreign country, insolvency laws should provide rules on cross-border insolvency, including the recognition of foreign proceedings, by adopting the UNCITRAL Model Law on Cross-Border Insolvency.

B. Balancing the key objectives

14. Since an insolvency regime cannot fully protect the interests of all parties, some of the key policy choices to be made when designing an insolvency law relate to defining the goals of the insolvency law and achieving the desired balance between the objectives identified above. Insolvency laws achieve that balance by reapportioning the risks of insolvency in a way that suits a country's economic, social and political goals. As such insolvency regimes can have widespread effects in the broader economy.

15. The first task for any insolvency system is to establish a framework of principles that determines how the estate of the insolvent debtor is to be administered for the benefit of all affected parties. The creation of such a framework and its integration with the wider legal process are vital to maintaining social order and stability. All parties need to be able to anticipate their legal rights in the event of a debtor's inability to pay, or to pay in full, what is owed to them. This allows both creditors and equity investors to calculate the economic implications of default by the debtor, and so estimate their risks.

16. There is no universal solution to the design of an insolvency regime because countries vary significantly in their needs, as do their laws on other issues of key importance to insolvency, such as security interests, property and contract rights, remedies and enforcement procedures. Although there may be no universal solution, most insolvency systems address the range of issues raised by the key objectives, albeit with different emphasis and focus. Some laws favour stronger recognition and enforcement of creditor rights and commercial bargains and give creditors more control over the insolvency process than the debtor (sometimes referred to as "creditor-friendly" regimes), while other laws lean towards giving the debtor more control over the process (referred to as "debtor-friendly" regimes). Some laws give more prominence to liquidation of the debtor to weed out inefficient and incompetent market players while others favour reorganization. The focus on reorganization may serve a number of different aims: as a means of enhancing the value of creditors' claims as part of an ongoing business concern, providing a second chance to the shareholders and management of the debtor; providing strong incentives for the adoption by entrepreneurs and managers of appropriate attitudes to risk; or protecting vulnerable groups, such as the debtor's employees, from the effects of business failure.[1]

[1] There is not necessarily a direct correlation between the debtor or creditor friendliness of an insolvency regime, the emphasis on liquidation or reorganization and the subsequent success or failure of reorganization. While it is beyond the scope of this Guide to discuss these issues in any detail, they are important for the design of an insolvency regime and deserve consideration. While the rate of successful reorganizations varies considerably even among those regimes classified as creditor-friendly, research appears to suggest that the assumption that creditor-friendly regimes lead to fewer or less successful reorganizations than debtor-friendly regimes is

17. But adopting a reorganization-friendly approach should not result in establishing a safe haven for moribund enterprises – enterprises that are beyond rescue should be liquidated as quickly and efficiently as possible. To the extent that some interests may be regarded as being of lower priority than others, the establishment of mechanisms outside of the insolvency regime may provide a better solution than trying to address those interests under the insolvency regime. For example, where the insolvency law ranks employee claims lower than secured and priority creditors, insurance arrangements can be used to protect employee entitlements (see Part two, chapter ..).

18. Because society is constantly evolving, insolvency law cannot be static but requires reappraisal at regular intervals to ensure that it meets current social needs. Responses to perceived social change involve an act of judgement that can be informed by international best practice and those practices transposed into national insolvency regimes, taking into account the realities of the system and available human and material resources.

C. General features of an insolvency regime

19. [24] Designing an effective and efficient insolvency regime involves the consideration of a common set of issues relating to both the legal framework (rights and obligations of the parties, both substantively and procedurally) and the institutional framework (to implement these rights and obligations) required. The substantive issues, which are discussed in detail in Part two, chapters [..] of this Guide, include:

(a) identifying the debtors that may be subject to insolvency proceedings, including those debtors that may require a special insolvency regime;

(b) determining when insolvency proceedings may be commenced and the type of proceeding that may be commenced, the party that may request commencement and whether the commencement criteria should differ depending upon the party requesting commencement;

(c) the extent to which the debtor should be allowed to retain control of the business once insolvency proceedings commence or be displaced and an independent party (in this Guide referred to as the insolvency representative) appointed to supervise and manage the debtor, and the distinction to be made between liquidation and reorganization in that regard;

(d) protection of the assets of the debtor against the actions of creditors, the debtor itself and the insolvency representative, and where the protective measures apply to secured creditors, the manner in which the economic value of the security interest be protected during the insolvency proceedings;

(e) the manner in which the insolvency representative may deal with contracts entered into by the debtor before the commencement of proceedings and in respect of which both the debtor and its counterparty have not fully performed their respective obligations;

(f) the extent to which setoff or netting rights will be suspended by the commencement of the insolvency proceedings;

(g) the manner in which the insolvency representative may use or dispose of assets of the insolvency estate;

(h) the extent to which the insolvency representative can avoid certain types of

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not necessarily true.

transactions that result in the interests of creditors being prejudiced;

(i) in the case of reorganization, preparation of the reorganization plan and the limitations, if any, that will be imposed on the content of the plan, the preparer of the plan and the conditions required for its approval and implementation;

(j) the ranking of creditors for the purposes of distributing the proceeds of liquidation; and

(k) implementation of the reorganization plan, distribution of the proceeds of liquidation, discharge or dissolution of the debtor and conclusion of the proceedings.

20. [25] In addition to these specific subject areas, a more general issue to be considered is how an insolvency law will relate to other substantive laws and whether the insolvency law will effectively modify those laws. Relevant laws may include labour laws that provide certain protections to employees, laws that limit the availability of setoff and netting, laws that limit debt-for-equity conversions and laws that impose foreign exchange and foreign investment controls that may affect the content of a reorganization plan (see labour contracts and employees [Part two, chapter ..]; setoff and netting [Part two, chapter ..]; and content of reorganization plan [Part two, chapter ..]).

21. While the institutional framework is not discussed in any detail in this Guide, some of the issues are touched upon in Part two, chapter ... Notwithstanding the variety of substantive issues that must be resolved, insolvency laws are highly procedural in nature. The design of the procedural rules plays a critical role in determining how roles are to be allocated among the various participants, particularly in terms of decision-making. To the extent that the insolvency law places considerable responsibility upon the institutional infrastructure to make key decisions, it is essential that that infrastructure be sufficiently developed to perform the required functions.

II. Types of insolvency proceedings

22. [26] Two main types of proceedings are common to the majority of insolvency regimes—liquidation (typically a formal proceeding) and reorganization (which may be a formal proceeding, an informal process or in some cases a process which combines informal and formal elements).

23. [26] The traditional division or distinction between these two types of processes can be somewhat artificial and can create unnecessary polarization and inflexibility. It does not accommodate, for example, cases not easily situated at the poles—those cases where a flexible approach to the debtor's financial situation is likely to achieve the best result for both the debtor and the creditors in terms of maximizing the value of the insolvency estate For example, the term "reorganization" is sometimes used to refer to a particular way of ensuring preservation and possible enhancement of the value of the insolvency estate in the context of liquidation proceedings, such as where the law provides for liquidation to be carried out by transferring the business to another entity as a going concern. In that situation, the term "reorganization" merely points to a technique other than traditional liquidation (i.e. straightforward, piecemeal sale of the assets), being used in order to obtain as much value as possible from the insolvency estate. Similarly, reorganization may require the sale of significant parts of the debtor's business or [27] contemplate an eventual liquidation or sale of the business to a new company and the dissolution of the existing

debtor.

24. [27] For these reasons, it is desirable that an insolvency law provide more than a choice between a strictly traditional liquidation process and a single, narrowly defined type of reorganization process. Since the concept of reorganization can accommodate a variety of arrangements, it is desirable that an insolvency law adopt an approach that is not prescriptive and supports arrangements that will achieve a result that provides more value to creditors than if the debtor was liquidated.

25. [28] In discussing the core provisions of an effective and efficient insolvency regime, this Guide focuses upon a liquidation procedure on the one hand and a reorganization procedure on the other. However, the adoption of this approach is not intended to indicate a preference for particular types of processes or a preference for the manner in which the different processes should be integrated into an insolvency law. Rather, the Guide seeks to compare and contrast the core elements of the different types of procedures and to promote an approach that focuses upon maximizing the result for the parties involved in an insolvency process. This may be achieved by designing an insolvency law that incorporates the traditional formal elements in a way that promotes both maximum flexibility and the use of informal processes where they will be most effective.

A. Liquidation

26. [29] The type of proceedings referred to as "liquidation" is regulated by the insolvency law and generally provide for a public authority (typically, although not necessarily, a judicial court acting through a person appointed for the purpose) to take charge of the debtor's assets, with a view to terminating the commercial activity of the debtor, transforming non-monetary assets into monetary form and subsequently distributing the proceeds of sale of the assets proportionately to creditors. The sale of assets may occur in a piecemeal manner or may involve sale of the business in productive units or as a going concern and these proceedings usually result in the dissolution or disappearance of the debtor as a commercial legal entity. Other terms used for this type of proceedings include bankruptcy, winding-up, faillite, quiebra, and Konkursverfahren.

27. [30] Liquidation proceedings tends to be close to "universal" in their concept, acceptance and application and normally follow a pattern that includes:

(a) an application to a court or other competent body either by the debtor or by creditor(s);
(b) an order or judgement that the debtor be liquidated;
(c) appointment of an independent person to conduct and administer the liquidation;
(d) closure of the business activities of the debtor;
(e) termination of the powers of owners and management and the employment of employees;
(f) sale of the debtor's assets, either piecemeal or as a going concern;
(g) adjudication of the claims of creditors;
(h) distribution of available funds to creditors (under some form of priority); and
(i) dissolution of the debtor, where it is a corporation or has some other form of legal personality, or discharge, in the case of an individual debtor.

28. [31] There are a number of legal and economic justifications for the liquidation

process. Broadly speaking, it can be argued that a commercial business that is unable to compete in a market economy should be removed from the market place. A principal identifying mark of an uncompetitive business is one that satisfies one of the tests of insolvency, that is, it is unable to meet its mature debts as they become due or its debts exceed its assets. More specifically, the need for liquidation procedures can be viewed as addressing inter-creditor problems (when an insolvent debtor's assets are insufficient to meet the claims of all creditors it will be in a creditor's own best interests to take action to recover its claim before other creditors can take similar action) and as a disciplinary force that is an essential element of a sustainable debtor-creditor relationship. An orderly and effective liquidation procedure addresses the inter-creditor problem by setting in motion a collective proceeding that seeks to avoid those actions that, whilst viewed by individual creditors as being in their own best self interest, essentially lead to the loss of value for all creditors. A collective proceeding is designed to provide equitable treatment to creditors, by treating similarly situated creditors in the same way, and to maximize the value of the debtor's assets for the benefit of all creditors. This is normally achieved by the imposition of a stay on the ability of creditors to enforce their individual rights against the debtor and the appointment of an independent person whose primary duty is to maximize the value of the debtor's assets for distribution to creditors.

29. [32] An orderly and relatively predictable mechanism for the enforcement of the collective rights of creditors can also provide creditors with an element of predictability at the time when they make their lending decisions, as well as more generally promote the interest of all participants in the economy by facilitating the provision of credit and the development of financial markets. This is not to say that an insolvency regime should function as a means of enforcing the rights of individual creditors, although there is a clear and important relationship between the two types of processes. The efficiency and effectiveness of procedures for the individual enforcement of creditors' rights will mean that creditors are not forced to use the insolvency process for that purpose, especially since insolvency proceedings generally require a level of proof, cost and procedural complexity that make it unsuitable for use in that way. Nevertheless, an effective insolvency process will ensure that where debt enforcement mechanisms fail, creditors will have an avenue of final recourse that can operate as an effective incentive to a recalcitrant debtor to encourage payment of the particular creditor.

B. Reorganization

30. [33] An alternative to liquidation is a process that is designed to save a business rather than sell off its assets and terminate it. This process, which may take one of several forms and may be less universal in its concept, acceptance and application than liquidation, is referred to by a number of different names including reorganization, rescue, restructuring, turnaround, rehabilitation, arrangement, composition, concordat préventif de faillite, suspensión de pagos, administración judicial de empresas, and Vergleichsverfahren. For the sake of simplicity, the term "reorganization" is used in the Guide in a broad sense to refer to the type of proceedings whose ultimate purpose is to allow the debtor to overcome its financial difficulties and resume or continue normal commercial operations (even though in some cases it may include a reduction in the scope of the business, its sale as a going concern to another company or its eventual liquidation).

1. Formal reorganization proceedings

31. [34] As noted above, reorganization proceedings may be covered by the insolvency

law or be an informal process or a process which combines both formal and informal elements. One of the justifications for including a formal reorganization procedure in an insolvency law is that not all debtors that falter or experience serious financial difficulty in a competitive market place should necessarily be liquidated; a debtor with a reasonable prospect of survival (such as one which has a potentially profitable business) should be given that opportunity where it can be demonstrated that there is greater value (and, by deduction, greater benefit for creditors in the long term) in keeping the essential business and other component parts of the debtor together. Reorganization procedures are designed to give a debtor some breathing space to recover from its temporary liquidity difficulties or more permanent overindebtedness and, where necessary, provide it with an opportunity to restructure its operations and its relations with creditors. Where reorganization is possible, generally it will be preferred by creditors if the value derived from the continued operation of the debtor's business will enhance the value of their claims. Reorganization, however, does not imply that all of the stakeholders must be wholly protected or that they should be restored to the financial or commercial position that would have obtained had the event of insolvency not occurred. It does not imply that the debtor will be completely restored or its creditors paid in full, or that ownership and management of an insolvent debtor will maintain and preserve their respective positions. Management may be terminated and changed, the equity of shareholders may be reduced to nothing, employees may be retrenched and the source of a market for suppliers may disappear. In general, however, reorganization does imply that whatever form of plan, scheme or arrangement is agreed, the creditors will eventually receive more than if the debtor was to be liquidated.

32. Additional factors supporting the use of reorganization include that [38] the modern economy has significantly reduced the degree to which the value of the debtor's assets can be maximized through liquidation. In cases where technical know-how and goodwill are more important than physical assets, the preservation of human resources and business relations are essential elements of value that cannot be realised through liquidation. Also, long-term economic benefit is more likely to be achieved through reorganization procedures, since they encourage debtors to take action before their financial difficulties become severe. Lastly, there are social and political considerations which are served by the existence of reorganization procedures which protect, for example, the employees of a troubled debtor.

33. [35] Reorganization procedures may take a number of different forms. They may include a simple agreement concerning debts (referred to as a composition) where, for example, the creditors agree to receive a certain percentage of the debts owed to them in full, complete and final satisfaction of their claims against the debtor. The debts are thus reduced and the debtor becomes solvent and can continue to trade. They may also include a complex reorganization under which, for example, debts are restructured (e.g., by extending the length of the loan and the period in which payment may be made, deferring payment of interest or changing the identity of the lenders); some debt may be converted to equity together with a reduction (or even extinguishment) of existing equity; the non-core assets may be sold; and the unprofitable business activities closed. The choice of the way in which reorganization is carried out is typically a response to the size of the business and the degree of complexity of the debtor's specific situation.

34. [36] Although the reorganization process is not as universal as liquidation, and may not therefore follow such a common pattern, there are a number of key or essential elements that can be determined:

(a) submission of the debtor to the process (whether voluntarily or on the basis of an application by creditors), which may or may not involve judicial control or supervision;
(b) automatic and mandatory stay or suspension of actions and proceedings against the assets of the debtor affecting all creditors for a limited period of time;
(c) continuation of the business of the debtor, either by existing management, an independent manager or a combination of both;
(d) formulation of a plan which proposes the manner in which creditors, equity holders and the debtor itself will be treated;
(e) consideration of, and voting on, acceptance of the plan by creditors;
(f) possibly, the judicial approval/confirmation of an accepted plan; and
(g) implementation of the plan.

35. [37] The benefits of reorganization are increasingly accepted, and many insolvency laws include provisions on formal reorganization proceedings. The extent to which formal reorganization proceedings as opposed to some form of informal process are relied upon to achieve the objectives of reorganization varies between countries. It is generally recognized that the existence of a liquidation procedure can facilitate the reorganization of a debtor, whether by formal reorganization proceedings or informal means through an out-of-court process, by providing an incentive to both creditors and debtors to reach an appropriate agreement. Indeed, in many economies, reorganization largely takes place informally "in the shadow" of the formal insolvency regime.

36. [37] There is often, however, a correlation between the degree of financial difficulty being experienced by the debtor, the complexity of its business arrangements, and the difficulty of the appropriate solution. Where, for example, a single bank is involved, it is likely that the debtor can negotiate informally with that bank and resolve its difficulties without involving trade creditors and without the need for formal proceedings to be commenced. Where the financial situation is more complex and requires the involvement of a large number of different types of creditors, a greater degree of formality may be needed to find a solution which addresses the disparate interests and objectives of these creditors [38] since out-of-court reorganization requires unanimity. Formal reorganization procedures may assist in achieving the desired goal where those procedures enable the debtor and a majority of creditors to impose a plan upon a dissenting minority of creditors, especially where there are creditors who "hold-out" during out-of-court negotiations.

2. Informal reorganization processes *[to be co-ordinated with paras. 363-366, A/CN.9/WP.63/Add.12]*

37. [39] Informal processes were developed some years ago by the banking sector, as an alternative to formal reorganization proceedings. Led and influenced by internationally active banks and financiers, the informal process has gradually spread to a considerable number of jurisdictions, although use of such processes varies – in some jurisdictions they are reported to be rarely used, whilst in others most reorganizations are reported to be conducted informally. To some extent these results may reflect the existence (or not) of what is sometimes described as a "rescue culture" - the degree to which participants regard informal processes as likely to be successful, irrespective of the formal absence of features of proceedings under the insolvency law, such a moratorium, and the need to achieve consensus among creditors in order for an informal agreement to be achieved.

38. [39] The application of the informal process has generally been limited to cases of corporate financial difficulty or insolvency in which there is a significant amount of debt owed to banks and financiers. The process is aimed at securing an agreement both between the lenders themselves and the lenders and the debtor for the reorganization of the debtor, with or without rearrangement of the financing. An informal reorganization can provide a means of introducing flexibility into an insolvency system by reducing reliance on judicial infrastructure, facilitating an earlier pro-active response from creditors than would normally be possible under formal regimes and avoiding the stigma that often attaches to insolvency. While not based or reliant upon the provisions of the insolvency law, informal processes do rely upon the existence and availability of the formal insolvency framework to provide sanctions that can assist to make the informal process successful. Unless the debtor and its bank and financial creditors take the opportunity to join together and commence the informal process, the debtor or the creditors can invoke the formal insolvency law, with some potential for detriment to both the debtor and its creditors in terms of delay, cost and outcome.

39. Although not regulated by the insolvency law, many legal systems do contemplate that a debtor can enter into agreement or arrangements with some of all of its creditors which may be governed by, for example, contract law, company or commercial law or civil procedural law, or in some cases relevant banking regulations. However, there are a few jurisdictions which do not allow reorganization to occur outside of the court system or the insolvency law or which would regard the steps associated with such informal reorganization as sufficient for the courts to make a declaration of insolvency. Similarly, there are a number of jurisdictions which, because they impose on the debtor an obligation to commence formal insolvency proceedings within a certain time after a defined event of insolvency, restrict the conduct of such informal proceedings to circumstances where the formal conditions for commencement of proceedings have not been met. [Nevertheless, it is suggested that banks and other creditors in these jurisdictions do often use various techniques to achieve some form of reorganization of debtors.]

(a) Necessary pre-conditions

40. The informal reorganization depends for its effectiveness on a number of well-defined initial premises. These may include:

(a) a significant amount of debt owed to a number of main banks or financial institution creditors;
(b) the present inability of the debtor to service that debt;
(c) acceptance of the view that it may be preferable to negotiate an arrangement, as between the corporate debtor and the financiers and also between the financiers themselves, to resolve the financial difficulties of the corporate debtor;
(d) the use of relatively sophisticated refinancing, security and other commercial techniques that might be employed to alter, rearrange or restructure the debts of the debtor or the debtor itself;
(e) the sanction that if the negotiation process cannot be started or breaks down there can be swift and effective resort to the insolvency law;
(f) the prospect that there may be a greater benefit for all parties through the negotiation process than by direct and immediate resort to the insolvency law (in part because the outcome is subject to the control of the negotiating parties and the process is less expensive and can be accomplished quickly without disrupting the debtor's business);

(g) the debtor does not need relief from trade debts, or the benefits of formal insolvency, such as the automatic stay or the ability to reject burdensome debts; and
(h) favourable or neutral tax treatment for reorganization both in the debtor's jurisdiction and the jurisdictions of foreign creditors.

(b) Main processes

41. To be effective, an informal reorganization process requires a number of different steps to be followed and range of skills to be employed. The main elements in the process are discussed below.

(i) Commencing the process

42. The informal process essentially involves bringing together the debtor and creditors or at least the main creditors, one or more of whom must initiate the process (as there can be no reliance upon a law or a facilitator for initiation, imposition or assistance of the process). A debtor might be unwilling to commence a dialogue with creditors or at least with all of its creditors and creditors, while concerned for their own position, may have little interest in a collective process. It is at this point that the availability and effectiveness of individual creditor remedies or formal insolvency proceedings can be used to encourage the commencement and progress of the informal process. A debtor who remains reluctant to participate may find itself subject to individual debt or security enforcement actions or even insolvency proceedings, which it will not be able to defeat or delay. At the same time, creditors may also find themselves subject to formal insolvency proceedings which effectively prevent them from enforcing their individual rights and might not represent the optimal process for recovery of their debt. Creating a forum in which the debtor and creditors can come together to explore and negotiate an arrangement to deal with the debtor's financial difficulty therefore is crucial to this type of process.

(ii) Co-ordinating participants – appointing a lead creditor and steering committee

43. The reorganization should involve all key constituencies; generally the lenders group and sometimes key creditor constituencies who may be affected by the reorganization are critical to the process. To better co-ordinate negotiations, a principal creditor should be appointed to provide leadership, organization, management and administration. This creditor typically reports to a committee that is representative of creditors (a steering committee) and can provide assistance and act as a sounding board for proposals regarding the debtor.

(iii) Agreeing a "standstill"

44. To allow business operations to continue and to ensure that sufficient time is available to obtain and evaluate information about the debtor and to formulate and assess proposals to resolve the debtor's financial difficulties, a contractual agreement to suspend adverse actions by both the debtor and the main creditors may be required. That agreement would generally need to endure for a defined, usually short period, unless inappropriate in a particular case.

(iv) Engaging advisors

45. Few, if any, attempts are made at an informal reorganization without the

involvement of independent experts and advisors from various disciplines (e.g. legal, accounting, finance and business regulation, marketing). While it may be suggested that this involvement will lead to unnecessary cost and intrusion into the affairs of the debtor and creditors, as well as a loss of control, it is generally necessary to ensure the provision of information, independently verified, as well as professionally developed plans for refinancing, restructuring, management and operation that are essential to the success of the process.

(v) Ensuring adequate cash flow and liquidity

46. A debtor that becomes a candidate for a possible informal reorganization will often require continued access to established lines of credit or the provision of fresh credit. Provision of credit by existing secured creditors may not present a problem. Where this is not available, however, and fresh credit is required, there may be difficulties in guaranteeing the eventual repayment of the fresh credit if the reorganization fails. While this issue can be addressed under the insolvency law by providing some form of priority for such ongoing lending (see Part two, chapter VI.B), the law will not generally extend to such an arrangement under an informal process.

47. Those creditors who participate in an attempted reorganization, nevertheless, can agree amongst themselves that if one or more of them extends further credit the others will subrogate their claims to enable the new credit to be repaid ahead of their own claims. Thus, as between those creditors, there will be a contractual agreement for the repayment of new money where the reorganization is successful. Where the reorganization fails, however, and the debtor is liquidated, the creditor who has provided the fresh credit may be left with an unsecured claim (unless security was provided) and receive only partial repayment along with other unsecured creditors.

(vi) Access to complete, accurate information on the debtor

48. This is essential to enable proper evaluation to be made of the financial position of the debtor and any proposals to be made to relevant creditors. Information concerning the assets, liabilities and business of the debtor should be made available to all relevant creditors but unless already publicly available, may need to be treated as confidential.

(vii) Dealing with creditors

49. The complexity of the interests of creditors often presents critical problems for informal processes. Providing for theoe differing interests, and persuading those creditors that have already commenced recovery or enforcement action against the debtor that they should participate in the informal process may be possible only if there is a prospect of a better result through the informal process or if the threat of formal insolvency proceedings will restrain creditors from pursuing their individual rights.

50. In many cases, however, it will not be possible (or indeed necessary) to involve every creditor in the informal process, either because of their number and diverse interests or because of the inefficiency of involving creditors who are owed only small amounts of money or who do not have the commercial expertise, knowledge or will to participate effectively in the process. While creditors who fall into these categories often may be left out of the process, they cannot be ignored as they may be important to the continued operation of the business (as suppliers of essential goods or services or as participants in

essential parts of the debtor's production process) and there are no rules which can compel such creditors to accept the decision of a majority of their number.

51. Often in an informal reorganization, trade and small creditors recover payment in full. Although this suggests unequal treatment, it may make commercial sense to a group of major creditors. An alternative approach is to secure agreement of the main creditors to a reorganization plan and then use the plan as the basis of a formal court supervised reorganization process in which other creditors participate (sometimes referred to as a "pre-packaged" plan – see Part two, chapter V.B). This plan can then bind the other creditors. Without an effective formal insolvency regime, this result could not be achieved.

(c) Rules and guidelines for informal reorganization

52. [43] To assist the conduct of informal reorganization, and in particular to address the problems noted above in the context of complex, multinational businesses, a number of organizations have developed non-binding principles and guidelines. One such approach is called the "London Approach" named after the non-binding guidelines issued to commercial banks by the Bank of England. Banks are urged to take a supportive attitude toward their debtors that are in financial difficulties. Decisions about the debtor's longer-term future should only be made on the basis of comprehensive information, which is shared among all the banks and other parties that would be involved in any agreement as to the future of the debtor. Interim financing is facilitated by a standstill and subordination agreement, and banks work together with other creditors to reach a collective view on whether and on what terms a debtor entity should be given a financial lifeline. Similar guidelines have been developed by the central banks of other countries. [A/CN.9/WP.63/Add.12, para. 365] An international organization which has undertaken work in this area is the International Federation of Insolvency Professionals (INSOL) which has developed *Principles for a global approach to multi-creditor workouts*. The Principles are designed to expedite informal processes and increase the prospects of success by providing guidance to diverse creditor groups about how to proceed on the basis of some common agreed rules.

3. Reorganization processes which include both informal and formal elements

53. [47] Some countries have adopted what can be described as "pre-insolvency" or "pre-packaged" procedures that are, in effect, a combination of informal reorganization processes and formal reorganization proceedings. Under one insolvency law, for example, regulations have been issued that allow the court to formally approve a reorganization plan that was negotiated informally and approved by creditors through a vote that occurred before the commencement of formal proceedings. Such processes are designed to minimize the cost and delay associated with formal reorganization proceedings while at the same time providing a means by which a reorganization plan negotiated informally nevertheless can be approved in the absence of unanimous support of the creditors. Such a process allows the work undertaken in the informal negotiations to be used to achieve a reorganization that will bind all creditors, whilst at the same time providing the protections of the insolvency law to affected creditors.

54. [48] Another insolvency law provides that in order to facilitate the conclusion of an amicable settlement with its creditors, a debtor may ask the court to appoint a "conciliator." The conciliator has no particular powers but may request the court to impose a stay of execution against all creditors if, in his or her judgement, a stay would facilitate the

conclusion of a settlement agreement. During the stay, the debtor may not make any payments to discharge prior claims (except salaries) or dispose of any assets other than in the regular course of business. The procedure ends when agreement is reached either with all creditors or (subject to court approval) with the main creditors; in the latter case, the court may continue the stay against non-participating creditors by providing a grace period to the debtor of up to two years.

55. These types of procedures are discussed in more detail in Part two, chapter V.B.

C. Administrative processes

56. [44] In recent years a number of crisis-affected jurisdictions have developed semi-official "structured" forms of informal processes, largely inspired by government or central banks, to deal with systemic financial problems within the banking sector. These processes have been developed on a similar pattern. First, each has a facilitating agency to encourage and, in part, co-ordinate and administer informal reorganization to provide the incentive and motivation necessary for development of the informal processes. Second, each process is underpinned by an agreement between commercial banks in which the participants agree to follow a set of "rules" in respect of corporate debtors who are indebted to one or more of the banks and which may participate in the process. The rules provide the procedures to be followed and the conditions to be imposed in cases where corporate reorganization is attempted. In some of the jurisdictions, a debtor corporation that seeks to negotiate an informal reorganization is required to agree to the application of these rules. Third, time limits are provided for various parts of the procedures and, in some cases, agreements in principle can be referred to the relevant court for a formal reorganization to occur under the law. In addition, one jurisdiction established a special agency which has extremely wide powers under its governing legislation to acquire non-performing loans from the banking and finance sector and then to impose extra-judicial processes upon a defaulting corporate debtor, including a forced or imposed reorganization.

57. Both because these processes are relatively complex and involve the development of special rules and regulations and because they address particular situations of systemic failure they are not discussed in any detail in the Guide.

D. The structure of the insolvency regime

58. [52] Although many insolvency laws include both liquidation and reorganization proceedings, approaches differ widely as to the structure of the procedure which leads to the choice of one of these processes. Some insolvency laws provide for a unitary, flexible insolvency proceeding with a single commencement requirement alternatively resulting in liquidation or reorganization depending on the circumstances of the case. Other laws provide for two distinct proceedings, each setting forth its own access and commencement requirements, with different possibilities for conversion between the two proceedings.

59. [53] Those laws that treat liquidation and reorganization procedures as distinct from each other do so on the basis of different social and commercial policy considerations and with a view to achieving different objectives. However, a significant number of issues are common to both liquidation and reorganization, resulting in considerable overlaps and linkages between them, in terms of both procedural steps and substantive issues, as will become evident from the discussion in Part Two which follows.

60. [54] Where two distinct procedures are provided in the insolvency law, the determination of whether the business of the insolvent debtor is viable should determine, at least in theory, which procedure will be used. As a matter of practice, however, at the time of commencement of either procedure, it is often impossible to make a final evaluation as to the financial viability of the business. Some of the disadvantages of this approach are that it may create an undesirable degree of polarization between liquidation and reorganization and can result in delay, increased expense and inefficiency, especially, for example, where the failure of reorganization requires a new and separate application to be made for liquidation. This inefficiency can be overcome, to some extent, by providing linkages between the two proceedings, with a view to allowing conversion of one type of proceeding to the other in certain specific circumstances, and by including devices designed to prevent the abuse of insolvency process, such as commencing reorganization proceedings as a means of avoiding or delaying liquidation (see …).

61. [55] As to the question of choice of procedures, some countries provide that the party applying for the insolvency proceedings will have the initial choice between liquidation and reorganization. When liquidation proceedings are initiated by one or more creditors, the law will often provide a mechanism which enables the debtor to request conversion into reorganization proceedings where this is feasible. When the debtor applies for reorganization proceedings, whether on it's own motion or as a consequence of an application for liquidation by a creditor, the application for reorganization should logically be decided first. With a view to protecting creditors, however, some insolvency laws will provide a mechanism enabling reorganization to be converted into liquidation upon a determination, either at an early stage of the proceedings or later, that reorganization is not likely to, or cannot, succeed. Another mechanism of protection for creditors may consist of setting forth the maximum period for which reorganization against the will of the creditors may be granted.

62. [56] As a general principle, although usually presented as separate procedures, liquidation and reorganization procedures are normally carried out sequentially, that is, a liquidation procedure will only run its course if reorganization is unlikely to be successful or if reorganization efforts have failed. In some insolvency systems, the general presumption is that a business should be reorganized and liquidation procedures may be commenced only when all attempts to reorganize the entity have failed. In insolvency systems providing for conversion, a request for reorganization to be converted into liquidation may be made by the debtor, the creditors or the insolvency representative, depending upon the circumstances set forth by the law. These circumstances may include where the debtor is unable to pay post-petition debts as they fall due; where the reorganization plan is not approved by creditors or the court; where the debtor fails to fulfil its obligations under an approved plan; or where the debtor attempts to defraud creditors (see Part two, chapter ..). Whilst it is often possible for reorganization proceedings to be converted to liquidation proceedings, most insolvency systems do not allow reconversion to reorganization once conversion of reorganization to liquidation has already occurred.

63. [57] Difficulties of determining at the very outset whether the debtor should be liquidated rather than reorganized have led some countries to revise their insolvency laws by replacing separate proceedings with "unitary" proceedings.[2] Under the "unitary"

[2] Where a unitary system is chosen, some changes will need to be made to the various core elements of the insolvency law. These are identified in Annex ..

approach there is an initial period (usually referred to as an “observation period”, which in existing examples of unitary laws may last up to three months) during which no presumption is made as to whether the business will be eventually reorganized or liquidated. The choice between liquidation or reorganization proceedings only occurs once a determination has been made as to whether reorganization is actually possible. The basic advantages offered by this approach are its procedural simplicity, its flexibility and possible cost efficiency. A simple, unitary procedure, allowing both reorganization and rehabilitation, may also encourage early recourse to the proceedings by debtors facing financial difficulties, thus enhancing the chances of successful rehabilitation. A disadvantage of this procedure, however, may be the delay that occurs between the decision to commence and the decision as to which procedure should be followed, and the consequences for the debtor’s business and the value of the debtor’s assets that may flow from that delay.

64. However the insolvency law is arranged in terms of liquidation and reorganization, it should ensure that once a debtor is in the system, it cannot exit without some final determination of its future.

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Draft legislative guide on insolvency law

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Part Two (continued)

II. Applications and commencement

A. Eligibility and jurisdiction

1. Eligibility: debtors to be covered by an insolvency law

1. An important threshold issue in designing a general insolvency law focussed on debtors engaged in commercial activities is determining and clearly defining which debtors will be subject to the law. To the extent that any debtor is excluded from the process, it will not enjoy the protections offered by the process, nor will it be subject to the discipline of the process. This argues in favour of an all-inclusive approach to the design of an insolvency law, with limited exceptions. The design of eligibility provisions which will identify the types of debtors whose assets may be liquidated or reorganized and any debtors that are to be excluded from the application of the law raises two questions. Firstly, whether the law should distinguish between individual debtors and debtors which are some form of limited liability enterprise or corporation, each of which will raise not only different policy considerations, but also considerations concerning social and other attitudes, and secondly, what types of debtors (regardless of the question of whether the debtor is an entity or an individual), if any, should be excluded from the application of the insolvency law.

2. Countries adopt different approaches to defining the scope of application of their insolvency laws. Some insolvency laws apply to all debtors with certain specified exceptions, such as those discussed below. Other countries distinguish between individual (natural person) debtors and juridical or legal person debtors and provide different insolvency laws for each. A further approach distinguishes between entities or individuals on the basis of their engagement in commercial (or consumer) activities. Some of these laws address the insolvency of "merchants" which are defined by reference to engagement in commercial activities as an ordinary occupation, or companies incorporated in accordance with commercial laws and other entities that regularly undertake commercial activities. Some laws also include different procedures on the basis of levels of indebtedness, and a number of countries have developed special insolvency regimes for different sectors of the economy, particularly the agricultural sector.

(a) Debtors: individuals engaged in commercial activities

3. [1] Policies towards individual or personal debt and insolvency often evidence cultural attitudes that are not as relevant to commercial debtors and may include, for example, attitudes toward the incurring of personal debt; the availability of relief for

unmanageable debt; the social effect of bankruptcy on the status of individuals; the need for counselling and educational assistance with respect to individual debt; and the provision of a fresh start for debtors through a discharge from debts and claims. Policies applicable to insolvency in the commercial sector, in comparison, are generally restricted to economic and commercial considerations such as the important role that business plays in the economy; the need to preserve and encourage commercial and entrepreneurial activity; and the need to encourage the provision of credit and to protect creditors where credit is provided.

4. [2] The principal issue for consideration relates to individuals involved in commercial activity (including, for example, partnerships of individuals and sole traders) and deciding whether they should be included within the scope of a commercial insolvency law. The interests of individual commercial debtors differ from those of individual consumer debtors, at least in some aspects of their indebtedness, but it is often difficult to separate an individual's personal indebtedness from their commercial indebtedness for the purposes of determining how they should be treated in insolvency. Different tests may be developed to facilitate that determination, such as focussing upon the nature of the activity being undertaken, the level of debt and the connection between the debt and the commercial activity. Indicators of involvement in commercial activity may include whether the business is registered as a trader or other commercial operative; whether it is a corporate entity under the commercial law; the nature of its regular activities; information concerning turnover and assets and liabilities; and […]. Many countries include individual debtors involved in commercial activity within the scope of their commercial insolvency laws. The experience of other countries suggests that although individual business activities form part of commercial activity, these cases often are best dealt with under the regime for individual insolvency because ultimately the proprietor of a personal business will conduct its activities through a structure that does not enjoy any limits on liability and will remain personally liable, without limitation, for the debts of the business. These cases also raise difficult issues of discharge (release of the debtor from liability for part or all of certain debts after the conclusion of the proceedings) such as the length of time required to expire before the debtor can be discharged and the obligations which can be discharged or exempted from discharge. Debts which cannot be discharged often involve personal matters such as settlements in divorce proceedings or child support obligations. An additional consideration is that the inclusion of individual insolvency within the commercial insolvency regime may have the potential, in some countries, to act as a disincentive to use of the commercial regime because of the social attitude towards individual insolvency, irrespective of its commercial nature. It is desirable that these concerns be considered in designing an insolvency law to address commercial insolvency. This Guide focuses upon the conduct of commercial activities, irrespective of the vehicle through which those activities are conducted, and identifies those issues where additional or different provisions will be required if individual debtors are included in the insolvency law.

(b) State-owned enterprises

5. [3] A general insolvency law can apply to all forms of entity engaged in commercial activities, both private and state-owned, especially those state-owned enterprises which compete in the market place as distinct commercial or business entities and are otherwise subject to the same commercial and economic processes as privately-owned entities. Government ownership of an enterprise may not, in and of itself, provide a sufficient basis for excluding the enterprise from the coverage of the insolvency law, although a number of countries do adopt that approach. Where the state plays different

roles with respect to the enterprise not only as owner, but also as lender and largest creditor, normal incentives will not apply, compromise solutions may be difficult to achieve and there is clear ground for conflicts of interest to arise. Inclusion of these enterprises in the insolvency regime therefore has the advantages of subjecting them to the discipline of the regime, sending a clear signal that government financial support for such enterprises will not be unlimited, and providing a procedure which has the potential to minimise conflicts of interest. The need for exceptions to a general policy of inclusion may arise where the government has adopted a policy of extending an explicit guarantee in respect of the liabilities of such enterprises, and where the treatment of state enterprises is part of a change in macroeconomic policy, such as a large-scale privatization program. In these cases, independent legislation dealing with relevant issues, including insolvency, may be warranted. The Guide does not address issues specifically relevant to that independent legislation.

(c) Entities requiring special treatment

6. [4] Although it may be desirable to extend the protections and discipline of an insolvency law to as wide a range of entities as possible, separate treatment may be provided for certain entities of a specialized nature, such as banking and insurance institutions, utility companies, and stock or commodity brokers. Exceptions for these types of entities are widely reflected in insolvency laws and are generally justified on the basis of the detailed regulatory legal regimes to which they are often subjected outside of the insolvency context. These regulatory regimes often include provisions addressing the insolvency of the regulated entity. The special considerations arising from the insolvency of such entities and consumer insolvency are not specifically addressed in the Guide.

2. Jurisdiction

7. [5] In addition to possessing the necessary business or commercial attributes, a debtor must have a sufficient connection to the State to be subject to its insolvency laws. In many cases, no issue as to the applicability of the insolvency law will arise as the debtor will be a national or resident of the State and will conduct its commercial activities in the State through an entity registered or incorporated in the State. Where there is a question of the debtor’s connection with the State, however, insolvency laws adopt different tests including that the debtor has its centre of main interests in the State, that the debtor has an establishment in the State and that the debtor has assets in the State.

(a) Centre of main interests

8. [6] Although some insolvency laws use tests such as principal place of business, UNCITRAL has adopted, in the Model Law on Cross-Border Insolvency (“the UNCITRAL Model Law”), the test of “centre of main interests” of the debtor to determine the proper location of what is termed the “main proceedings” for that debtor. Although the Model Law deals with matters of international insolvency, the test of “centre of main interests” is also relevant to domestic insolvency. In addition to the UNCITRAL Model Law, that term is used in the UNCITRAL Convention on the Assignment of Receivables in International Trade and in the Council (EC) Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings (“the EC Regulation”). The UNCITRAL Model Law does not define the term; the EC Regulation (13th Recital) indicates that the term should correspond to “the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.” An appropriate test would be the one provided in article 16(3) of the UNCITRAL Model Law and article 3 of the EC

Regulation: the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the centre of main interests, unless it can be shown that the centre of main interests is elsewhere. A debtor which has the centre of its main interests in a State should be subject to that State's insolvency law.

9. [7] Notwithstanding the adoption of the "centre of main interests" test, a debtor which has assets in more than one State may find itself satisfying the requirements to be subject to the insolvency law of more than one State because of the different tests of debtor eligibility or different interpretations of the same test, with the possibility of separate insolvency proceedings in those countries. In such cases, it will be appropriate to have in place legislation based on the UNCITRAL Model Law to address questions of co-ordination and co-operation (see Part two, chapter VIII).[1]

(b) Establishment

10. [8] Some laws provide that insolvency proceedings may be commenced in a jurisdiction where the debtor has an establishment. The term "establishment" is defined in article 2 of the UNCITRAL Model Law to mean "any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services." Article 2 of the EC Regulation includes a similar definition but omits the reference to "services". Essentially, an establishment is a place of business which is not necessarily the centre of main interests. The definition, like the term "centre of main interests", is important to the overall structure of the UNCITRAL Model Law and its treatment of cross-border insolvency cases as a criterion for recognition of foreign insolvency proceedings and the application of measures for relief. It is therefore of relevance to a domestic insolvency regime and the commencement of proceedings in respect of the assets of a debtor's establishment in a particular State. In many countries, managers of an establishment that is unable to pay its debts will have personal liability to creditors unless they commence an insolvency proceeding. Eligibility to commence proceedings under the insolvency law of the State on the basis of an establishment therefore is necessary.

11. [8] The EC Regulation similarly provides that secondary insolvency proceedings may be opened in a jurisdiction where a debtor has an establishment. Generally those proceedings will be restricted to liquidation proceedings covering the assets of the debtor situated in the territory of that State. Depending upon the nature of the debtor's business and the assets concerned, there may be limited situations where reorganization proceedings could be based upon establishment.

(c) Presence of assets

12. [9] Some laws provide that insolvency proceedings may be commenced by or against a debtor that has assets within the jurisdiction or has had assets within the jurisdiction without requiring an establishment or centre of main interests within the jurisdiction. The UNCITRAL Model Law does not provide for the recognition of foreign proceedings commenced on the basis of presence of assets. It does provide, however, that once proceedings commenced in the jurisdiction where the debtor has its centre of main

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[1] It has been proposed that the Model Law and Guide to Enactment (revised to take account of developments in cross-border insolvency practice since the adoption of the Model Law) should be included as an additional chapter of this Guide.

interests have been recognized in the foreign State, local proceedings based on presence of assets can be commenced in the recognizing State to deal with those local assets.[2]

13. [9] A distinction can perhaps be made between liquidation and reorganization proceedings commenced on the basis of presence of assets; while presence of assets may be an appropriate basis for commencement of liquidation proceedings involving specific assets located in a State, it may not be sufficient for the commencement of reorganization proceedings, particularly where proceedings commenced in the centre of man interests are liquidation proceedings. Although one country does provide that the presence of assets will be sufficient to commence reorganization proceedings (and that those proceedings can involve the assets of the debtor wherever located), there will be a need to co-ordinate those proceedings with other jurisdictions where the debtor will have its centre of main interests and possibly establishments. The test of presence of assets may therefore raise multi-jurisdictional issues, including multiple proceedings and questions of co-ordination and co-operation between proceedings that may implicate the UNCITRAL Model Law (see Part two chapter VIII).

Recommendations

Purpose of legislative provisions

The purpose of provisions on eligibility and jurisdiction is to establish:

(a) which types of debtors can be subject to the [general] insolvency law;
(b) which types of debtors may be excluded from the [general] insolvency law;
(c) which debtors have sufficient connection to a State to be subject to its insolvency laws; and
(d) which courts have jurisdiction over insolvency matters.

Content of legislative provisions

Eligibility

(11) The insolvency law should govern insolvency proceedings of all debtors, including individuals and State-owned enterprises, which engage in commercial activities.

(12) Exclusions from the application of the [general] insolvency law should be limited and clearly identified in the law.[3]

Jurisdiction

(13) The insolvency law should specify which debtors have sufficient connection to a State to be subject to its insolvency laws. Different approaches may be taken to

[2] UNCITRAL Model Law, article 28.
[3] Highly regulated entities such as banks and insurance companies may require specialized treatment which can appropriately be provided in a separate insolvency regime or through special provisions in the general insolvency law. Where a special regime or special provisions have been developed, those entities may be excluded from the provisions of the general insolvency regime.

identifying appropriate connecting factors, but the grounds upon which a debtor can be subject to the insolvency law should include:

(a) that the debtor has its centre of main interests in the State; or
(b) that the debtor has an establishment in the State.

(14) In interpreting the phrase "centre of main interests", the insolvency law should provide a presumption that, in the absence of proof to the contrary, a legal person's centre of main interests is in the State in which it has its registered office, and a natural person's centre of main interests is in the State in which it has its habitual residence.

(15) The insolvency law should define "establishment" to mean "any place of operations where the debtor carries out non-transitory economic activity with human means and goods or services". [4]

(16) [(15)] The insolvency law should clearly indicate which court has jurisdiction over insolvency proceedings and over matters arising in the conduct of an insolvency proceeding.

[4] UNCITRAL Model Law on Cross-Border Insolvency art. 2(f).

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Part Two (continued)

II. Applications and commencement

B. Application and commencement criteria

1. Introduction

14. [10] Application and commencement criteria are central to the design of an insolvency law. By providing the basis upon which an application for the commencement of insolvency proceedings can be made, these criteria are instrumental to identifying the entities that can be brought within the protective and disciplinary mechanisms of the insolvency process and determining who may make an application, whether the debtor, creditors or other parties.

15. [11] As a general principle it is desirable that access to the insolvency process be convenient, inexpensive and quick in order to encourage financially distressed or insolvent businesses to voluntarily submit themselves to the process. It is also desirable that access is flexible in terms of the types of insolvency procedures available (liquidation and reorganization), the ease with which the procedure most relevant to a particular debtor can be accessed and conversion between the different types of procedures can be achieved. Restrictive access can deter both debtors and creditors from commencing procedures, while delay can be harmful in terms of its effect on the value of assets and the successful completion of the process, particularly in cases of reorganization. Ease of access needs to be balanced with proper and adequate safeguards to prevent improper use of the process. Examples of improper use may include where a debtor that is not in financial difficulty applies for the commencement of insolvency proceedings in order to take advantage of the protections provided by the law, such as the automatic stay, to avoid or delay payment to creditors and where creditors who are competitors of the debtor take advantage of the process to disrupt the debtor's business and thus gain a competitive edge.[1]

16. [12] Laws differ on the specific criteria that must be satisfied before insolvency proceedings can commence. A number of laws include alternative criteria, and distinguish between the criteria applicable to commencement of liquidation and reorganization proceedings, as well as to applications by a debtor and creditors.

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[1] This is discussed further in the context of denial of the commencement application and dismissal of proceedings.

2. Application criteria

(a) Liquidity or cash flow standard

17. [14] A criterion that is used extensively for commencement of insolvency proceedings is what is known as the liquidity, cash flow or general cessation of payments standard. This requires that the debtor has generally ceased making payments and will not have sufficient cash flow to service its current obligations as they come due in the ordinary course of business. Reliance on this standard is designed to activate proceedings sufficiently early in the period of the debtor's financial distress to minimize dissipation of assets and avoid a race by creditors to grab assets that would cause dismemberment of the debtor to the collective disadvantage of all creditors. Allowing commencement to take place only at a later stage when the debtor can demonstrate greater financial distress, such as balance sheet insolvency (when the balance sheet of the entity shows that the value of the debtor's liabilities exceed its assets – discussed below), may only serve to delay the inevitable and diminish recoveries.

18. [15] One problem associated with the general cessation of payments standard is that the inability of the debtor to pay its debts as they become due may point to only a temporary cash flow or liquidity problem in a business that is otherwise viable. In today's competitive markets, where competition may compel market participants to accept ever lower profits or even losses in order to become competitive, the concept of inability to pay debts and the manner in which it is incorporated into the insolvency law as a commencement criteria may need to be carefully considered.

(b) Balance sheet standard

19. [17] An alternative to the general cessation of payments standard would be the balance sheet approach which is based on excess of liabilities over assets as an indication of financial distress. A practical limitation of this approach is that it is rarely possible for parties other than the debtor to ascertain the true state of the debtor's financial affairs until after it has become a settled and often irreversible fact, and thus may not easily form the basis for a creditor application. This approach has a number of other disadvantages. Where accounting standards and valuation techniques give rise to results that do not reflect the fair market value[2] of a debtor's assets or where markets are not sufficiently developed or stable to enable that value to be established, this approach can be an inaccurate measure of insolvency. This may also be true in the case of service businesses that under this test may technically be insolvent, even when the business is essentially viable. This test can also lead to delay and difficulties of proof as an expert would generally be required to review books, records and financial data[3] to reach a determination of the entity's fair market value. This is especially difficult where those records are not properly maintained or readily available. For these reasons the balance sheet test often leads to proceedings being

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[2] Fair market value is generally considered to be the value that reasonably can be expected to be obtained in an arm's length sale between a buyer and a seller, where neither party is under a compulsion to buy or sell. In the absence of a real sale, value may be somewhat speculative, as values are based on assumptions made regarding the conditions for the sale of the assets in question. To reduce the speculation, techniques have been developed to approximate value on the basis of sale of comparable businesses and assets, or on the basis of a multiple of the enterprises earnings potential. In markets where assets cannot be easily sold, because the market is saturated or because a market for the assets in question does not exist, value is difficult to measure.

[3] Book value – *to be completed*

commenced after the possibilities of reorganization have disappeared, and negatively affects the debtor's ability to deal collectively with its creditors when the debtor maintains an operating business. It may thus circumvent the objective of maximization of value. While the balance sheet approach may be used to assist in defining insolvency, for the reasons outlined above it may not be sufficiently reliable to constitute the sole basis of that definition.

(c) Designing the commencement standard

20. Insolvency laws use the general cessation of payments standard and the balance sheet approach in different combinations to establish a commencement test. Some laws adopt a simple form of the general cessation of payments standard, requiring that the debtor be unable to meet its obligations as they fall due. Other laws adopt that test and add further requirements, for example, that the cessation of payments must reflect a difficult financial situation that is not temporary, that the creditworthiness of the debtor must be at stake and that it be just and equitable for the debtor to be liquidated. Another approach is that in addition to having ceased making payments, the debtor must be overindebted where overindebtedness is determined, for example, by the debtor's inability to satisfy its debts as they become mature because its liabilities exceed its assets.

(i) Imminent insolvency (Prospective illiquidity)

21. Some laws which adopt the cessation of payments test also make provision for a debtor to apply for commencement on the basis of imminent insolvency or prospective inability to pay, where the debtor will be unable to meet its future obligations as they fall due. While in some cases the prospective inability might relate to a short period into the future, there may be cases where it will relate to a significantly longer term, depending upon the nature of the obligation to be met. Factual circumstances which could establish prospective inability might include that the debtor has a long term obligation to make a bond payment that it knows it will not be able to make, or that it is the defendant to a mass tort claim that it knows it cannot successfully defend and will not be able to pay the associated damages.

(ii) Types of proceedings that may be commenced

22. [16] A second dimension of the commencement standard is the type of proceeding that can be commenced. In some laws the commencement standard, whether based on general cessation of payments or the balance sheet test, provides the basis for commencement of either a liquidation or reorganization procedure. Where the liquidation application is made by creditors, the insolvency law may permit the debtor to apply for the proceedings to be converted from liquidation to reorganization. Under other insolvency laws where reorganization is favoured, a reorganization procedure must be commenced, but can be converted to liquidation when it is shown that the debtor cannot be reorganized. Under a further approach, the effect of the application is neutral and the choice between liquidation and reorganization will only be made after a period of assessment of the debtor's financial situation.

3. Liquidation

(a) Parties who may apply

23. [13] Insolvency laws generally provide for an application for liquidation proceedings to be made by the debtor (often described as voluntary proceedings), by one or more creditors (often described as involuntary proceedings), by a government authority or by operation of law where the failure by the debtor to meet some statutory requirement (such as maintenance of a specified level of assets) automatically triggers insolvency proceedings (also described as involuntary).

(b) Debtor application

24. [18] Many insolvency laws adopt the general cessation of payments standard for debtor applications for liquidation. As a matter of practice, an application by a debtor to commence liquidation proceedings will generally be a last resort where it is unable to pay its debts and, in the absence of opposition, satisfaction of those requirements will not be strictly followed. That practice is reflected in some laws that allow a debtor to make an application either on the basis that it has ceased to repay its debts as they become due or, in the alternative, on the basis of a simple declaration of its financial condition, such as that it is unable to or does not intend to pay its debts (which in the case of a legal person may be made by the directors or other members of a governing body). At least one insolvency law dispenses with the need for the debtor to allege any particular financial state.

(i) Establishing an obligation for debtor to apply

25. [19] A matter related to debtor applications is the question of whether or not the debtor should have an obligation to make an application for commencement of proceedings at a certain stage of its financial difficulty. There is no widely agreed approach to this issue. Some insolvency or business governance laws include provisions such as that the debtor must make an application within a period of time varying from two weeks to 60 days after being unable to pay its debts as they become due or after learning of its overindebtedness determined by reference to its balance sheet. Some laws specify how cessation of payments is to be determined which may include, for example, by reference to bank records that show that the debtor has failed to pay a certain percentage of its aggregate debts for a certain period of time, such as two months. In the case of liquidation, the imposition of such a duty may protect creditors' interests by preventing further dissipation of the debtor's assets and, in the case of reorganization, increase the chances of success by encouraging early action. This may be important in countries where there isn't an active creditor class that can be relied upon to commence proceedings. Experience in some countries suggests, however, that imposing an obligation on the debtor to apply after a certain number of days or weeks of inability to pay or cessation of payments simply leads to debtor applications which do not reflect a true position of insolvency (and thus a real need for liquidation or reorganization). In some countries it has also placed additional strain on the insolvency infrastructure where it may not have been sufficiently developed to handle a large number of such applications.

26. [19] Establishing such an obligation may also raise difficult practical questions of how and when it should apply, particularly where a delay in applying for formal proceedings could lead to personal liability of members of the debtor, its governing body or its managers. In those circumstances it may operate to discourage the debtor from pursuing alternative solutions to its financial difficulties, such as an out-of-court

reorganization agreement, which may be a more appropriate alternative in particular cases. In addition, an obligation to file will be of no effect where it is not combined with enforceable (and enforced) sanctions for the failure to comply. The adoption of incentives (such as the application of a stay to protect the debtor against enforcement and other actions – see Part two, chapter III.B) may be a more effective means of encouraging debtors to initiate proceedings at an early stage.

(c) Creditor application

27. [20] Many insolvency laws also adopt the cessation of payments requirement for creditor applications for liquidation, often with the additional requirement that the debt be undisputed. In a few laws, that debt must be based upon a court judgement. Where the standard of general cessation of payments is adopted for creditor applications, problems of proof may arise. While creditors may be able to show that the debtor has failed to pay their own claim or claims, providing evidence of a general cessation of payments may not be so easy. There is a practical need for a creditor to be able to present proof, in relatively simple form, which establishes a presumption of insolvency on the part of the debtor, without placing an unreasonably heavy burden of proof on creditors. To refine the standard of general cessation of payments in order to establish a threshold of proof that creditors may satisfy, a reasonably convenient and objective test may be the failure of a debtor to pay a matured debt within a specified period of time after a written demand for payment has been made, or a specified time after the debt became due. A number of insolvency laws include such provisions, with the specified time ranging from eight days to 24 weeks in those cases where a formal demand is required. Some insolvency laws also include provision for the application to be based upon an unsuccessful debt recovery action that took place within a specified period of time, such as three months, before the application for commencement is made.

28. [20] Creditors holding unmatured claims also have a legitimate interest in the commencement of insolvency proceedings. A particular concern may arise, for example, in the case of holders of long-term debt. Where the test is one of maturity of debt those creditors might never be eligible to seek commencement of proceedings, although it may be clear that the debtor will be unable to meet the obligation when the time comes. However, developing a test that would allow such a creditor to make an application may raise difficult issues of proof, particularly in connection with the debtor’s financial status. Where an insolvency law provides that applications may be made by creditors not holding mature debt, the issues of proof may need to be balanced against the objective of convenient, inexpensive and quick access.

30. [21] In addition to the requirements for cessation of payments, maturity of the debt and that the claim be undisputed, some insolvency laws include requirements such as that the application be made by more than one creditor (each of which may be required to be an unsecured creditor holding an undisputed claim); and that creditors not only hold mature claims, but that their claims represent a specified composite value of claims (or a combination of both a specified number of creditors and a composite value of claims). Another approach (in the case of an application by a single creditor) requires that the debtor furnish information to the court that will enable the court to determine whether non-payment of the debt is the result of a dispute with the particular creditor or is evidence of a lack of liquid assets.

31. [22] The requirement that more than one creditor make the application is often based upon the desire to minimise possible improper use by a single creditor who may

seek to use the insolvency process as a substitute for a debt enforcement mechanism, particularly where the debt in question is small. That concern may need to be balanced, however, against the objective of facilitating quick and easy access to the insolvency process. Furthermore, the concern may be addressed by taking into account the value of the claim of the single creditor (although specifying a particular value for claims may not always be an optimal drafting technique as currency fluctuations may necessitate amendment of the law) or adopting a procedure like that outlined in the previous paragraph which requires the debtor to provide information to the court. It can also be addressed by providing for certain consequences, such as damages for harm done to the debtor, where the creditor application is an improper use of the insolvency process. These damages may relate not only the costs and expenses incurred by the debtor, but also to disruption to the debtor's business.

29. [23] There may also be exceptional circumstances where there is no mature claim, but that would otherwise justify commencement of insolvency proceedings. These circumstances may include where there is evidence that the debtor is treating some creditors preferentially or where the debtor is acting fraudulently with regard to its financial situation. Some of these situations may more appropriately be addressed through laws dealing with fraud rather than by application of the insolvency law in the absence of evidence of insolvency.

(d) Application by a governmental authority

32. [24] An insolvency law may give a governmental agency (normally the public prosecutor's office or the equivalent) or other supervisory authority non-exclusive authority to initiate liquidation proceedings against any entity if it ceases to make payments, in which case the same commencement criteria as apply in the case of applications by other creditors should generally apply.

33. [24] Some countries provide a more broadly-based power for governmental or other authorities to commence insolvency proceedings where initiation is considered to be in the public interest. In that case, a demonstration of illiquidity may not be necessary, enabling the government to terminate the operations of otherwise healthy businesses that have been engaged in certain activities, for example, of a fraudulent or criminal nature. The exercise of such police powers is only appropriate in certain limited circumstances which involve actual indications of insolvency, and it is clearly desirable that they are used only as a last resort in the absence of appropriate remedies under other laws. A preliminary investigation of the affairs of the debtor may be required before proceedings can be commenced, or preliminary measures, such as application of a stay and appointment of an interim insolvency representative, granted to address a current situation with the court to decide, at the expiry of that period, on the commencement of insolvency proceedings. These powers would generally only be available to commence liquidation proceedings, although there may be circumstances where liquidation could be converted to reorganization, subject to certain controls. These controls might include that the business activity is lawful and that management of the entity is taken over by an insolvency representative or governmental agency.

4. Reorganization

(a) Debtor application

34. [25] One of the objectives of reorganization proceedings is to establish a framework that will encourage debtors to address their financial difficulties at an early stage. A commencement criterion which is consistent with that objective may be one which does not require the debtor to wait until it has ceased making payments generally (i.e. wait until it is illiquid) before making an application, but allows an application in financial circumstances which, if not addressed, will result in a state of insolvency. Approaches to debtor applications for reorganization vary between insolvency laws. In some laws, the reorganization procedure does not actually require the satisfaction of any substantive criterion: the debtor may make an application whenever it wishes and is only required to file a simple petition in the appropriate court. Other laws, including those that adopt a unitary approach (see Part two, chapter I), specify that the debtor may make an application if it envisages that, in the future, it will not be in a position to pay its debts when they come due (prospective or imminent insolvency or illiquidity). A number of reorganization laws also require evidence of a real or reasonable prospect of survival of the debtor or of the economic viability of the debtor.

35. [26] It may be suggested that a relaxation of the commencement criteria could invite abuse of the procedure. For example, a debtor that is not in financial difficulty may apply to commence proceedings and submit a reorganization plan that is designed to allow it to shed onerous obligations, such as labour contracts, to allow it to renegotiate its debt or to prevaricate and deprive creditors of prompt payment of debts in full. Whether such improper use could arise is a question of how the elements of the reorganization procedure are designed including the commencement criteria, requirements for preparation of the reorganization plan, debtor control of the business after commencement and sanctions for improper use of the process. Means of addressing possible improper use by the debtor could include providing that the relevant court has the power to dismiss the application and, in that event that the debtor should be liable to creditors for their costs associated with resisting the application and for any harm caused by the application.

(b) Creditor application

36. [27] Although insolvency laws generally provide for liquidation proceedings to be initiated by either a creditor or a debtor, there is no consensus as to whether reorganization proceedings can also be initiated by a creditor and a number of laws include provision only for debtor applications. Given that one of the objectives of reorganization proceedings is to provide an opportunity for creditors to enhance the value of their claims through the continued operation and reorganization of the entity, it may be desirable that the ability to apply not be given exclusively to the debtor. The ability of creditors to apply for reorganization is also central to the question of whether creditors can propose a reorganization plan (see Part two, chapter V). A number of countries take the position that, since in many cases creditors are the primary beneficiaries of a successful reorganization, creditors should have an opportunity to propose the plan. If that approach is followed, it seems reasonable to provide that creditors can make an application for reorganization proceedings.

37. [28] Where creditors can make an application for reorganization of the debtor, different views are taken as to the commencement criteria. One view is reflected in those insolvency laws which adopt the same criterion of prospective illiquidity as applies in the

case of a debtor application for reorganization A different view is that that approach is difficult to justify not only because of the difficulties associated with creditors being able to prove that a standard of prospective illiquidity has been met. It is also because, as a general matter, it would seem unreasonable for any form of insolvency proceeding to be commenced against the debtor's will, unless creditors can demonstrate that their rights already have been impaired. To address those difficulties, commencement criteria could require creditors to demonstrate, for example, that ongoing cash will be available to pay for the day to day running of the business, that the value of the assets will support reorganization and that the return to creditors in a reorganization is likely to exceed the return in liquidation. One disadvantage of that approach is that it requires the creditors to have made, or be able to make, a thorough assessment of the business before making an application. To address any problem associated with creditors gaining access to relevant information, an insolvency law could provide, on the making of an application by creditors, for an assessment of the debtor's financial situation to be undertaken by an independent authority. Such a procedure may have the advantage of ensuring that proceedings are only commenced in appropriate cases, but care may be needed to ensure that the additional requirements do not delay commencement of the proceedings with consequences for maximization of value of the assets and the likelihood of successful completion of the reorganization.

38. [31] Some laws adopt a variation of the cessation of payments standard, and require the application to be made by a specified number of creditors or by creditors holding a specified composite value of matured claims, or both. Other laws require creditors, on making an application, to provide a bond or payment to cover the costs of the commencement proceedings.[4]

39. [29] The question of the complexity or simplicity of commencement standards is closely linked to the consequences of commencement and the conduct of the insolvency proceedings. For example, in insolvency laws that apply a stay automatically on commencement of the proceedings, the ability of the business to continue trading and be successfully reorganized can be assessed after commencement (and conversion of the proceedings to liquidation can occur if reorganization is determined to be inappropriate, where the law allows this course). In other systems, that information may be needed before an application is made because the choice of reorganization presupposes that it will lead to a greater return for creditors than liquidation.

40. [30] For these reasons, it may be appropriate to apply the same commencement standard to applications by creditors for both liquidation and reorganization of the debtor (i.e. general cessation of payments). Such a standard would appear to be consistent with both the two-track approach and the unitary approach (see Part two, chapter I.C), where the application of a different commencement standard is not so much a function of the type of proceedings being initiated, but rather whether the applicant is the debtor or a creditor. The exception to the approach of having the same commencement criteria for both liquidation and reorganization would be those systems which favour reorganization and where both a debtor and a creditor are precluded from initiating liquidation proceedings until it has been determined that reorganization is impossible. In that case, the commencement criterion for liquidation would not be general cessation of payments, but rather a determination that reorganization cannot succeed.

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[4] Such a payment may also provide remuneration for the insolvency representative (see chapter V.B, and see also the discussion on costs of the insolvency proceeding chapter II.B.7).

5. Procedural issues

(a) Initiation of the process

41. The insolvency law should specify how the application for insolvency can be made. Many insolvency laws require an application to be filed with a specified court, although there are other examples such as a law that provides for the process to be initiated by lodgement of a declaration by the debtor with the corporate regulatory authority. This raises the question of the involvement of the court in the insolvency process, which is discussed in Part one.

(b) The decision to commence insolvency proceedings

42. [32] A preliminary procedural issue relates to the manner in which the proceeding is commenced once the application has been made. In many countries the normal practice is for a court of competent jurisdiction to determine, on the basis of the application for commencement, whether the requisite conditions for commencement have been met. In some countries, that determination can also be made by the appropriate administrative agency, where that agency plays a central supervisory role in the insolvency process. The central issue, however, is not so much who makes the decision to commence proceedings but rather what that body is required to do in order to reach its decision. Entry conditions which are designed to facilitate early and easy access to the insolvency process not only will facilitate the court's consideration of the application by reducing complexity and assisting it to reach a decision in a timely manner, but also have the potential to reduce the cost of proceedings and increase transparency and predictability. The issue of cost may be of particular importance in the case of the insolvency of small and medium business entities.

43. [33] In addressing requirements for commencement, some insolvency laws draw a distinction between voluntary and involuntary applications. In some laws, a voluntary application by a debtor functions as an acknowledgement of insolvency and leads to an automatic commencement of proceedings, unless it can be shown that the process is being abused by the debtor to evade its creditors. In contrast, in the case of an involuntary application, the court is required to consider whether the commencement criteria have been met before deciding to commence the proceedings. In other laws, irrespective of whether the application is voluntary or involuntary, the court is required not only to determine whether the entry conditions have been met, but also to determine whether the type of proceedings applied for are appropriate to the particular circumstances of the debtor. If the assessment to be made is complex and there is a potential for delay between application and commencement, there is also the potential for further debts to be incurred in that period, as the debtor continues to trade and allows trade debts to increase in order to preserve cash flow, and for assets to be dissipated by the actions of creditors. Where that approach is followed, one means of reducing the potential complexity of the assessment is to provide, firstly, for the assessment to be made after commencement when the court can be assisted by the insolvency representative and other experts and, secondly, for conversion between liquidation and reorganization. Where this approach is adopted, an insolvency law may need to provide clear rules regarding the priority for repayment of debts incurred during such period, the debtor's authority to dispose of assets during this period, and the potential for avoidance or unauthorized transactions occurring during the assessment period.

(c) Establishing a time limit for making the commencement decision

44. [34] Where a court is required to make a decision as to commencement, it is desirable that that decision be made in a timely manner to ensure both certainty and predictability of the decision-making process and the efficient conduct of the proceedings without delay. Some insolvency laws prescribe set time limits for the period after the application within which the decision to commence must be made. These laws tend to distinguish between voluntary and involuntary applications with voluntary applications tending to be determined more quickly. Any additional period for involuntary applications is to allow for prompt notice to be given to the debtor and to provide the debtor with an opportunity to respond to the application.

45. [34] Although the approach of fixing time limits may serve the objectives of providing certainty and transparency for both the debtor and creditors, the achievement of these objectives may need to be balanced against possible disadvantages. For example, a fixed time limit may be insufficiently flexible to take account of the circumstances of the particular case. It may establish an arbitrary limit which takes no account of the resources available to the body responsible for supervision of the insolvency process or of the local priorities of that body (especially where insolvency is only one of the matters for which it has responsibility). It may also prove difficult to ensure that the decision-making body adheres to the established limit and to provide for what should occur where there is no compliance. The time period between application and the decision to commence proceedings should also reflect the proceedings applied for, the application process, and the consequences of commencement in any particular regime. For example, the extent to which notification of interested parties and information gathering must be completed prior to commencement will vary between regimes, requiring different periods of time. For these reasons, it is desirable that an insolvency law adopt a flexible approach that emphasizes the advantages of quick decision-making and provides guidance as to what is reasonable, but at the same time also recognizes local constraints and priorities.

(d) Denial of the application to commence

46. [15] The preceding paragraphs refer to a number of instances where it is desirable for the court to have the power to deny the application for commencement, either because of questions of improper use of the process or for technical reasons relating to satisfaction of the commencement criteria. The cases referred to include examples of both voluntary and involuntary applications. Principal amongst the grounds for denial of the application are those cases where the debtor is found not to satisfy the commencement criteria; where the debt is subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt; where the debtor uses insolvency as a means of prevaricating and depriving creditors of prompt payment of debts in full or to obtain relief from onerous obligations, such as labour contracts; where a creditor uses insolvency as a substitute for debt enforcement procedures (which may not be well developed) or to attempt to force a viable business out of the market place or to obtain preferential payments. A related issue is that of conversion of the application or the proceedings from, for example, liquidation to reorganization. (Conversion is discussed in Part two, chapter I.C and chapter V.A.14.) Where there is evidence of improper use of the process by either the debtor or creditors, the insolvency law may provide that sanctions can be imposed on a party that abuses the process or that the party improperly using the process should pay costs and possibly damages to the other party. Remedies may also be available under non-insolvency law.

(e) Notice of commencement

47. [35] Provision of notice of the commencement of insolvency proceedings is central to several key objectives of an insolvency regime – it ensures the transparency of the process and that all creditors are equally well-informed in the case of voluntary proceedings.

(i) Notice to creditors

48. [36] In the event of a voluntary or debtor application, creditors and other interested parties have a direct interest in receiving notice of the proceedings and an opportunity to dispute the presumptions of eligibility and insolvency (perhaps within a specified time period to prevent the proceedings from being prolonged unnecessarily). The question arises, however, as to the time at which creditors should be notified - at the time the application is made or the time the proceedings commence. The interests of creditors in knowing that the application has been made may need to be balanced, in certain circumstances, against the possibility, where notice of the application is provided, that the position of the debtor may be unnecessarily affected if its application is rejected or that creditors may be encouraged to take last minute action to enforce their claims. These concerns may be addressed by providing that creditors be notified of commencement of the proceedings.

(ii) Notice to the debtor

49. [37] In the event of an involuntary or creditor application for insolvency proceedings, however, the debtor should be entitled to immediate notice of the application and should have an opportunity to be heard and to dispute the creditors' claims as to its financial position (see Part two, chapter IV.A). [35] Nevertheless, there may be exceptional circumstances where provision could be made, with the consent of the court, for notice to the debtor to be dispensed with on the basis that it may be impossible to provide or may thwart the purpose of a particular application. These circumstances may include where the debtor or management of the debtor has disappeared or where giving notice of the application may lead to assets being placed by the debtor beyond the reach of the creditors or the insolvency representative. Where the court dispenses with notice of the application and commences the proceedings, the debtor should nevertheless receive notice of the court's order as soon as possible.

(iii) Notice to parties other than creditors

50. There may be a number of parties other than creditors who may require notice of the commencement of proceedings. These parties may include the postal administration (especially where mail for the debtor is to be delivered to the insolvency representative), tax authorities, social service authorities, and corporate regulators.

(iv) Manner of providing notice and content of the notice

51. [38] In addition to the question of the time at which notice should be given, an insolvency law may need to address the manner in which notice is provided and the information to be included in the notice to ensure its effectiveness. The manner of providing the notice could address both the party required to give the notice (e.g. the court or the party making the application) and how the information can be made available. For example, while notice may be provided directly to known creditors, the need to inform

unknown creditors has led legislators to require publication in an official government publication or a commercial or widely circulated national newspaper (see article 14, UNCITRAL Model Law on Cross-Border Insolvency). Consideration may need to be given to whether such a requirement will be cost effective in all cases. The information required in the notice may include the effect of the commencement of proceedings (especially as to the application of the stay – see chapter III); the time for submission of claims; the manner in which claims should be submitted and the place at which they should be submitted; the procedure and any form requirements necessary for submitting a claim; advice as to which creditors should make claims (i.e. whether secured creditors need to submit a claim - see Part two, chapter VI.A); consequences of failure to make a claim; and information concerning meetings of creditors.

(f) Assetless estates

52. [175] Many debtors which would satisfy the criteria for commencement of insolvency proceedings never progress to be formally liquidated because it appears to creditors that there are no assets in the insolvency estate to fund the administration of the insolvency and debtors in such a position will rarely take steps to commence proceedings. Some insolvency laws provide that where an application for commencement is made, it will be dismissed where there is an assessment of absence of assets by the court, while others provide a mechanism for appointment and remuneration of an insolvency representative (see Part two, chapter IV.B). Some other laws provide for a surcharge on creditors to pay for the administration of estates (see Costs below).

53. There are a number of reasons, particularly of a public interest nature, for devising a mechanism to enable the administration of an apparently assetless debtor under a formal proceeding. Where an insolvency law does not provide for exploratory investigations of insolvent assetless companies, it does little to ensure the observance of fair commercial conduct or to further standards of good governance of commercial entities. Assets can be moved out of companies or into related companies prior to liquidation with no fear of investigation or the application of avoidance provisions or other civil or criminal provisions of the law. A mechanism for administration will assist in overcoming any perception that such abuse is tolerated, may provide a return for creditors where antecedent transactions can be avoided and may provide a means of investigating the conduct of the management of such debtors.

54. Mechanisms for pursuing the administration of such estates may include, as noted above, levying a surcharge on creditors to fund administration; establishing a public office or utilising an existing office to administer insolvent debtors; establishing a fund out of which the costs may be met; [176] appointing an insolvency professional on the basis of a roster or rotation system, which is designed to ensure a fair and ordered distribution of all insolvency cases, whether assetless or otherwise where the insolvency representative will be paid a prescribed stipend by the State or the costs will be borne directly by the insolvency representative and cross-subsidised by their clients generally (since their remunerative rates can be adjusted to take into account unremunerative work). Where such a mechanism is included in an insolvency law, consideration may also need to be given to defining those debtors to which the provisions will apply, such as by reference to a debtor having available less than a prescribed value of unencumbered assets that would otherwise enable the liquidation to proceed.

6. Costs of the insolvency proceedings

55. Cost effectiveness, in addition to speed and efficiency, is an important aspect of an effective insolvency regime and one that bears upon all phases of the insolvency process. It is thus important, when designing an insolvency regime, to avoid the situation where the procedure is subject to cost burdens that will deter creditors and frustrate the basic objectives of the procedure. This is of particular importance in the case of insolvency of small and medium business, It may also be particularly important where, for example, the debtor has a large debt which comprises a number of smaller creditors whose individual debts may not support the costs of the application procedure or where the estate has few assets.

56. [39] Applications by both debtors and creditors for commencement of insolvency proceedings may be subject to the payment of fees. Different approaches may be taken to the level of fee imposed. One approach may be to set a fee that can be used to help defray the costs of the insolvency system. [39] Where the resultant fee is high, however, it may operate as a deterrent and run counter to the objective of convenient, cost effective and quick access to the insolvency process. A very low fee, on the other hand, may not be sufficient to deter frivolous applications and it is therefore desirable that a balance between these objectives be reached. Some insolvency laws require the creditors making an application to guarantee the payment of the costs of the proceedings up to a certain fixed amount, to pay a certain percentage of the total of claims or a fixed amount as a guarantee for costs. In some laws where a payment as security for costs is required, that amount may be refunded from the estate if there are sufficient assets and certain creditors, such as employees, are exempted from providing the required security. Other laws require, as a condition of commencement, that the unencumbered assets of the estate must be sufficient to cover the costs of the proceedings. Where they are insufficient, the insolvency generally provides for the application to be dismissed or for it to be treated in accordance with provisions on assetless estates (see above).

Recommendations

Purpose of legislative provisions

The purpose of provisions on application and commencement ~~criteria~~ of insolvency proceedings is to:

(a) facilitate access for debtors and creditors to the remedies provided by the insolvency law;
(b) identify the court that will have jurisdiction over insolvency proceedings and over any matter arising in the conduct of an insolvency proceeding;
(c) establish application and commencement criteria that are transparent and certain;
(d) enable applications for insolvency proceedings to be made and dealt with in a speedy, efficient and cost effective ~~inexpensive~~ manner;
(e) establish effective requirements for notification of commencement of proceedings;
(f) establish basic safeguards to protect both debtors and creditors from improper use of the ~~[insolvency law]~~ the application procedure.

Content of legislative provisions

Eligibility for application

(17) [(16)] The insolvency law should provide that an application to commence insolvency proceedings is to be made to the specified court and clearly state who may make an application. This should include the debtor and creditors.

Commencement criteria

(18) [(17)] The insolvency law should provide that the criteria for commencement of insolvency proceedings, both liquidation and reorganization, should be:

(a) in the case of a debtor application, that the debtor is or will be unable to pay its ~~mature~~ debts as they mature [or alternatively, that its liabilities exceed the value of its assets];
(b) in the case of a creditor application, that the debtor is unable to pay its mature debts [or alternatively, that its liabilities exceed the value of its assets].

Presumption that the debtor is unable to pay

Version 1

(19) [(18)] The insolvency law ~~should~~ may provide that if the debtor fails to pay one or more of its mature debts, and the debt is not subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt, the debtor is presumed to be unable to pay its debts.[5]

Version 2

(19) [(18)] The insolvency law might include a presumption to the effect that the debtor is presumed unable to pay its debts in specified circumstances in order to facilitate commencement of proceedings by one or more creditors.[6] Those circumstances might include:

(a) that the debtor has failed to pay a specified number of creditors, whether by reference to a number of matured claims (such as one or more), a particular value of matured claims (such as …) or both; and
(b) that the matured debts are not subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt.

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[5] Where the debtor has not paid a mature debt and the creditor has obtained a judgement against the debtor in respect of that debt, there would be no need for a presumption to establish that the debtor was unable to pay its debts.

[6] The debtor could rebut the presumption by showing, for example, that it was able to pay its debts; that the debt was subject to a legitimate dispute; or that the debt was not mature. The recommendations on notice of commencement provide protection for the debtor by requiring notice of the application for commencement of proceedings to be given to the debtor and providing the debtor with an opportunity to rebut the presumption.

Commencement on debtor application

(20) [(19)] Where the application for commencement is made by the debtor, the insolvency law should provide that proceedings will should be commenced by either:

(a) the application functioning as automatic commencement of proceedings; or

(b) the court, which should be required to promptly determine whether the insolvency proceeding should be commenced.

Commencement on creditor application

(21) [(20)] Where the application for commencement is made by a creditor, the insolvency law should require that:

(a) notice of the application promptly be given to the debtor;

(b) the debtor be given the opportunity to respond to the application; and

(c) the court promptly determine whether the insolvency proceeding should be commenced.

Notification of commencement

(22) [(21)] The insolvency law should provide that notification of the commencement of insolvency proceedings be made generally available in a publication such as the official government gazette or a widely circulated national newspaper, as appropriate and cost effective, or be made available through [appropriate][relevant] public registries [whether electronic or not]. The insolvency law may identify who has the obligation to provide such notification.

(23) [(22)] The insolvency law should require all known creditors [who may be identified from the books and records of the debtor] to be notified individually, unless the court considers that, under the circumstances, some other or additional form of notification would be more appropriate.

(24) [(22)] The insolvency law should require that the notification of commencement of proceedings to creditors should specify:

(a) any applicable time period for submitting a claim, the manner in which the claim should be submitted and the place at which the claim can be submitted;

(b) the procedure and any form requirements necessary for submitting a claim; (c) the consequences of failure to submit a claim; and

[(d) information concerning meetings of creditors].

Denial of an application to commence proceedings

(25) [(23)] Where the decision to commence proceedings is made by the court, (whether on the application of the debtor or creditors),[7] the insolvency law should allow the court to deny the application ~~or refuse to commence proceedings~~ if the court determines that:[8]

(a) the application is an improper use of the insolvency law;
(b) in the case of a creditor application, the debt is subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt; or
(c) in an application for liquidation, ~~[that the debtor is solvent]~~ the commencement criteria have not been met.

Assetless estates

(26) The insolvency law should address the treatment of those estates where there are no assets. Different approaches may be taken including denial of the application upon an assessment by the court that there are no assets, or commencement of the proceedings and appointment of an insolvency representative to administer the estate, where different mechanisms for appointment and remuneration of the insolvency representative may be available [see chapter IV.B].

[7] Refer recommendations (20) and (21).

[8] In certain circumstances it may be appropriate for the proceedings, once commenced, to be converted from liquidation to reorganization or from reorganization to liquidation: see chapter I section B.

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Part Two (continued)

III. Treatment of assets on commencement of insolvency proceedings

A. Assets to be affected

1. Introduction

57. [40] Fundamental to the insolvency process is the need to identify, collect, preserve and dispose of assets belonging to the debtor. Many insolvency systems place the assets of the insolvent debtor under a special regime sometimes referred to as the insolvency estate, over which the insolvency representative will have specified powers. This Guide uses the term "estate" in its functional sense to refer to assets owned by the debtor that are controlled by the insolvency representative and are subject to the insolvency proceedings. There are some important differences in the way in which the concept of the insolvency estate is understood in various jurisdictions. In some countries, the insolvency law provides that legal title over the assets is transferred to the designated official. In other countries, the debtor continues to be the legal owner of the assets, but its powers to administer and dispose of the assets are limited (e.g. either the debtor will have no such power, or its powers will be limited to dealing with assets in the ordinary course of business and disposition, including by the creation of security rights, will require the consent of the insolvency representative or the court).

58. [41] Irrespective of the applicable legal tradition, an insolvency law will need to clearly identify the assets that will be subject to the insolvency proceedings (and therefore included within the concept of the "estate" where that term is used) and indicate how they will be affected by those proceedings, including clarifying the relative powers of the various participants with respect to the assets. Identification of assets and their treatment will determine the scope and conduct of the proceedings and, particularly in reorganization, will have a significant bearing on the likely success of those proceedings. A clear statement will ensure transparency and certainty for both creditors and the debtor.

2. Assets of the insolvency estate

(a) General definition of the insolvency estate

59. [43] The estate may be expected to include all assets in which the debtor has an interest, whether or not they are in the possession of the debtor at the time of commencement, including all tangible and intangible assets. Generally, assets acquired after commencement of the insolvency proceedings by either the debtor or the insolvency

representative would also be included. Tangible assets should be readily found on the debtor's balance sheets, such as cash, equipment, inventory, works in progress, bank accounts, accounts receivable and real estate. The assets to be included within the category of intangible assets may be defined differently in different States, depending upon the national law, but may include intellectual property, bills of lading, securities and financial instruments, policies of insurance, contract rights (including those relating to property owned by third parties), and rights of action arising from a tort[1] to the extent of the debtor's interest. In the case of natural persons, the estate may also include assets such as inheritance rights in which the debtor has an interest or to which the debtor is entitled at the commencement of the insolvency or which come into existence during the insolvency proceedings.

(b) Secured assets

60. One question of some importance is whether the insolvency law includes secured assets as part of the insolvency estate. [46] Insolvency laws adopt different approaches to the treatment of assets subject to security interests. Many laws provide that secured assets are included in the insolvency estate, with the commencement of proceedings giving rise to different effects, such as restricting the exercise of security rights held by creditors or third parties (such as by application of a stay and other effects of commencement). Where the secured assets are included in the insolvency estate, they may be subject to certain protections such as those relating to maintaining the value of the secured asset and to specified situations where the secured asset may be separated from the estate (see for example chapter III.C). Where secured assets are to be included in the estate, an insolvency law should make it clear that such an inclusion will not deprive secured creditors of their property rights in the secured assets, even if it does operate to limit the exercise of those rights.

61. [46] Other insolvency laws provide that the security right is unaffected by the insolvency and secured creditors may proceed to enforce their legal and contractual rights. There are examples of laws which provide that even where secured assets are unaffected by the insolvency, the debtor, with the insolvency representative's consent, can ask the court to prevent enforcement where the asset is necessary for the business to continue operating. [47] Exclusion of secured assets may have the advantage of generally enhancing the availability of credit because secured creditors would be reassured that their interests would not be adversely affected by the commencement of insolvency proceedings. However, this general advantage to an economy may need to be weighed against other advantages to be derived in specific insolvency cases, particularly in reorganization and where the business is to be sold as a going concern in liquidation, from having all assets of the debtor available to the insolvency proceedings from the time of commencement. Restricting the exercise of rights by secured creditors may assist not only in ensuring equal treatment of creditors, but may be crucial to the proceedings where the secured asset is essential to the business. For example, where manufacturing equipment or a leased factory building is central to the debtor's business operations, reorganization or sale of the business as a going concern cannot take place unless the equipment and the lease can be retained for the proceedings.

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[1] Some jurisdictions exclude torts of a personal nature such as defamation, injury to credit or reputation, where the debtor remains personally entitled to sue and to retain what is recovered on the basis that the incentive to vindicate wrongdoing otherwise would be diminished. *[What is the position regarding personal bodily injury?]*

62. Insolvency laws may provide secured creditors with different options for dealing with their security. These may include, for example, realizing the security where the insolvency law permits this to be done, with the creditor submitting a claim as an unsecured creditor for any shortfall if the amount realized is less than the amount of the claim (where the amount realized is in excess of the claim, the secured creditor will have to account to the insolvency representative for the surplus); having the property valued and submitting a claim as an unsecured creditor for the balance; and surrendering the secured asset to the insolvency representative subject to payment for its value.

(c) Joint assets

63. Where the debtor is an individual and personal property is owned jointly by the debtor and the debtor's spouse insolvency laws adopt different approaches to the treatment of these assets. One approach is to completely exclude the property from the estate. Another approach provides that where the proceedings are opened against the assets of one spouse, the part of the mutual assets belonging to that spouse can become part of the insolvency estate if, under the general law, they can be divided for purposes of execution (where division of the assets will be conducted outside of the insolvency law and proceedings).

(d) Third party owned assets

64. [48] Complex issues may arise in determining whether an asset is owned by the debtor or by another party, and whether assets of a third party that are in the possession of the debtor, subject to use, lease or licensing arrangements at the time of commencement should be included in the assets of the estate. Some insolvency laws treat those assets as subject to the estate. In other cases the estate will generally include, as indicated above in the general definition of the estate, any rights that the debtor might have in respect of the third party owned assets. [48] There will be cases where the third party owned assets, like secured assets, may be crucial to the continued operation of the business, whether in reorganization or sale as a going concern in liquidation, and it will be advantageous for the insolvency law to include a mechanism which will permit those assets to remain at the disposal of the insolvency proceedings. This issue is discussed further in chapter III.C.

(e) Time of constitution of the estate

65. [42] The insolvency law should specify the date by reference to which assets will be considered to be part of the estate to provide certainty for the debtor and for creditors. The estate may be expected to include the assets of the debtor as of the date of commencement of the insolvency proceedings as well as assets acquired by the insolvency representative and the debtor after that date, whether in the exercise of avoidance powers (see chapter III.F) or in the normal course of operating the debtor's business.

3. Assets excluded from the insolvency estate

(a) General exclusions

66. The insolvency law may specify the exclusion of certain assets from the estate. Insolvency laws adopt different approaches to this issue. Assets excluded from the estate may include certain assets owned by a third party that are in the possession of the debtor when the proceedings commence, such as trust assets and assets that are in the possession of the debtor subject to an arrangement (whether contractual or otherwise) that

does not involve a transfer of title but rather use of the assets and return to the owner once the purpose for which they were in the possession of the debtor has been fulfilled.[2] The treatment of assets being used by the debtor pursuant to a lease agreement where the lessor retains legal title may require special attention. In some jurisdictions, assets in which a creditor retains legal title or ownership (for example, retention of title by the secured creditor, or under a lease arrangement) may be separated from the insolvency estate. In other jurisdictions, if the economic terms of the transaction (that does not involve a transfer of the title to the debtor) demonstrate that is a device to finance the acquisition of an asset, although structured as a lease, the arrangement may be treated as a secured lending arrangement and the lessor will be subject to the same treatment as other secured creditors. A transaction will be a financing device where, at the end of the term of the lease, either the debtor can retain the asset for the payment of a nominal sum or the remaining value of the asset is negligible. Under either approach, the asset may be used by the insolvency representative subject to certain conditions as described in chapter III.C.

[N*ote that the current draft of the UNCITRAL Legislative Guide on Secured Transactions recommends that all such legal devices be grouped with other forms of secured credit arrangements into a general category of "security interests" and be treated similarly in insolvency proceedings, but this approach is yet to be finalised by Working Group VI.*]

(b) Foreign assets

67. Whether the debtor's property outside the country where the proceedings are taking place will become part of the estate raises issues of cross-border insolvency. Some insolvency laws take the approach that there should be a single insolvency procedure, based in the country where the debtor has its head office or place of registration or incorporation (centre of main interests), that will apply to the debtor's assets wherever situated (the universal approach). Other insolvency laws are based upon the approach of commencing different proceedings in the jurisdictions in which the enterprise has assets or in which different branches or establishments of the debtor are located (the territorial approach). The diversity of approaches creates considerable uncertainty and undermines the effective application of national insolvency laws. The UNCITRAL Model Law on Cross-Border Insolvency establishes a regime for effective co-operation in cross-border insolvency cases through recognition of foreign decisions and access for foreign insolvency representatives to local court proceedings. The regime is intended to be compatible with all legal systems and is discussed in more detail in chapter VIII.

(c) Where the debtor is a natural person

68. [45] In the case of insolvency of a natural person, the insolvency law may provide that the estate should exclude certain assets such as those relating to post-application earnings from the provision of personal services, assets that are necessary for the debtor to earn a living and personal and household assets, such as furniture, household equipment, bedding, clothing and other assets which are necessary to satisfy the basic domestic needs of the debtor and its family. Where an insolvency law provides exclusions in respect of the assets of a natural person, they should be clearly identified and their number limited to the minimum necessary to preserve the personal rights of the debtor and allow the debtor to lead a productive life. In identifying these exclusions, consideration might need to be given to applicable human rights obligations, including international obligations, which are

[2] Such an arrangement may be known as a bailment, depositum or [..].

intended to protect the debtor and relevant family members and may affect the exclusions that can be made.[3]

4. Recovered assets

(a) Avoidance proceedings

69. [50] Assets that will be subject to the proceedings will include any assets recovered by the insolvency representative that were improperly transferred or transferred at a time of insolvency with the result that the *pari passu* principle (i.e. that creditors of the same class are treated equally and are paid in proportion to their claim out of the assets of the estate) has been violated. Most legal systems provide a means of setting aside and recovering the value of antecedent transactions that result in preferential treatment to some creditors or were fraudulent in nature or made in an effort to defeat the rights of creditors (see Part two, chapter III.F).

(b) Unauthorized transactions

70. Many insolvency laws adopt measures intended to limit the extent to which a debtor subject to insolvency proceedings can deal with its assets without the authorization of the court or the insolvency representative. These restrictions generally will apply after the application for commencement of proceedings (in those cases where the powers to deal with assets of the estate are given to an interim insolvency representative) and after the commencement of insolvency proceedings. Some insolvency laws treat transactions which result in the unauthorized transfer of assets as invalid and unenforceable as against the insolvency estate, and enable the assets transferred to be reclaimed, except in some cases where the counterparty gave value or can prove that the transaction did not impair creditors' rights. Other insolvency laws achieve the same result by addressing unauthorized contracts in terms of avoidance provisions. Some of these laws specify the types of transactions that can be avoided in such cases, including performance of obligations arising before commencement, payment of pre-application debts, creation of security over assets of the estate and disposal of any right or asset forming part of the estate.

Recommendations

Purpose of legislative provisions

The purpose of provisions relating to assets affected by the commencement of insolvency proceedings is to:

(a) identify those assets that will constitute the insolvency estate;
~~(b) indicate the manner in which rights in those assets will be affected by the commencement of insoslvency proceedings;~~
(b) identify those assets that will specifically be excluded from the insolvency estate;

[3] In Europe, for example, the European Convention on Human Rights is relevant.

~~(d) indicate the manner in which assets owned by third parties and assets subject to a security interest will be affected by the commencement of insolvency proceedings.~~

Content of legislative provisions

Assets constituting the insolvency estate

(27) [(24)] The insolvency law should identify the assets to be included in the insolvency estate. Those assets might ~~constituting the insolvency estate should~~ include:

(a) assets owned by the debtor, including both tangible and intangible assets,[4] irrespective of whether they are in the possession of the debtor and whether they are subject to a security interest in favour of a creditor [*determined in accordance with the property and secured transactions law of the State*];
(b) assets acquired after commencement of the insolvency proceedings; and
(c) assets recovered through avoidance and other actions commenced by the insolvency representative, including in respect of unauthorized transactions.

(28) In the case of an insolvency proceeding where the debtor has its centre of main interests, the insolvency law should specify whether the insolvency estate would include all assets wherever located.

Assets that may be excluded ~~– natural persons~~

(29) [(25)] The insolvency law should specify which assets are to be excluded from the insolvency estate. Where the debtor is a natural person, ~~the insolvency law should specify the assets to be excluded from the insolvency estate, specifically~~ exclusions will include those assets required to preserve the personal rights of the debtor, which may include assets acquired after commencement of the insolvency proceedings. Exclusions generally are not provided for entity debtors.

[4] Intangible assets may be differently defined according to national law, but may include intellectual property, bills of lading, securities and financial instruments, policies of insurance, contract rights (including those relating to property owned by third parties), and rights of action arising from a tort.

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Part Two (continued)

III. Treatment of assets on commencement of insolvency proceedings

B. Protection and preservation of the insolvency estate

1. Introduction

71. [53] An essential objective of an effective insolvency system is the establishment of a protective mechanism to ensure that the value of the insolvency estate's assets is not diminished by the actions of the various parties in interest and that the insolvency proceedings can be administered in a fair and orderly manner. The parties from whom the estate needs the greatest protection are the debtor and its creditors.

2. Protection of the estate by application of a stay

72. [54] With regard to creditors, one of the fundamental principles of insolvency law is that it is a collective proceeding, which requires that the interests of all creditors be protected against individual action by one of them. Many insolvency laws provide for the imposition of a mechanism that not only prevents creditors from enforcing their rights through legal remedies during some or all of the period of the liquidation or reorganization proceedings, but also suspends actions already underway and prevents the commencement of new actions. This mechanism is variously termed a moratorium, suspension or stay, depending on the scope of the mechanism. For the purposes of this Guide, the term "stay" is used in a broad sense to refer to both suspension of actions and a moratorium against the commencement of actions.

73. [55] As a general principle, the emphasis in liquidation is on selling the assets, in whole or in part, so that creditors can be repaid from the proceeds of sale as quickly as possible. Maximizing value is an overriding objective. The imposition of a stay in liquidation can ensure a fair and orderly administration of the proceedings, providing the insolvency representative with adequate time to avoid making a forced sale that fails to maximize the value of the assets being liquidated, and also an opportunity to see if the business can be sold as a going concern, where the collective value of assets may be greater than if the assets were to be sold piecemeal. The difficult balance is between the competing interests of secured creditors, who will often hold security in some of the most important assets of the business, and the interests of unsecured creditors.

74. [55] In reorganization proceedings, a stay of proceedings allows the debtor a breathing space to organize its affairs, time for preparation and approval of a

reorganization plan and for the other steps necessary to ensure successful implementation of the reorganization to be taken, including shedding unprofitable activities and onerous contracts. Given the goals of reorganization, the impact of the stay is greater and therefore more crucial than in liquidation and can provide an important incentive to encourage debtors to initiate reorganization proceedings. At the same time, the commencement of proceedings and the imposition of the stay give notice to all those who do business with the debtor that the future of the business is uncertain. This can cause a crisis of confidence and uncertainty as to how the insolvency will impact upon them as suppliers, customers and employees of the debtor's business.

75. [56] One of the key issues in the design of an effective insolvency law is how to balance these concerns - the immediate benefits that accrue to the debtor by having a broad stay quickly imposed to limit the actions of creditors and the longer-term benefits that are derived from limiting the degree to which the stay interferes with contractual relations between debtors and creditors, especially secured creditors.

76. [57] The scope of rights that are affected by the stay varies considerably among insolvency laws. There is little debate regarding the need for the suspension of actions by unsecured creditors against the debtor or its assets. The application of the stay to secured creditors, however, is potentially more difficult and requires a number of competing interests to be balanced. These include, for example, observing commercial bargains and contracts; respecting the pre-insolvency priorities of secured creditors as regards their rights over the security; protecting the value of secured interests; ensuring that creditors are paid out of the assets of the estate in proportion to their claim; maximizing asset values for all creditors; and, in cases of reorganization, ensuring the successful reorganization of a viable entity.

[(b) Provisional measures moved to 4(b) Time of application of the stay]

3. Scope of application of the stay

(a) Actions to which the stay will apply

77. [60] Some countries adopt the approach that to ensure the effectiveness of the stay, it must be very wide, applying to all remedies and proceedings against the debtor and its assets, whether administrative, judicial or self-help and restraining both unsecured and secured creditors from exercising enforcement rights, as well as governments from exercising priority rights. Examples of the types of actions that may be stayed could include: the commencement or continuation of actions or proceedings against the debtor or in relation to its assets; the commencement or continuation of enforcement proceedings in relation to assets of the debtor, including the execution of a judgement and perfection or enforcement of a security interest; recovery by any owner or lessor of property that is used or occupied by, or is in the possession of, the debtor; payment or provision of security in respect of a debt incurred by the debtor prior to the commencement date; the right to transfer, encumber or otherwise dispose of any assets of the debtor (in reorganization, this might be limited to transfer, encumbrance or disposal outside the ordinary course of business); and termination, suspension or interruption of supplies of essential services (for example, water, gas, electricity and telephone) to the debtor. Article 20 of the UNCITRAL Model Law on Cross-Border Insolvency (see chapter VIII), for example, provides that commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities and execution against the debtor's assets are stayed.

78. [61] Some insolvency laws provide that, where legal proceedings against the debtor (including both continuation and commencement of those proceedings) are within the scope of the stay in liquidation, those proceedings can be continued at the discretion of the court if it is considered necessary to preserve a claim or establish the quantum of a claim. Article 20(3) of the UNCITRAL Model Law on Cross-Border Insolvency, for example, provides that the application of the stay to commencement or continuation of individual actions or proceedings against the debtor is not to affect the right to commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor. Other insolvency laws allow the commencement or continuation of legal proceedings, but the application of the stay prevents enforcement of any resulting order. In some insolvency laws a distinction is made between regulatory and pecuniary actions; some laws allow claims of both a regulatory and pecuniary nature to be continued, others only regulatory claims. Other insolvency laws provide that specific actions, such as employee actions against the debtor, can be commenced or continued, but any enforcement action resulting from those proceedings will be stayed. Some insolvency laws also allow commencement or continuation of actions seeking to restrain the debtor from undertaking certain activities, such as those causing environmental damage. Where claims can be pursued against the debtor, the insolvency representative will need to be involved where the debtor is divested of control.

79. [62] To ensure transparency and predictability, it is highly desirable that an insolvency law clearly identify the actions that are to be included within and excluded from the scope of the stay, irrespective of who may commence those actions, whether unsecured creditors (including preferential creditors such as employees, legislative lienholders or governments), third parties (such as a lessor or owner of property in the possession or use of the debtor or occupied by the debtor), secured creditors or other parties. Exclusions might include: [63] set-off rights and netting of financial contracts (see Part two, chapter III.F), actions to protect public policy interests, such as to restrain environmental damage, or to prevent abuse, such as the use of insolvency proceedings as a shield for illegal activities.

(b) Secured creditors

80. [69] Creditors generally seek security for the purpose of protecting their interests in the event that the debtor fails to repay. If security is to achieve this objective, it can be argued that, upon commencement of insolvency proceedings, the secured creditor should not be delayed or prevented from immediately realising its security. The secured creditor has, after all, bargained for security in exchange for value that reflects the reliance on the security. For that reason, the introduction of any measure that will diminish certainty in the ability of the secured creditor to recover debt or erode the value of security interests, such as applying the stay to secured creditors, may need to be carefully considered. Such a measure may ultimately undermine not only the autonomy of the parties in their commercial dealings and the importance of observing commercial bargains, but also the availability of affordable credit; as the protection provided by security interests declines, the price of credit may need to increase to offset the greater risk. [72] Some of the insolvency laws that exclude secured creditors from the stay focus on encouraging pre-commencement negotiations between the debtor and creditors to achieve agreement on how to proceed. Where that process is effective, a stay may not need to apply to secured creditors. [70] A growing number of insolvency laws recognize, however, that in some cases permitting secured creditors to freely separate their security (in order to satisfy their claims) from the insolvency estate can frustrate the basic objectives of the insolvency

proceedings, particularly in reorganization, but also where the business can be sold as a going concern in liquidation.

81. [71] Where secured interests are included within the scope of the stay, an insolvency law can adopt measures that will ensure the secured rights are not diminished by the stay. These measures may relate to the duration of the stay, protection of the value of the security, payment of interest and provision of relief from the stay where the secured interests are not sufficiently protected or where the security is not necessary to the sale of the entire business or a productive part of it.

(i) Reorganization

82. [70] In reorganization proceedings, [74] where there is a genuine possibility of effecting a reorganization, it is desirable that the extent of the stay be very wide and all embracing. [70] Where assets essential to the operation of the debtor's business are encumbered by security interests, enforcement by secured creditors of their claims at the commencement of the proceedings may make it impossible for the debtor to keep the business operating while it formulates a reorganization plan and, where secured creditors are not bound by the plan, make it impossible to implement the plan (see Part two, chapter V.A).

(ii) Liquidation

83. [72] Insolvency laws take different approaches to the application of the stay to secured creditors in liquidation proceedings. As a general principle, where the insolvency representative's function is to collect and realize assets and distribute proceeds among creditors by way of dividend, the secured creditor may be permitted to freely realize its security to satisfy its claim despite the liquidation. Some insolvency laws thus exclude secured creditors from the scope of the stay on the basis that where the assets are to be liquidated the balance will weigh in favour of allowing secured creditors to enforce their rights. Where that approach is adopted, some flexibility may be needed, however, where the insolvency representative may be able to achieve a better result that maximizes the value of the assets for the collective benefit of all creditors if the stay is applied to restrict realization of the security. This may be particularly relevant where the business can be sold as a going concern in the context of the liquidation proceeding. It may also be true in some cases where even though assets are to be sold in a piecemeal manner, some time is needed to arrange a sale that will give the highest return for the benefit of all unsecured creditors.

4. Procedural issues

(a) Discretionary or automatic application of the stay

84. [64] A preliminary question on application of the stay is whether it should apply automatically (by operation of the insolvency law) or at the discretion of the court. Local policy concerns and factors such as the availability of reliable financial information and the ability of the debtor and creditors to have access to an independent judiciary with insolvency experience may affect the decision on this issue. Applying the stay on a discretionary basis may allow the stay to be tailored to the needs of the specific case (as regards the debtor, its assets and its creditors) and avoid both unnecessary applications of the stay and unnecessary interference with the rights of secured creditors. This approach, however, has the potential to cause delay while the court considers the relevant issues; does not create a predictable situation for those creditors and third parties to whom the stay

may apply; and may create a need for some mechanism, such a provisional measures, to address the period before the court decides on the pplication of the stay; as well as requirements for the provision of notice as to application of the stay. An alternative approach which minimizes delay, will assist the achievement of the maximization of the value of the assets and ensure that the insolvency process is fair and ordered as well as transparent and predictable, might be to provide for the stay to apply automatically to specified actions, with the possibility of extension of the stay to other actions at the discretion of the court. This approach is adopted in the UNCITRAL Model Law on Cross-Border Insolvency: article 20 specifies the types of actions that will be stayed automatically upon recognition of foreign main proceedings, while article 21 indicates examples of additional relief that may be provided upon recognition, at the discretion of the court. The automatic stay is a feature of many modern insolvency law regimes.

(b) Time of application of the stay

85. [65] A further concern related to application of the stay is the time at which it will apply in both liquidation and reorganization proceedings.

(i) From commencement - the need for provisional measures

86. [66] Different approaches may be taken to the time of application of the stay. The most common approach is for the stay to apply on commencement of the proceedings, when issues of eligibility, jurisdiction and satisfaction of the commencement criteria will have been resolved and it is clear that proceedings should be commenced rather than the application be denied. In some insolvency laws, the application of the stay on commencement is combined with provisional measures to address the period between application and commencement, [58] when there is the potential for the debtor's business situation to change and for dissipation of the debtor's assets - the debtor may be tempted to transfer assets out of the business, and creditors, on learning of the application, may take remedial action against the debtor to pre-empt the effect of any stay that may be imposed upon commencement of the proceedings. Where an insolvency law provides for the granting of provisional measures, it is important that it also address what happens to those measures on commencement of the insolvency proceedings.

87. [59] These provisional measures may be available on the application of the debtor, creditors or ordered by the court on its own motion and may include: appointing a preliminary insolvency representative; prohibiting the debtor from disposing of assets; taking control of some or all of the debtor's assets; suspending enforcement by creditors of security interests against the debtor; staying any action by creditors to separate a debtor's assets, such as by a secured creditor or holder of a retained title; or preventing the commencement of individual actions by creditors to enforce their claims. Since these measures are provisional in nature and are granted before the court's determination that the commencement criteria have been met, applicants may be required by the court to provide evidence that the measure is necessary to preserve the value of the insolvency estate and avoid dissipation of assets. Where the application is made by a creditor, some form of security for costs or damages that may be incurred may also be required in case proceedings are not subsequently commenced. The insolvency law may also need to consider the question of provision of notice of an order for provisional measures and the parties to whom that notice needs to be given. Bearing in mind the need to avoid unnecessary damage to a debtor against whom insolvency proceedings are not subsequently commenced, that notice may need to be limited to parties directly affected by the order. Relief from the application of provisional measures, such as modification or

termination, may also be appropriate in cases where the interests of the persons affected are being harmed. Such relief might be available on the application of the affected party, the insolvency representative or on the motion of the court itself.

(ii) From the time of the application for commencement

88. [66] A different approach is for the stay to apply from the making of an application for either liquidation or reorganization proceedings, irrespective of whether it is a debtor or creditor application. This approach may avoid the need to consider the availability of interim or provisional measures of protection to cover the period between the making of the application and the commencement of proceedings, but will require the application of the stay at a time when a number of factual matters are not necessarily clear, in particular whether the debtor will satisfy the commencement criteria. To balance against the risk of abuse in this situation, it is desirable if this approach is followed, that clear procedures for seeking relief from the application of the stay on an expedited basis be included in the insolvency law.

(iii) Specifying the exact time of application of the stay

89. Whether the stay is to be applicable by reference to the time of application or commencement, it is important that an insolvency law address the question of the exact time at which the stay will become effective to ensure protection of the estate, especially in relation to payments. Different approaches are taken to this issue. In some laws, the stay becomes effective as of the time of the court's decision to commence proceedings, in others when the decision as to commencement becomes publicly available, while in yet other laws the stay has effect retroactively from the first hour of the day of the commencement order. A similar diversity of approaches is taken where the stay has effect upon the making of the application for proceedings.

(c) Duration of application of the stay

(i) Unsecured creditors

90. Many insolvency laws provide for the stay to apply to unsecured creditors for the duration of both liquidation and reorganization proceedings.

(ii) Secured creditors

- Reorganization

91. [74] In some cases it may be desirable for the stay to apply to secured creditors for the duration of the proceedings[1] to ensure that the reorganization can proceed in an orderly manner without the possibility of assets being separated before the reorganization can be finalised. However, to avoid delay and encourage a speedy resolution of the proceedings, there may also be some advantage in limiting the application of the stay to the time that it may reasonably take for a reorganization plan to be approved to avoid application of the stay for an uncertain or unnecessarily lengthy period. Such a limitation may also have the

[1] This provision will be affected by the time at which the insolvency law treats proceedings as completed: under some laws proceedings are treated as completed when the plan is approved (and confirmed where this is required under the insolvency law); under other laws on completion of implementation of the plan.

advantage of providing secured creditors with a degree of certainty and predictability as to the duration of the period of interference with their rights. The difficulty with establishing a fixed time limit, however, is that it may not always be sufficiently long, depending on the size and complexity of the reorganization, and may be difficult to enforce. A solution may be to establish clear time limits, with the possibility of extension (see below). Provision may also be made in an insolvency law for relief from the stay to be provided to secured creditors in certain circumstances. (see below).

- *Liquidation*

92. [72] Some insolvency laws which apply the stay to secured creditors adopt the approach that the stay automatically applies upon commencement of liquidation proceedings but only for a brief period, such as 30 or 60 days, except in those cases where the security is essential to the sale of the business as a going concern (in which case the stay may be extended). This period would allow the insolvency representative to assume its duties and take stock of the assets and liabilities of the estate. Where the secured asset was not required for the sale of the business, the stay could be lifted (see below). Another approach extends the stay to secured creditors for the duration of the liquidation proceedings, subject to a court order for relief where it can be shown that the value of the security is being adversely affected.

(d) Extension of the duration of the stay

93. [73] Where the stay is limited to a specified period, the law may include provision for extension of the stay. This could be on application of the insolvency representative when it can be demonstrated that an extension is required in order to maximize value (e.g. there is a reasonable possibility that the debtor, or business units of the debtor, can be sold as a going concern) provided that secured creditors will not suffer unreasonable harm. To provide additional protection and avoid the stay being applied for an uncertain or unnecessarily lengthy period, an insolvency law may limit the period for which the stay can be extended.

(e) Relief from the stay

94. [81] In liquidation and reorganization proceedings, circumstances may arise where it is appropriate to provide relief from the stay by providing that the secured creditor can apply to the court or that the insolvency representative can be given the power to release the security without approval of the court. Relevant circumstances may include where the secured creditor is not receiving protection for the value of its security, where the provision of protection may not be feasible or would be overly burdensome to the estate; where the security is not needed for the reorganization or sale of the business as a going concern in liquidation; or where the asset is of no value to the estate. There may be other circumstances where it may be appropriate to provide relief from the stay, such as actions involving perishable goods.

95. [82] While provisions on relief from the stay principally address the interests of secured creditors, there are examples of insolvency laws which provide that relief from the stay may be granted to an unsecured creditor. This may be relevant, for example, in those cases where the insolvency law does not allow commencement or continuation of claims, to allow a claim to be determined in another forum where litigation may be well advanced and it would be efficient for it to be completed, or a claim against an insurer of the debtor to be pursued.

5. Protection of secured creditors

96. It is desirable that an insolvency law address the issue of protection of the value of the secured creditor's interest against erosion in value or improper conduct during the period of application of the stay.

97. [76] One of the set of measures designed to address the negative impact of the stay on secured creditors is that directed at maintaining the economic value of secured claims during the period of the stay (in some jurisdictions referred to as "adequate protection"). One approach is to protect the value of the security itself on the understanding that, upon liquidation, the proceeds of sale of the security will be distributed directly to the creditor to the extent of the value of the secured portion of their claim. This approach may require a number of steps to be taken.

98. [77] During the period of the stay it is possible that the value of the creditor's security will diminish. Since, at the time of eventual distribution, the extent to which the secured creditor will receive priority will be limited by the value of the secured asset, such a depreciation can prejudice the secured creditor's interests. Some insolvency laws provide that the insolvency representative should compensate secured creditors for the amount of this diminution either by providing additional or substitute security or making periodic cash payments corresponding to the amount of the diminution in value. This approach is only necessary where the value of the security is less that the amount of the secured claim. If the value exceeds the claim, the secured creditor will not be harmed by the erosion of value until that value becomes insufficient to pay the secured claim. [77] Some countries that preserve the value of the security as outlined also allow for payment of interest during the period of the stay to compensate for delay imposed by the proceedings. Provision of interest may be limited however to the extent that the value of the security exceeds the value of the secured claim. [78] Otherwise, compensation for delay may deplete the assets available to unsecured creditors. [77] Such an approach may encourage lenders to seek adequate security that will exceed the value of their claims.

99. [77] In some liquidation cases the insolvency representative may find it necessary to use or sell encumbered assets (see Part two, chapter II.C) in order to maximize the value of the estate. For example, to the extent that the insolvency representative is of the view that the value of the estate can best be maximized if the business continues to operate for a temporary period, it may wish to sell inventory that is partially encumbered. Thus, in cases where secured creditors are protected by preserving the value of the security, it may be desirable for an insolvency law to allow the insolvency representative the choice of providing the creditor with substitute equivalent security or paying out the full amount of the value of the assets that secure the secured claim.

100. [78] Another approach to protecting the interests of secured creditors is to protect the value of the secured portion of the claim. Immediately upon commencement, the encumbered asset is valued and, based on that valuation, the amount of the secured portion of the creditor's claim is determined. This amount remains fixed throughout the proceedings and, upon distribution following liquidation, the secured creditor receives a first-priority claim to the extent of that amount. During the proceedings, the secured creditor could also receive the contractual rate of interest on the secured portion of the claim to compensate for delay imposed by the proceedings.

101. A further means of protecting the secured asset is to provide for relief from the stay, as noted above (see Part two, chapter III.C), and to allow the secured creditor to enforce its security.

102. [79] The desirability of the types of approaches that provide protection for the security may need to be weighed against the potential complexity and cost of those measures and the need for the court to be able to make difficult commercial decisions on the question of appropriate protection. Where protection is provided, it may be desirable for an insolvency law to provide guidance to determine when and how creditors holding some type of security over the debtor's assets would be entitled to the types of protection described above.

6. Limitations on disposal of assets by the debtor

103. [83] In addition to measures designed to protect the insolvency estate against the actions of creditors and third parties, insolvency laws generally adopt measures which are intended to limit the extent to which the debtor can deal with the assets of the estate, both after an application for commencement is made and after proceedings have commenced. Where an interim insolvency representative is appointed as a provisional measure before commencement of the proceedings, the debtor may be subject to supervision or control of that insolvency representative, and will have limited powers to deal with its assets.

104. Where an insolvency representative is appointed on commencement of the insolvency proceedings, many insolvency laws provide that the debtor will lose either all control of the insolvency estate and will not be able to enter into any transactions after commencement, or will have continuing, but limited, powers in relation to the day-to-day conduct of the business and can enter into transactions in the ordinary course of business. Transactions which do not fall into that category, such as the sale of significant assets, may require authorization by the insolvency representative, the court or in some cases, the creditors.[2] Some insolvency laws address contracts entered into and transactions implemented by the debtor between application and commencement and after commencement that are not authorized, whether by the insolvency law, the insolvency representative, the court or creditors (as required), in terms of avoidance provisions (see Part two, chapter III.E).

Recommendations

Purpose of legislative provisions

The purpose of provisions on protection and preservation of the insolvency estate is to:

(a) provide for the application of measures that will ensure the assets are not diminished by the actions of the [various interested parties] [debtor, creditors or third parties];

(b) determine the scope of those measures and the parties to whom they will apply;

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[2] Further aspects of these transactions are discussed in Part two, chapters III.A.4(b), III.D.7 and IV.

(c) establish the conditions for application of those measures, including method, time and duration of application;
(d) establish the grounds for relief from the application of those measures.

Content of legislative provisions

Provisional measures[3]

(30) [(26)] The insolvency law should provide that the court may grant relief of a provisional nature, at the request of any interested party, [where relief is urgently needed to protect the assets of the debtor or the interests of the creditors,] between the making of an application to commence an insolvency proceeding and commencement of the proceedings, including:

(a) staying execution, enforcement and steps to create valid security rights against the debtor's assets;[4]
(b) entrusting the administration or supervision of the debtor's business [including the power to use and dispose of assets in the ordinary course of business] to an interim insolvency representative or other person designated by the court[, in order to protect and preserve the value of assets];
(c) entrusting the realization of all or part of the debtor's assets[5] to an interim insolvency representative or other person designated by the court, in order to protect and preserve the value of assets that, by their nature or because of other circumstances, are perishable, susceptible to devaluation or otherwise in jeopardy; and
(d) any other relief of the type applicable automatically on commencement of proceedings (recommendation (35)(d)).[6]

(31) The insolvency law should clearly indicate the balance of the [powers][responsibilities] of the debtor and any interim insolvency representative appointed as a provisional measure (recommendation (30)). Between the time of an application for commencement of insolvency proceedings and commencement of those proceedings, the debtor should be able to continue to operate it business and to use and dispose of assets in the ordinary course of business unless those powers have been granted to an interim insolvency representative.

(32) The insolvency law may provide for appropriate notice to be given to those parties affected by a court order for provisional measures.

[3] See Art. 19 UNCITRAL Model Law on Cross-Border Insolvency
[4] The reference to assets is intended to be limited to assets that would be part of the insolvency estate upon commencement of insolvency proceedings.
[5] Ibid.
[6] The application, on a provisional basis, of the relief mentioned in recommendation (35)(d) would be limited to assets that would constitute the insolvency estate once insolvency proceedings were commenced.

Modification or termination of provisional measures

(33) [(34)] The insolvency law should provide that the court, at the request of the insolvency representative or any person affected by provisional measures (of the kind referred to in recommendation (30) ~~and 28)~~), or at its own motion, may modify or terminate those measures [if such modification would not be detrimental to the estate or the interests of creditors and if the party seeking such modification would be harmed by the continuation of such measures].

(34) [(27)] Where provisional measures (of the kind referred to in recommendation (30) are not terminated by the court (recommendation (33)), the insolvency law should provide that they terminate when the measures automatically applicable on commencement (recommendation (35) take effect, unless they are continued by the court (recommendation (36).

Measures automatically applicable on commencement

(35) [(28)] Upon the commencement of an insolvency proceeding, the insolvency law should provide that:

(a) commencement or continuation of individual actions or proceedings[7] concerning the assets of the insolvency estate and the rights, obligations or liabilities of the debtor, including perfection or enforcement of security interests, are stayed except to the extent those individual actions or proceedings [are considered necessary by the court] [may be necessary] to preserve or quantify a claim against the debtor;
(b) execution or other enforcement against the assets of the insolvency estate is stayed;
(c) termination of any contract with the debtor is stayed;[8] and
(d) transfer, encumbrance or other disposition of any assets of the insolvency estate is suspended.[9]

Additional measures available on commencement[10]

(36) [(29)] The insolvency law should provide that, where necessary to protect the interests of the creditors, assets of the debtor, or the ability to reorganize the debtor's business, the court may, following the commencement of an insolvency proceeding, grant

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[7] See Art. 20 UNCITRAL Model Law on Cross-Border Insolvency. It is intended that the individual actions referred to in paragraph (a) of recommendation (35) would also cover actions before an arbitral tribunal. It may not always be possible, however, to implement the automatic stay of arbitral proceedings, such as where the arbitration does not take place in the State but in a foreign location. In any event, the interests of the parties may be a reason to allow the arbitral proceedings to continue, a possibility that is envisaged in paragraph (a).

[8] See Part two, chapter III.D(2)(a) and recommendation (53) [(42)].

[9] The limitation on the right to transfer or dispose of assets of the estate may be subject to an exception for those cases where the continued operation of the business by the debtor is authorised and the debtor can transfer, encumber or otherwise dispose of assets in the ordinary course of business.

[10] See Art. 21 UNCITRAL Model Law on Cross-Border Insolvency.

relief additional to the measures automatically applicable on commencement (of the kind referred to in recommendation (35)).

(37) The insolvency law may provide for appropriate notice of any additional measures ordered by the court to be given to parties affected by those additional measures.

Time and duration of application of measures of protection

(38) [(30)] The insolvency law should clearly state the specific time at which provisional measures (recommendation (30)) and measures automatically applicable on commencement (recommendation (35) become effective.[11]

(39) [(31)] The insolvency law should provide that the measures automatically applicable on commencement of insolvency proceedings (recommendation (35), will apply (subject to recommendation (40) and its application to secured creditors) for the duration of the insolvency proceedings.

Secured creditors

(40) [(32)] The insolvency law should provide that measures automatically applicable on commencement of insolvency proceedings (recommendation (35)) will apply to secured creditors:

(a) in respect of a reorganization proceeding, for the duration of that proceeding;
(b) in respect of a liquidation proceeding, for a period of [*30-60*] days, unless the court extends that period [for an additional […] day period] upon a showing that:
  (i) an extension is necessary to maximize the value of assets for the benefit of creditors; and
  (ii) the secured creditor will not [suffer unreasonable harm] [be harmed] as a result of an extension.

(41) [32)] A secured creditor is entitled to relief from the type of measures automatically applicable on commencement referred to in recommendation (35)(a) and (b) on grounds that may include:

(a) that the secured asset has no value to the estate[12] and is not necessary,
  (i) to a reorganization of the debtor's business that is in prospect; or
  (ii) to a sale of the business as an ongoing business concern that is in prospect;
(b) that, in reorganization, a reorganization plan is not approved within […] days (where the reorganization law includes such a time limitation); or
(c) that the economic value of the secured asset is eroding and the asset is not protected against the erosion of its value.

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[11] E.g. at the time of the making of the order, retrospectively from the commencement of the day on which the order is made or some other specified time.

[12] See also recommendations on burdensome, no value and hard to realize assets: chapter III.C.

~~(d) that there is no reasonable prospect for a reorganization of the debtor's business.~~

(42) [(33)] The insolvency law should address the diminution of the value of secured assets and provide appropriate protections. Where the value of the secured assets exceeds the amount of the secured claim and will be sufficient to meet the secured claim, protection may not be required. Where the value of the secured assets does not exceed the amount of the secured claim or will be insufficient to meet the secured claim if the value of the secured asset erodes, protection ~~against diminution of the value of secured assets~~ may be provided by, for example,

(a) cash payments;
(b) provision of additional security; or
(c) such other means as the court determines will provide appropriate protection.

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Draft legislative guide on insolvency law

Note by the Secretariat

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[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Add.3 and Add.4; Chapter III.A and B appear in documents A/CN.9/WG.V/WP.63/Add.5 and Add.6; Chapter III.D-F and chapters IV-VII appear in subsequent addenda]

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Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.
Recommendation numbers in [..] refer to relevant recommendations in A/CN.9/WG.V/WP.61 and A/CN.9/WG.V/WP.61/Add.1, the previous version of the recommendations. Additions to the recommendations are indicated in this document by underlined text.

Part Two (continued)

III. Treatment of assets on commencement of insolvency proceedings

C. Use and disposition of assets

1. Introduction

105. Although as a general principle it is desirable that an insolvency law not unduly interfere with the ownership rights of third parties or those of secured creditors, the conduct of insolvency proceedings will often require assets of the insolvency estate and assets in the possession of the debtor being used in the debtor's business to continue to be used or disposed of in order to enable the goal of the particular proceedings to be realized. This will be especially important in reorganization, but also in liquidation where the business is to be sold as a going concern. It may also be relevant in some cases of liquidation where the business needs to be continued in liquidation for a short period to enable the value of the assets to be maximized even if they are to be sold off piecemeal. For these reasons, it is desirable that an insolvency law include provisions on the use, lease or disposal of assets of the insolvency estate and third party owned assets, addressing the conditions upon which those assets may be used and the provision of protection for the interests of third party owners and the secured creditors.

2. Assets of the insolvency estate

106. With respect to use and disposition of assets of the insolvency estate, some insolvency laws draw a distinction between the exercise of these powers in the ordinary course of conducting the business of the debtor and their exercise other than in the ordinary course of business in terms of who may exercise the powers and the protections that are required. For example, decisions as to sale, use and lease of property in the ordinary course of business may be taken by the insolvency representative without requiring notice to be given to creditors or a hearing of the court. Where the sale, use or lease is not in the ordinary course of business, approval of the court or of the creditors may be required. Some insolvency laws also distinguish between different types of property in terms of how it may be used and the conditions that will apply. Special provisions may be made, for example, with respect to perishable or other assets that will diminish in value if not sold quickly, or for cash, and property held jointly by the debtor and another person.

(a) Methods of sale

107. Where assets of the insolvency estate are to be sold it is important that they are sold in a manner that will maximize the sale price and that creditors receive adequate notice of the sale. Different approaches are taken to achieving this goal. Many insolvency laws require assets to be sold by auction, with some providing that creditors or the insolvency representative can approve some other means of sale if it will be more profitable. Some insolvency laws give the power of sale to the insolvency representative and impose a duty to obtain the best price reasonably obtainable at the time of sale. Some of those laws also impose limits on the insolvency representative's discretion to choose the method of sale. In cases where the insolvency representative chooses to conduct the sale privately rather than through a public auction, the law may require that the court adequately supervise the sale or that the creditors specifically approve it. Other insolvency laws provide for the court to play a significant role in the sale of assets, with the court fixing the time, the form and the conditions of sale; the insolvency representative plays a subsidiary role in collecting offers and obtaining the views of the creditors. Some insolvency laws also address issues such as sales to a creditor to offset that creditor's claim and sale of the debtor's assets in the possession of a third party to that third party for a reasonable market price.

108. Although it may be suggested that an insolvency law should specifically preclude a sale to related parties to avoid collusion, as long as the sale is adequately supervised an absolute prohibition on such a sale may not be necessary.

(b) Sale of secured assets

109. An insolvency law will need to address the question of disposal of secured assets and whether the insolvency representative or the secured creditor will have the power to sell those assets. To a large extent, the approach adopted will depend upon whether the insolvency law includes secured assets in the insolvency estate; if not the secured creditor will generally be free to enforce its security interest. Where secured assets are included in the estate, insolvency laws take different approaches to this issue, which in some cases depends upon the application of other provisions of the insolvency law such as application of the stay and the insolvency representative's ability to sell secured assets free and clear of interests. It may also depend on the nature of the sale proposed, whether as an individual asset or as an integral part of a sale of the business as a going concern. Some insolvency laws, for example, provide that only the insolvency representative will be able to dispose of such assets in both liquidation and reorganization. Some laws distinguish between liquidation and reorganization; only the insolvency representative will be able to dispose of the assets during reorganization, but in liquidation this ability is time limited. After the expiration of the insolvency representative's exclusive period, the secured creditor may exercise its rights. A further approach depends upon the application of the stay; while the stay applies only the insolvency representative can dispose of the assets.

(c) Ability of the insolvency representative to sell free and clear of interests

110. Some insolvency laws provide that the insolvency representative can sell assets of the estate free and clear of interests, including security interests, subject to certain conditions. These may include that the sale is permitted under general law other than the insolvency law, that the interested party consents to the sale, that the sale price is in excess of the value of the interest or that the interested party could be compelled (in other legal proceedings) to accept cash in settlement of its interest. Some laws also provide that where

the interested party does not consent to the sale, the insolvency representative may apply to the court for authorization of the sale. This may be granted provided the court is satisfied, for example, that the insolvency representative has made reasonable efforts to obtain the consent, that the sale is in the interests of the debtor and its creditors and that the sale will not substantially prejudice the interested party.

(d) Joint assets

111. Where assets are owned by the debtor and another person in some form of joint or co-ownership, different approaches may be taken to sale of the debtor's interest. Where the assets can be divided under the general law between the debtor and the co-owners for the purposes of execution, the insolvency estate's interest can be sold without affecting the co-owners. Some insolvency laws, however, provide that both the estate's interest and the interest of co-owners may be sold by the insolvency representative where certain conditions are met. A sale of both interests may be permitted where, for example, division of the property between the estate and the co-owners is impracticable, where the sale of a divided part would realize significantly less for the estate than a sale of the undivided whole free of the interests of the co-owners, and where the benefit to the estate of such a sale outweighs any detriment to the co-owner. The insolvency law may also provide that the co-owner can purchase the debtor's interest before completion of the sale to another party.

(e) Burdensome, no value and hard to realize assets

112. [51] It may be consistent with the objective of maximizing value and reducing the costs of the proceedings to allow the insolvency representative, subject to approval by the court or creditors, to relinquish the estate's interest in certain assets, including land, shares, contracts and other property, provided such relinquishment does not violate any compelling public interest. Situations in which this approach may be appropriate include where assets have a negative or insignificant value; where assets are not essential to a reorganization; where the asset is burdened in such a way that retention would require excessive expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money; or where the asset is unsaleable or not readily saleable.

(f) Surrender of secured assets

113. [80] Where a security is determined to be valid but the secured assets have no value to the insolvent estate, or cannot be realized in a reasonable period of time by the insolvency representative, the insolvency law may allow the insolvency representative to surrender the secured assets to the secured creditor, with or without court approval.

(g) Receivables

114. Where the assets of the estate include receivables (the debtor's contractual right to payment of a monetary sum), it may be advantageous for the insolvency representative to be able to assign the rights to payment to obtain, for example, value for the estate or credit. Different approaches are taken to the question of assignment in the context of insolvency (see Part two, chapter III.D). [111] Some insolvency laws specify that non-assignment clauses are made null and void by the commencement of insolvency proceedings. Other insolvency laws leave the matter to general contract law. If the contract contains a non-assignment clause then the contract cannot be assigned unless the

agreement of the counterparty or of all parties to the original contract is obtained. Some laws also provide that if the counterparty does not consent to assignment, the insolvency representative may assign with permission from the court if it can be shown that the counterparty is withholding consent unreasonably or if the insolvency representative can demonstrate to the counterparty that the assignee can adequately perform the contract. The insolvency representative is then free to assign the contract for the benefit of the estate. This approach is consistent with the approach taken in the UNCITRAL Convention on the Assignment of Receivables in International Trade (2001), article 9.

3. Third party owned assets

115. [48] Complex issues may be raised in determining whether an asset is owned by the debtor or by another party, and whether assets of a third party that are in the possession of the debtor (subject to use, lease or licensing arrangements) at the time of commencement should be included within the assets of the estate (see Part two, chapter III.A.(3)(a) and the discussion on retention of title arrangements). Irrespective of the answer to that question, there will be insolvency cases where third party owned assets, similarly to secured assets, may be crucial to the continued operation of the business, particularly in reorganization proceedings but also to a lesser extent in some liquidation proceedings. In those cases, it will be advantageous for an insolvency law to provide some mechanism which will enable these assets to be used in the insolvency proceedings. Some insolvency laws address this issue in terms of the types of assets to be included within the scope of the insolvency estate. Other insolvency laws, where the possession of the asset by the debtor is subject to a contractual arrangement, address it in the context of the treatment of contracts. This may include, for example, imposing restrictions on the termination of the contract pursuant to which the debtor holds the assets, preventing the owner from reclaiming its assets in the insolvency (at least without the approval of the court or the insolvency representative) and allowing the insolvency representative to continue to use it (see Part two, chapter III.D).

116. [49] Assets subject to a lease agreement which are being used by the debtor as lessee, where the lessor retains legal title, may require special attention. In countries where arrangements allowing the provider of finance to retain title or ownership of the asset as opposed to a mortgage or security interest are of considerable importance, there may be a need to respect the creditor's legal title in the asset and allow it to be separated from the estate (subject to the rules on treatment of contracts: the right to separate may be limited if, for example, the insolvency representative elects to continue the lease contract). By way of comparison, there are also examples of laws which provide for a court-ordered moratorium that prevents third parties from claiming their assets for a limited period of time after commencement. A balance between these two approaches may be desirable, with a view to achieving maximization of value and ensuring that the sale of the business as a going concern or a reorganization will not be rendered impossible by the free separation of the relevant asset. *[Note to the Working Group: This section is to be aligned with the secured transactions guide – see note in Part two, chapter III.A above at para. 66 under Assets to be affected]* There may also be circumstances where these types of financing arrangements should be scrutinized in order to determine whether the lease is, in fact, a disguised secured lending arrangement. In that case the lessor would be subject to the same restrictions in the insolvency proceedings as the secured lender.

117. Where third party owned assets are used in the insolvency proceedings, an insolvency law may also need to consider protection of the interest of the owner of the assets, much in the same way as appropriate protection is provided for secured creditors. It

is desirable that any benefits conferred on the estate by the continued use of the asset be paid for by the estate as an expense of administering the estate. It is also desirable that an insolvency law provide appropriate protection against diminution of the value of third party-owned assets.

Recommendations

Purpose of legislative provisions

The purpose of provisions on use and disposition of assets is to:

(a) address the manner in which assets may be used and disposed of in the insolvency proceedings, including methods for sale of assets;
(b) establish the limits to powers of use and disposition;
(c) provide for the treatment of burdensome assets, assets determined to be of no value to the insolvency estate and assets which cannot be realised in a reasonable period of time by the insolvency representative. ~~abandonment of burdensome assets and for the surrender of unprofitable securities~~

Content of legislative provisions

Assets of the insolvency estate

(43) [(35)] When continued operation of the business of the debtor is authorized under liquidation or reorganization, the insolvency law should:

(a) permit the insolvency representative to use, sell or lease ~~property~~ assets of the insolvency estate in the ordinary course of business;
(b) permit the insolvency representative to use, sell or lease ~~property~~ assets of the insolvency estate other than in the ordinary course of business, subject to approval by [the court] [creditors] [and in accordance with recommendations on the use of secured assets and third-party assets].

(44) For the purposes of recommendation (43), the insolvency law should provide that assets subject to security interests[1] can be used by the insolvency representative only where those assets will be of benefit to and are necessary for the conduct of the insolvency proceedings.[2]

(45) The insolvency law should address protection of the secured creditor where the insolvency representative uses assets subject to a security interest. The benefits conferred upon the insolvency estate by the use of the assets should be payable as an expense of administering the estate and the secured creditor should be entitled to protection against the diminution in value of the security.

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[1] Recommendation (27) includes secured assets in the insolvency estate.
[2] The use of these assets will be subject to other provisions of the insolvency law including on treatment of contracts.

Assets owned by a third party

(46) [(36)] The insolvency law should permit assets owned by a third party that are not part of the insolvency estate but are in the possession of the debtor at the date of commencement to be used by the insolvency representative where those assets will be of benefit to and are necessary for the conduct of the insolvency proceedings.[3] Where assets owned by a third party are in the possession of the debtor at the time of commencement, the insolvency law should provide for them to be returned to the third party where they will be of no benefit or value to the insolvency estate.

(47) The insolvency law should address protection of the third party owner of assets where the insolvency representative uses those assets. The benefits conferred upon the insolvency estate by the use of the assets should be payable as an expense of administering the estate and the owner of the assets should be entitled to protection against the diminution in value of the assets.

Burdensome, no value and hard to realize assets

(48) [(37)] The insolvency law should permit the insolvency representative to ~~abandon~~ determine the treatment of any assets that are burdensome[4] to the insolvency estate or that are not of benefit to the insolvency estate. In particular, the insolvency law may provide for the insolvency representative to relinquish the estate's interest in the assets [subject to approval by the court or creditors].

(49) [(38)] The insolvency law should permit the insolvency representative [subject to approval of the court or creditors] to ~~surrender~~ return to the secured creditor assets subject to a valid security interest where the asset is determined to be a burden to the insolvency estate or is determined to be of no value to the insolvency estate. The insolvency law [should] [may] also provide that where an asset subject to a valid security interest cannot be realised in a reasonable period of time by the insolvency representative, or where there is a reasonable indication that the secured creditor can sell the asset more easily and at a better price, the asset can be returned to the secured creditor.

Methods of sale of assets

(50) [(39)] The insolvency law should provide for methods of sale that will maximize the value of the assets being sold [outside the ordinary course of business] [whether in liquidation or reorganization], permitting both public auctions and private sales and requiring that adequate notice of any sale be provided to creditors. Private sales should ~~may~~ be subject to [supervision] [approval] by the court or approval by creditors.

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[3] The use of these assets will be subject to other provisions of the insolvency law including on treatment of contracts.

[4] The insolvency law may establish the circumstances in which an asset may be regarded as burdensome, including [51] where the assets have a negative or insignificant value; where the assets are not essential to a reorganization; where the asset is burdened in such a way that retention would require excessive expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money; or where the asset is unsaleable or not readily saleable.

Ability to sell assets of the insolvency estate free and clear of security interests

(51) [(40)] The insolvency law may permit the insolvency representative to sell assets of the insolvency estate free and clear of any security interest ~~of an entity other than the estate~~, provided that:

~~(a) law other than insolvency law permits such a sale;~~
~~(b) the entity consents;~~
(a) the insolvency representative notifies the secured creditor of its intent to sell the secured asset;
(b) the secured creditor is given the opportunity to object to the proposed sale;[5]
(c) relief from the stay has not been granted; and
(d) the priority of interests in the proceeds of sale of the asset is preserved.

[5] In the case of a secured creditor, an objection could generally only be sustained on the basis that it could sell the asset for a greater return than the sale proposed by the insolvency representative.

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Draft legislative guide on insolvency law

Note by the Secretariat

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[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Add.3 and Add.4; Chapter III. A-C appear in documents A/CN.9/WG.V/WP.63/Adds.5-7; Chapter III.E-F and chapters IV-VII appear in subsequent addenda]

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Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.
Recommendation numbers in [..] refer to relevant recommendations in A/CN.9/WG.V/WP.61 and A/CN.9/WG.V/WP.61/Add.1, the previous version of the recommendations. Additions to the recommendations are indicated in this document by underlined text.

Part Two (continued)

III. Treatment of assets on commencement of insolvency proceedings

D. Treatment of contracts

1. Introduction

118. [86] As an economy develops, more and more of its wealth is likely to be contained in or controlled by contracts, rather than contained in land. As a result, the treatment of contracts in insolvency is of overriding importance. There are two overall difficulties in developing legal policies in that regard. The first difficulty is that contracts are unlike all other assets of the insolvency estate in that usually they are tied to liabilities or claims. That is, it is often the case that the estate must perform or pay in order to enjoy the rights that are potentially valuable assets. The result is that difficult decisions must be made about the treatment of a contract so as to produce the most value for the estate. [89] A second difficulty is that contracts are of many different types. They include simple contracts for the sale of goods; short-term or long-term leases of land or of personal property; and immensely complicated contracts for franchises or for the construction and operation of major facilities, among many others. Additionally, the debtor could be involved in the contract as buyer or seller, lessor or lessee, licensor or licensee, provider or receiver and the problems presented in insolvency may be very different when viewed from different sides.

119. [87] Achieving the objectives of maximizing the value of the estate and reducing liabilities and, in reorganization, enabling the entity to survive and continue its affairs to the maximum extent possible in an uninterrupted manner may involve taking advantage of those contracts that are beneficial and contribute value, and rejecting those which are burdensome, or those where the ongoing cost exceeds the benefit of the contract. As an example, in a contract where the debtor has agreed to purchase particular goods at a price which is half the market price at the time of the insolvency, obviously it would be advantageous to the insolvency representative to continue to purchase at the lower price and sell at the market price. The counterparty would naturally like to get out of what is now an unprofitable agreement, but in many systems it will not be permitted to do so, although it may be entitled to an assurance that it will be paid the contract price in full. In many examples, continuation of the contract will be beneficial to both contracting parties, not just to the debtor.

120. [88] Deciding how contracts are to be treated in insolvency raises an initial question of the relative weight to be attached to upholding general contract law in insolvency on the one hand and the factors justifying interference with those established

contractual principles on the other. There are a number of competing interests which may need to be balanced. These include the extent to which public policy goals outweigh the need for predictability and the particular social concerns raised by some types of contracts such as labour contracts (see below); the effect of interfering with the terms of unperformed contracts on the predictability of commercial and financial relations, and on the cost and availability of credit (the wider the powers to continue [adopt] or reject contracts in insolvency, the higher the cost and the lower the availability of credit is likely to be); as well as the extent to which interfering with contracts will enhance the recycling of economic assets.

121. [88] Where the insolvency law adopts the approach of permitting interference with general contractual principles, further considerations are the extent of the interference that is permitted and the types of contracts that can be affected. [para 84] It is almost inevitable that at the commencement of insolvency proceedings, the debtor will be a party to at least one contract where the debtor and the counterparty have remaining obligations to be performed other than the payment of money, such as the contract price for goods delivered. [85] No special rules are required for the situation where only one party has not fully performed its obligations. If it is the debtor that has not fully performed, the other party will have a claim for performance or damages which it can submit in the insolvency (see Part two, chapter VI.A). If it is the counterparty that has not fully performed its obligations, the insolvency representative can demand performance or damages from that party. However, where both parties have not fully performed their obligations, it is a common feature of many insolvency laws that in defined circumstances, those contracts will continue or can be rejected (or possibly assigned, although this is not widely permitted). Typically, the insolvency representative is charged with making this evaluation. In some jurisdictions, court approval is also required.

122. [88] As to the types of contracts to be affected, a common solution is for insolvency laws to provide general rules for all kinds of contracts and exceptions for certain special contracts. The ability to reject labour contracts, for example, may need to be limited in view of concerns that liquidation can be used as a means of expressly eliminating the protections afforded to employees by such contracts. Other types of contracts requiring special treatment may include financial market transactions (see Part two, chapter III.F) and contracts for personal services, where the identity of the party to perform the agreement, whether the debtor itself or an employee of the debtor, is of particular importance.

2. Continuation [adoption]

123. [95] In reorganization, where the objective of the proceedings is to enable the entity to survive and continue its affairs to the extent possible, the continuation of contracts that are beneficial or essential to the business and contribute value may be crucial to the success of the proceedings.

124. [100] In liquidation, the desirability of contracts continuing after commencement of proceedings is likely to be less important than in reorganization, except where the contract may add value to the business or to a particular asset or promote the sale of the business as a going concern. A lease agreement, for example, where the rental is below market price and the remaining term is substantial, may prove central to any proposed sale of the business or may be sold to produce value for creditors.

(a) Automatic termination clauses

125. [96] Many contracts include a clause providing that commencement of insolvency proceedings or other indication of financial distress constitutes an event of default that gives the counterparty an unconditional right, for example, of termination or acceleration, or some other right. Some laws uphold the validity of these clauses for the benefit of the estate and where the insolvency representative wants a contract to continue after commencement of proceedings, this will only be possible if the counterparty does not elect, or can be persuaded not to elect, to terminate or accelerate the contract. In these corcumstances, where a counterparty can terminate a contract, an insolvency law may provide a mechanism that can be used to persuade the counterparty to allow the contract to continue, such as establishing a priority for payment for services provided after commencement of the proceedings (in some insolvency laws this may exist as a general provision which typically treats costs incurred after the commencement of proceedings as a first priority).

126. [97] The approach of upholding these types of termination clauses may be supported by a number of factors including: the desirability of respecting commercial bargains; the need to prevent the debtor from selectively performing contracts which are profitable and cancelling others (an advantage which is not available to the innocent counterparty); the effect on financial contract netting of not upholding an automatic termination provision; the belief that since an insolvent business will generally be unable to pay, delaying the termination of contracts potentially only increases existing levels of debt; the need for creators of intellectual property to be able to control the use of that property; and the effect on the counterparty's business of termination of a contract with respect to an intangible.

127. [98] Another approach provides that the insolvency representative can continue or adopt a contract over the objection of the counterparty, that is, any event of default, such as commencement of insolvency proceedings, which would give rise to a right to terminate or accelerate the contract is overridden by operation of the insolvency law. Permitting these termination and acceleration clauses to be overridden in reorganization proceedings may be crucial to the success of the proceedings where, for example, the contract is a critical lease or involves the use of intellectual property embedded in a key product. It may also enhance the earnings potential of the business; reduce the bargaining power of an essential supplier; capture the value of the debtor's contracts for the benefit of creditors and assist in locking all creditors into the reorganization. Where an insolvency law provides that termination clauses can be overridden, creditors may be tempted to take pre-emptive action to avoid that outcome by terminating the contract on some other ground before the application for insolvency proceedings is made (assuming a default by the debtor other than one triggered by commencement of the proceedings). Such a result may be mitigated by providing that the insolvency representative has the power to reinstate those contracts, provided both pre- and post-commencement obligations are fulfilled.

128. [101] In liquidation, the arguments in favour of overriding termination clauses include the need to keep the business together to maximize its sale value or to enhance its earnings potential; to capture the value of the contract for the benefit of all creditors rather than forfeiting it to the counterparty; and the desirability of locking all parties into the final disposition of the business.

129. [99] Although some jurisdictions have implemented provisions allowing termination clauses to be overridden, these provisions have not yet become a general

feature of insolvency laws. There is an inherent tension between promoting the debtor's survival, which may require the preservation of contracts, and injecting unpredictability and extra cost into commercial dealings by creating a variety of exceptions to the general rules. While this issue is one which may require a careful weighing of the advantages and disadvantages there are, nevertheless, circumstances where the ability of the insolvency representative to ensure that a contract continues will be crucial to the conduct and successful implementation of reorganization and also, but perhaps to a lesser extent, liquidation where the business is to be sold as a going concern. Any negative impact of a policy of overriding termination clauses can be balanced by providing compensation to creditors who can demonstrate that they have suffered damage or loss as a result of the contract continuing after commencement of proceedings.

(b) Procedure for continuation of contracts

130. [92] Insolvency laws adopt different approaches to continuation, or in some cases adoption, of contracts. Under some laws, contracts are unaffected by the commencement of insolvency proceedings so that contractual obligations remain binding and the general rules of contract law will continue to apply unless the insolvency law expressly provides for different rules to be applied, as in the case of automatic termination clauses (see above). [91] Some insolvency laws, however, require the insolvency representative to make a decision as to whether the contract is required and will continue, and set a deadline by which this decision must be taken. Failure to act within the specified time results in the contract being treated as rejected. Where this approach is adopted, a distinction between liquidation and reorganization might be made. In liquidation, it may be possible to provide for contracts to be automatically terminated unless the insolvency representative takes action within a specified time period to preserve a contract. In reorganization, however, more flexibility might be required to avoid a situation where the failure to take a timely decision deprives the estate of a contract that might be crucial for the procedure. One disadvantage of this approach is that in practice there may be many cases where no decision as to the contract can be taken because the contract cannot be performed, and to require an explicit choice to be made on each contract could result in an excessively costly and cumbersome procedure.

131. [92] Whatever rules are adopted with respect to the continuation of contracts, it is desirable that any rights of the insolvency representative should be limited to the contract as a whole, thus avoiding a situation where the insolvency representative could choose to continue or adopt certain parts of a contract and reject others. It is also desirable that the insolvency representative's power with respect to contracts is limited to the relevant types of contracts that are known to the insolvency representative or the court (where the court is involved in making determinations with respect to contracts). If this limitation is not adopted, the consequences of failure to take a decision with respect to a contract the existence of which is not known to the insolvency representative might lead to claims for damages and possible professional liability.

(c) Continuation of contracts where the debtor is in default

132. [93] Where the debtor is in default under a contract at the time of the application for insolvency, the policy issue is whether it is fair to require the counterparty to continue to deal with an insolvent debtor when there was already a pre-insolvency default. Some insolvency laws require, as a condition of a contract continuating, that the insolvency representative cure any defaults under the contract and provide assurance as to future performance by providing, for example, a bond or guarantee. Other insolvency laws do not

require past defaults to be cured, but may impose restrictions as to the circumstances in which this approach is possible, for example, contracts which can be divided into severable units, such as contracts for the supply of utilities. The insolvency representative may be required to give assurances of future performance and in some cases accept personal liability in the event of future default.

(d) Claims arising from continuing contracts

133. [94] Contracts that continue after commencement are treated as ongoing post-commencement obligations of the debtor that must be performed. Claims arising from the performance of the contract after the commencement of insolvency proceedings are treated in a number of insolvency laws as an administrative expense (see Part two, chapter VI.A) as opposed to an unsecured claim and given priority in distribution. Since the granting of such a priority constitutes a potential risk for other creditors (who will be paid after the priority creditors), it is desirable that only contracts that will be profitable or essential to the continued operation of the debtor continue after commencement of insolvency proceedings. Other insolvency laws provide no priority for such claims and they will rank with other unsecured claims.

(e) Amendment of continuing contracts

134. [88] A further issue to be considered is the circumstances in which an insolvency representative may alter the terms and conditions of contracts that continue after commencement. Where a contract continues, the terms and conditions of the contract must be respected. As a general principle, the insolvency representative will have no greater rights in respect of amendment of the contract than the debtor itself would normally have. This will require the insolvency representative to negotiate any amendment with the counterparty, and any modification without the consent of that other party, will constitute a breach of contract for which the counterparty may claim damages.

(f) Exceptions to the power to continue contracts

135. [102] Exceptions to the power of the insolvency representative to decide a contract should continue generally fall into two categories. In respect of the first, where the insolvency representative has the power to override automatic termination provisions, specific exceptions may be made for contracts such as short-term financial contracts (e.g. swap and futures agreements – see Part two, chapter III.F). The second category relates to those contracts where, irrespective of how the insolvency law treats automatic termination provisions, the contract cannot continue because it provides for performance by the debtor or an employee of the debtor of irreplaceable personal services (the contract may involve, for example, particular intellectual property, services involving a partnership agreement, provision of services by a person with highly specialised skills, or by a named person with a particular skill).

3. Rejection

136. [103] For the general reasons discussed in the introduction above, it is desirable that an insolvency representative has the power to reject a contract in which both parties have not fully performed their obligations. [91] It is also desirable that any right to reject a contract should be limited to the contract as a whole, thus avoiding a situation where the insolvency representative could choose to continue certain parts of a contract and reject others.

137. [107] In reorganization, the prospects of success may be enhanced by allowing the insolvency representative to reject burdensome contracts, such as those contracts where the cost of performance is higher than the benefits to be received or, in the case, for example, of an unexpired lease, the contract rate exceeds the market rate.

(a) Rejection procedure

138. [104] As in the case of continuation of contracts different mechanisms may be used to reject a contract. Many laws link continuation and rejection in a common procedure which provides, for example, that the insolvency representative is required to take action with respect to a contract, such as by providing notice to the counterparty that the contract is to continue or be rejected. Some laws require the notice to be given within a specified period of time. Unless this time limit is included, this approach may not achieve the key objectives of certainty, predictability and efficient progress of the proceedings if the insolvency representative does not take timely action and allows the matter to continue unresolved for some time. Where the contract in question involves an ongoing service, failure by the insolvency representative to act may also lead to the accrual of unnecessary expense (e.g. rent for real or personal property which is leased by the debtor can be a significant administrative cost if a lease is not promptly terminated), or to the provision of an essential service being terminated (where the insolvency representative is required to promptly decide that a contract should continue).

139. [105] Under a second approach the contract may be regarded as automatically rejected if the insolvency representative does not decide, within a specified time period, that it should continue. The time period may be longer in reorganization than in liquidation. This approach is aimed at ensuring certainty for both parties. It requires the insolvency representative to take timely action with respect to contracts outstanding at the time of commencement and offers the counterparty some certainty as to the continued existence of the contract within a reasonable period after commencement. Some laws also provide that the counterparty can request the insolvency representative to make a decision on a particular contract within a specified time or apply to the court to require that decision to be made; where no decision is made in those circumstances, the contract may be treated as rejected.

140. [108] As noted above with respect to continuation, it may be appropriate to draw a distinction between liquidation and reorganization in terms of providing for a default position that a contract is rejected. While in liquidation it may be reasonable to assume that the failure of the insolvency representative to take a decision with respect to a contract would most likely imply a decision to reject, the same assumption may not always be appropriate in reorganization. In reorganization, it may be appropriate to allow the insolvency representative to make a decision as to rejection up to the time of approval of the reorganization plan, provided that any benefit received under the contract is paid for up to the time of rejection as an administrative expense and that the counterparty has the

ability to compel an earlier decision where it is required or desired. It is desirable that treatment of specific contracts is addressed clearly in the plan, with perhaps a provision that contracts not so addressed should be treated as automatically rejected on approval of the plan.

(b) Effect of rejection on the counterparty

141. [106] Pending continuation or rejection of a contract, it is desirable that the insolvency estate be required to pay for any benefits received under the contract. Where a contract is rejected, the counterparty is excused from performing the remainder of the contract and the only serious issue to be determined is calculation of the unsecured damages that result from the rejection. The counterparty becomes an unsecured creditor with a claim equal to that amount of damages. Where a contract has been performed for a period of time during the insolvency proceedings before being rejected, the counterparty may have claims both for the period before rejection (which may rank as an administrative claim)[1] and for the damages resulting from the rejection. Where the contract continues, both the estate and the counterparty will be obliged to perform the terms of the contract.

(c) Exceptions to the power to reject

142. [109] Irrespective of the extent of the rejection powers given to an insolvency representative, exceptions may be needed for certain contracts. One important exception to the power to reject is labour contracts (see Part two, chapter III.D.6) and certain financial contracts (see Part two, chapter III.F). A similar limitation may appropriately be applied to the case of agreements where the debtor is a lessor or franchisor, or a licensor of intellectual property and termination of the agreement would end or seriously affect the business of the counterparty, particularly where the advantage to the debtor may be relatively minor.

4. Leases

143. Some insolvency laws include specific provisions on unexpired leases. Under some laws, a lease of which the debtor is the lessee can be rejected without reference to the expiry date of the lease, provided the notice periods in the law or the lease are observed. Rejection would give rise to a claim by the lessor for compensation for premature termination. Where the debtor is a lessee and its lease is to continue, it may be appropriate for certain conditions to be imposed on the insolvency estate, such as that the insolvency representative must cure any default, provide compensation for any harm arising from such a default and provide assurance as to future performance under the lease. [109] It may also be desirable to set a ceiling on damages claimed by the lessor (which may be a monetary amount or a specified period of time in respect of which damages may be payable) so that the claim under a long-term lease does not overwhelm the claims of other creditors. Lessors ordinarily will have the opportunity to mitigate losses by re-letting the property.

5. Assignment

144. [110] The ability of the insolvency representative to elect to assign contracts notwithstanding insolvency-triggered termination provisions or restrictions on transfer contained in the contract can have significant benefits to the estate, and therefore to the

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[1] See Part two, chapter VI.C on ranking of claims.

beneficiaries of the proceeds of distribution following liquidation or as part of a reorganization. [111] While the ability to assign is considered of critical importance to the liquidation proceedings of some countries, in other countries it is entirely foreign and is precluded. [110] There may be circumstances, such as where the contract price is lower than the market value, where rejection of the contract may result in a windfall for the counterparty. If the contract can be assigned, the insolvency estate rather than the counterparty will benefit from the difference between the contract and market prices.

145. [111] However, providing for assignment of a contract against the terms of the contract may undermine the contractual rights of the counterparty and raise issues of prejudice, especially where the counterparty has little or no say in the selection of the assignee, [97] and the undesirability of compelling the transfer of a contract to a transferee who may not be known to the counterparty or with whom the counterparty may not wish to do business. Different approaches are taken to this issue. Some insolvency laws specify that non-assignment clauses are made null and void by the commencement of insolvency proceedings. Other insolvency laws leave the matter to general contract law; if the contract contains a non-assignment clause then the contract cannot be assigned unless the agreement of the counterparty or of all parties to the original contract is obtained. Some laws also provide that if the counterparty does not consent to assignment, the insolvency representative may assign with permission from the court if it can be shown that the counterparty is withholding consent unreasonably or if the insolvency representative can demonstrate to the counterparty that the assignee can adequately perform the contract. The insolvency representative is then free to assign the contract for the benefit of the estate.[2]

146. [112] Irrespective of the powers of the insolvency representative to assign contracts, some contracts cannot be assigned because they require the performance of irreplaceable personal services or because assignment is prevented by the operation of law. Some countries, for example, prevent the assignment of government procurement contracts.

6. General exceptions to the power to continue [adopt], reject and assign contracts

147. [112] A number of specific exceptions to the powers discussed in this section have been mentioned above. However, an insolvency law may need to consider general exceptions for some types of contracts not only to these powers but also to the application of other provisions of the insolvency law. Exceptions relating to financial contracts, netting and set-off are discussed in Part two, chapter III.F.

- *Labour contracts*

148. [113] One important exception to the powers discussed in this section is that of labour contracts. Although particularly relevant to reorganization, such contracts are also relevant in liquidation where the insolvency representative is attempting to sell the entity as a going concern. A higher price may be obtained if the insolvency representative is able to terminate onerous labour contracts or to achieve necessary downsizing of the labour force of the debtor. However, the relationship between employee and employer raises some of the most difficult questions in insolvency law. It is not simply the contract itself, which in essence is a pending contract like any other, but the usually mandatory provisions of non-insolvency law that protect the position of employees. These may relate to, for

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[2] This approach is consistent, for example, with the approach taken in the UNCITRAL Convention on the Assignment of Receivables in International Trade (2001), article 9.

example, unfair dismissal; minimum rates of pay; paid leave; maximum work periods; maternity leave; equal treatment and non-discrimination. The difficult question is generally the extent to which these provisions will impact upon the insolvency, raising issues that are much broader than termination of the contract and priority of monetary claims in respect of unpaid wages and benefits (see Part two, chapter VI.A and C). For these reasons, a number of countries have adopted special regimes to deal with the protection of employees' claims in insolvency and, in order to avoid insolvency proceedings being used as a means of eliminating employee protection, specifically limit the insolvency representative's ability to reject labour contracts. This approach may include limiting the use of the powers to certain specified circumstances such as where the employees remuneration is excessive in comparison to what the average employee would receive for the same work. In some countries the law provides for employees to follow the business in case of sale as a going concern in both liquidation and reorganization, in others only in reorganization.

149. [114] To enhance the transparency of the insolvency regime, it is desirable that the limitations on the powers of the insolvency representative to deal with these types of contracts are stated clearly in the insolvency law.

7. Post-commencement contracts

150. [114] A second category of contracts in insolvency are those entered into after the insolvency has commenced. In reorganization and where the business is to be sold as a going concern in liquidation, there will often be a need for contracts to be entered into (both in the ordinary course of business and otherwise) to maintain the business as a going concern and enable it to continue earning for the ultimate benefit of creditors. These contracts are generally regarded as post-commencement obligations of the estate and [90] breach of a contract in that category is usually a first claim on the available funds and therefore is paid in full as an expense of the insolvency administration (see Part two, chapter VI.C).

Recommendations

Purpose of legislative provisions

The purpose of provisions on treatment of contracts is to:

(a) establish the manner in which contracts, under which both ~~that have not or not fully been performed by either~~ the debtor and its counterparty have not yet fully performed their respective obligations, should be addressed in the insolvency law, including the relationship between the insolvency law and general contract law, with the objective of maximizing the value and reducing the liabilities of the estate;

(b) define the scope of the powers to deal with these contracts and the situations in which [and by whom] these powers may be exercised;

(c) identify the types of contracts that should be excluded from the exercise of these powers.

Content of legislative provisions

(52) [(41)] The insolvency law should address the treatment of contracts under which both ~~that have not or not fully been performed by either~~ the debtor and its counterparty have not yet fully performed their respective obligations.

Automatic termination clauses

(53) [(42)] The insolvency law [may] [should] render unenforceable [as against the insolvency representative] any contract provision that would provide a right to terminate a contract upon, or identify as an event of default:

(a) an application for commencement, or commencement, of insolvency proceedings;
(b) the appointment of an insolvency representative;
(c) the fact that the debtor satisfies the criteria for commencement of insolvency proceedings; or
(d) indications that the debtor is in a weakened financial position.

Continuation

(54) [(43)] The insolvency law should provide that the insolvency representative can [decide to] continue a contract where continuation would be beneficial to the insolvency estate.[3]

Where a continued contract is subsequently breached

(55) [(45)] Where a contract continues after commencement of proceedings, the insolvency law should provide that all terms of the contract are enforceable (except automatic termination clauses as provided in recommendation (53)) and damages for the subsequent breach of that contract by the insolvency representative should be payable as an expense of administering the estate.

Continuation of contracts where the debtor is in breach

(56) [(46)] Where the debtor is in default under a contract at the time of commencement of proceedings, and the insolvency representative seeks to continue that contract, the insolvency law may take different approaches to the issue of curing the breach:

(a) the insolvency representative may have the power to [decide to] continue that contract, provided the default [is] [is capable of being] cured and the non-breaching counterparty is returned to the position it was in before the breach, and the insolvency representative gives appropriate assurances as to the [debtor's][insolvency estate's] ability to perform under the continued contract;

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[3] Provided the automatic stay on commencement of proceedings applies to prevent termination (pursuant to an automatic termination clause) of contracts with the debtor, all contracts should remain in place to enable the insolvency representative to consider the possibility of continuation.

[(b) the insolvency representative may have the power to [decide to] continue certain contracts [for example, those that can be divided into severable parts, such as for the provision of utilities] without having to cure the breach, provided the insolvency representative gives assurance as to satisfaction of post-commencement claims arising from the contract. The counterparty [should submit][will have] a pre-commencement claim in respect of the default.]

Rejection

(57) [(47)] The insolvency law should provide that the insolvency representative can [decide to reject a contract that is burdensome[4] to the insolvency estate.

(58) [(44)] In the period after the commencement of an insolvency proceeding, and before a contract is rejected, the insolvency law should provide that if the counterparty has performed to the benefit of the insolvency estate, the benefits conferred upon the insolvency estate pursuant to the contract are payable as an expense of administering the estate.[5]

(59) Where a contract is rejected, the insolvency law should provide for the counterparty to be notified of the rejection and of its rights in respect to making a claim (in particular the time in which the claim should be made).

(60) [(48)] Where a contract is rejected, the insolvency law should provide that the rejection gives rise to a [ordinary unsecured] [pre-commencement] claim for the damages arising from the rejection, which would be determined in accordance with the general rules on damages. Claims relating to the rejection of a long-term contract may be limited by the insolvency law.

(61) [(49)] Where the insolvency representative decides to reject a contract, the insolvency law should indicate the time at ~~date on~~ which the rejection will be effective.

Timing of continuation and rejection

(62) [(50)] The insolvency law may provide a time limit within which the insolvency representative is to decide to continue (where the insolvency law requires a specific decision for a contract to continue)or reject a contract, which time period may be extended by the court. The insolvency law may specify the consequences of the failure of the insolvency representative to act.

(63) [Notwithstanding recommendation (62),] the insolvency law should permit a counterparty to request the insolvency representative to take prompt action to make a decision with respect to a contract where the counterparty can demonstrate prejudice as a consequence of the delay.

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[4] The insolvency law may establish the circumstances in which an asset may be regarded as burdensome, including [51] where the assets have a negative or insignificant value; where the assets are not essential to a reorganization; where the asset is burdened in such a way that retention would require excessive expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money; or where the asset is unsaleable or not readily saleable.

[5] See Part two, chapter VI.C.

Assignment of contracts

Variant A

[(64) [(51)] The insolvency law need not provide rules relating to assignment of contracts if this issue is addressed by other law, such as general contract law, and it is considered that such issues should be determined by the application of that other law.]

(65) [(52)] Where it is considered desirable to include special provisions relating to assignment of contracts in the insolvency law, the insolvency law might provide that the insolvency representative can [decide to] assign a contract, notwithstanding restrictions in the contract.

(66) [(53)] Where the counterparty objects to assignment of a contract, the insolvency law may provide that the court can nonetheless approve the assignment [if] [provided]:

(a) the assignee can perform the contractual obligations;

(b) the counterparty [does not suffer unreasonable harm as a result of] [is not disadvantaged by] the assignment; [and]

(c) the assignment is necessary for [or of benefit to] the reorganization of the debtor or the sale of the debtor's business as a going concern in liquidation.

Variant B

(51) The insolvency law [may][should] provide that the insolvency representative can [elect to] assign a contract that has been continued.

(52) Where the counterparty objects to assignment of a contract, the insolvency law may provide that the court can nonetheless approve the assignment [if] [provided]:

(a) the assignee can perform the contractual obligations;

(b) the counterparty [does not suffer unreasonable harm as a result of] [is not disadvantaged by] the assignment;

(c) the assignment is necessary for the reorganization of the debtor.

Special treatment of certain contracts

(67) [(54)] The insolvency law may provide special rules for the treatment of labour, financial, intellectual property and […] contracts.[6]

[6] For treatment of financial and related contracts, see Part two, chapter III.F.

Review of decisions concerning treatment of contracts

(55) The insolvency law should permit interested parties to seek judicial review of decisions taken by the insolvency representative with respect to continuation and rejection. Grounds for review may include: […].[7]

Post-commencement contracts

(68) The insolvency law should provide that contracts entered into in the ordinary course of business after the commencement of insolvency proceedings will be regarded as post-commencement obligations of the insolvency estate. Claims arising from those contracts should be treated as an administrative expense.

[7] NOTE TO THE WORKING GROUP: The Working Group may wish to consider whether this type of provision should be included under each topic heading (see for e.g. recommendations (64), (83)) or as a general provision perhaps under chapter IV, section B on "The Insolvency Representative" along the following lines:

The insolvency law need not provide rules relating to the right of interested parties to seek review of decisions taken by the insolvency representative in the administration of the proceedings if that right to review exists under other law and it is considered that that issue should be determined by the application of that other law. Where it is considered desirable for reasons of clarity and transparency to include special provisions in the insolvency law, the insolvency law might provide also the grounds upon which such a review might be sought.

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Draft legislative guide on insolvency law

Note by the Secretariat

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[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Add.3 and Add.4; Chapter III.A-D appear in documents A/CN.9/WG.V/WP.63/Adds.5-8; Chapters IV-VII appear in subsequent addenda]

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Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.
Recommendation numbers in [..] refer to relevant recommendations in A/CN.9/WG.V/WP.61 and A/CN.9/WG.V/WP.61/Add.1, the previous version of the recommendations. Additions to the recommendations are indicated in this document by underlined text.

Part Two (continued)

III. Treatment of assets on commencement of insolvency proceedings

E. Avoidance proceedings

1. Introduction

151. [124] Insolvency proceedings (both liquidation and reorganization) may commence at lengthy periods after a debtor first becomes aware that such an outcome cannot be avoided. In that intervening period, there may be significant opportunities for the debtor to attempt to hide assets from creditors, incur artificial liabilities, make donations to relatives and friends, or pay certain creditors to the exclusion of others or for creditors to initiate strategic action to place themselves in an advantageous position. The result of such activities, in terms of the eventual insolvency proceedings, is to disadvantage ordinary unsecured creditors who were not party to such actions and do not have the protection of security, and to undermine the key objective of equal treatment of similarly situated creditors.

152. [131] The use of the word “transaction” in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, a security, a guarantee, a loan or a release.

153. [125] Many insolvency laws include provisions which apply retrospectively and are designed to overturn those past transactions to which the insolvent debtor was a party or which involved the debtor’s property where they have certain effects. These include reducing the net worth of the debtor (for example, by gifting of its assets or transferring or selling assets for less than their fair commercial value); or upsetting the principle of equal

sharing between creditors of the same class (for example, by payment of a debt to an unsecured creditor or granting a security to a creditor who is otherwise unsecured when other unsecured creditors remain unpaid and unsecured). Many non-insolvency laws also address these types of transactions which are detrimental to creditors outside of insolvency, but they may also be relevant in insolvency. In some cases, the insolvency representative will be able to use those non-insolvency laws in addition to the provisions of the insolvency law.

154. [133] Transactions typically are made avoidable in insolvency for several reasons, including: to prevent fraud (for example, transactions designed to hide assets for the later benefit of the debtor or to benefit the officers, owners or directors of the debtor); to uphold the generally enforcement of creditors' rights; to ensure equitable treatment of all creditors by preventing favouritism where the debtor wishes to advantage certain creditors at the expense of the rest; to prevent a sudden loss of value from the business entity just before the supervision of the insolvency proceedings is imposed; and, in some countries, to create a framework for encouraging out-of-court settlement—creditors will know that last-minute transactions or seizures of assets can be set aside and therefore will be more likely to work with debtors to arrive at workable settlements without court intervention.

155. [125] The principal goals of avoidance powers are to preserve the integrity of the insolvency estate and ensure that creditors receive a fair allocation of an insolvent debtor's assets consistent with established priorities for payment. Notwithstanding this goal, it is important to bear in mind that many of the transactions that may be subject to avoidance powers are perfectly normal and acceptable when they occur outside an insolvency context, but become suspect when they occur in proximity to the commencement of insolvency proceedings. Avoidance powers are not intended to replace or otherwise affect other devices for the protection of interests of creditors that would be available under general civil or commercial law.

156. [126] Avoidance rules are much discussed, principally as to their effectiveness in practice and the somewhat arbitrary rules that are necessary to define, for example, relevant time periods and the nature of the transactions to be included. Nevertheless, avoidance provisions can be important to an insolvency law not only because the policy upon which they are based is sound, but also because they may result in recovery of assets or their value for the benefit of creditors generally, and because provisions of this nature help to create a code of fair commercial conduct and are part of appropriate standards for the governance of commercial entities.

157. [127] As is the case with a number of the core provisions of an insolvency law, the design of avoidance provisions requires a balance to be reached between competing social benefits such as, one the one hand, the need for strong powers to maximize the value of the estate for the benefit of all creditors and on the other hand, the possible undermining of contractual predictability and certainty. Even where an insolvency law adopts broad avoidance powers, the exercise of these powers can be subject to clear criteria which can assist in providing commercial certainty and predictability.

2. Avoidance criteria

158. [128] Approaches to establishing the criteria for avoidance actions vary considerably among insolvency laws in terms of specific criteria and how they are combined in each law. In terms of the applicable criteria, they can be grouped broadly as objective and subjective criteria.

159. [128] One approach emphasizes the reliance on generalized, objective criteria for determining whether transactions are avoidable. The question would be, for example, whether the transaction took place within a specified period prior to the application for commencement or the commencement of the insolvency proceedings (often referred to as the "suspect period") or whether the transaction evidenced any of a number of general characteristics set forth in the law (e.g. provision of appropriate value for the assets transferred or the obligation incurred, whether the debt was mature or the obligation due or the relationship between the parties to the transaction). While generalized criteria may be simple to apply, they can also have arbitrary results if relied upon exclusively. So, for example, legitimate and useful transactions that fall within the specified period might be avoided, while fraudulent or preferential transactions that fall outside the period are protected.

160. [129] Another approach emphasizes case-specific, subjective criteria such as whether there is evidence of intention to hide assets from creditors, whether the debtor had ceased making payments when the transaction took place or became unable to make payments as a result of the transaction, whether the transaction was unfair in relation to certain creditors and whether the counterparty knew that the debtor had ceased making payments. This individualized approach may require consideration in some detail of the intent of the parties to the transaction and of other factors such as the debtor's financial circumstances and what constitutes the normal course of business between the debtor and particular creditors.

161. Very few insolvency laws rely solely on subjective criteria as the basis of avoidance provisions; they are generally combined with time periods within which the transactions must have occurred. [129] In some countries a heavy reliance upon subjective criteria has led to considerable litigation and extensive cost to the insolvency estate. In order to avoid these costs, some laws have adopted a strictly objective approach of a short suspect period, such as three to four months. In some cases, this short suspect period has been combined with an arbitrary rule that all transactions occurring within that period would be suspect unless there was a roughly contemporaneous exchange of value between the parties to the transaction. A number of insolvency laws combine these different approaches to address different types of transactions. For example, preferential transactions and undervalued transactions may be defined by reference to objective criteria, while transactions aimed at defeating or hindering creditors will be defined by reference to the more subjective elements involving questions of intent. One insolvency law that adopts a combination of objective and subjective elements provides, for example, that transactions such as gifts, security for existing debts and extraordinary payments (those that have not been made with the usual means of payment or before the due time) can be avoided where they are made within three months prior to commencement. Other transactions can be set aside if the debtor has ceased making payments, the transaction is unfair or improper in relation to a group of creditors and the counterparty knew that the debtor had ceased making payments at the time the transactions occurred.

3. Types of transactions subject to avoidance

162. [132] Although variously defined, there are three broadly common types of avoidable transactions that are found in most legal systems and are used in this guide as the basis of the discussion. They are: transactions intended to defeat, hinder or delay creditors from collecting their claims (often referred to as fraudulent transactions), transactions at an undervalue, and transactions with certain creditors which could be

regarded as preferential. Some transactions may have the characteristics of more than one of these different classes, depending upon the individual circumstances of each transaction. For example, transactions which appear to be preferential may be more in the character of transactions intended to defeat, hinder or delay creditors when the purpose of the transaction is to put assets beyond the reach of a creditor or potential creditor or to otherwise prejudice the interests of that creditor and the transaction occurs when the debtor is in a position of financial difficulty and will be unable to pay its debts as they become due or where they leave the debtor with insufficient assets to conduct its business. Similarly, transactions at an undervalue may also be preferential when they involve creditors, but not when they involve third parties, and where there is a clear intent to hinder, defeat or delay creditors, they will fall in to the first category of transactions. For these reasons, it is desirable that an insolvency laws specify the particular characteristics that are essential for avoidance of transactions, rather than relying on broader labels, such as “fraudulent” or “preferential”.

(a) Transactions intended to defeat, hinder or delay creditors

163. [134] These types of transactions involve the debtor transferring assets beyond the reach of creditors to any third party with the intent of favouring certain creditors, and generally require that the third party knows of that intent, or in some cases should have known of that intent. These transactions cannot generally be automatically avoided by reference to an objective test of a fixed period of time in which the transactions occurred because of the need to prove the intent of the debtor. That intent is rarely proven by direct evidence, but rather by identifying common circumstances that are present during these types of transfers. Although these circumstances differ between jurisdictions, there are a number of common indicators, including:

(i) the relationship between the parties to the transaction or obligation, where a transfer was made or an obligation incurred directly to a related person or via a third party to a related person;
(ii) the lack or inadequacy of the value received for the transfer or the obligation incurred;
(iii) the financial condition of the debtor both before and after the transfer was made or the obligation incurred, particularly where the debtor was already unable to pay its claims or became unable to pay shortly after the transfer was made or the obligation incurred;
(iv) the existence of a pattern or series of transactions transferring some or substantially all the debtor’s assets occurring after the onset of financial difficulties or the threat of action by creditors;
(v) the general chronology of the events and transactions under inquiry, where for example, the transfer occurred shortly after a substantial debt was incurred;
(vi) the transfer or obligation is concealed by the debtor, especially when it was not made in the usual course of business, or fictitious parties were involved; or
(vii) the debtor absconds.

164. Some laws also specify circumstances in which there may be a presumption of intent or specify those transactions where intent or bad faith is deemed to exist, for example, transactions involving related persons occurring within a specified period prior to the commencement of proceedings (discussed further below). Under other laws it may be sufficient for a transaction to be avoided if the debtor could, and therefore should, have

realised that the effect, if not the intent, of a transaction would have been to disadvantage creditors and that the beneficiary could and therefore should have realised that the debtor's action could produce that effect. Some laws also provide that certain transfers, such as conveyances of land, will be exempt from avoidance under this category of transactions if the transfer was bona fide for good value and the beneficiary had no notice or was unaware of any intent to defraud.

165. [134] As a practical matter, in order to prove intent, if the debtor cannot explain the commercial purpose of a particular transaction which extracted value from the estate, it may be possible to show that the transaction is one which fits into this category. In designing an insolvency law, as noted above, it may be desirable to bear in mind that transactions of this type that are potentially avoidable under insolvency law are often perfectly valid under non-insolvency law.

(b) Undervalued transactions

166. [135] Many insolvency laws provide that transactions are generally avoidable where the value received by the debtor as the result of the disposal of an asset or the incurring of an obligation to a third party was either nominal, such as a gift, or much lower than the true value or market price of the asset disposed of or the obligation incurred, and where the transaction occurred within a specified period of time before a particular date (the suspect period). Some laws also require a finding that the debtor had ceased making payments at the time the transaction occurred, or became unable to make payments as a result of the transaction. These transactions include transactions with both creditors and third parties. Some insolvency laws provide that these types of transactions will not be avoided if certain conditions are satisfied, such as that the beneficiary acted in good faith, that the transaction was for the purpose of carrying on the debtor's business, that there were reasonable grounds for believing that the transaction would benefit the debtor's ordinary business, and where cessation of payments is a relevant requirement, that the debtor's assets exceeded its liabilities at the time of the transaction.

(c) Preferential transactions

167. [136] Preferential transactions may be subject to avoidance where (i) the transaction took place within a defined but usually rather short period of time before the application for commencement of the insolvency proceedings (the suspect period); (ii) the transaction involves a transfer to a creditor on account of a pre-existing debt; and (iii) as a result of the transaction, the creditor receives a larger percentage of its claim from the debtor's assets than other creditors of the same rank or class (in other words, a preference). Many insolvency laws also require that the debtor had ceased making payments or was close to being in a position where it was unable to pay its debts when the transaction took place. The rationale for including these types of transactions within the scope of avoidance provisions is that when they occur very close to the commencement of proceedings, a state of insolvency is likely to exist and they breach the key objective of equitable treatment of creditors.

168. [137] Examples of preferential transactions may include payment or set-off of debts not yet due; performance of acts which the debtor was under no obligation to perform; provision of security to secure existing debts; unusual methods of payment, other than in money, of debts that are due; payment of a debt of considerable size in comparison to the assets of the debtor; and payment of debts in response to extreme pressure from a creditor, such as litigation or attachment. A setoff, while not avoidable as such, may be considered

prejudicial when it occurs within a short period of time before the application for commencement of the insolvency proceedings and has the effect of altering the balance of the debt between the parties in such a way as to create a preference or where it involves transfer or assignment of claims between creditors to build up setoffs. It may also be subject to avoidance where the setoff occurs in irregular circumstances such as where there is no contract between the parties to the setoff.

169. [138] One defence to an allegation of a preferential transaction may be to show that although containing the elements of a preference the transaction was in fact consistent with normal commercial practice and, in particular, with the normal course of business between the parties to the transaction. For example, a payment made on receipt of goods that are regularly delivered and paid for may not be preferential even if made within proximity of the commencement of insolvency proceedings, whereas payment of a long overdue debt could be preferential. This approach encourages suppliers of goods and services to continue to do business with a debtor which may be having financial problems, but which is still potentially viable. Other defences available under insolvency laws include that the beneficiary extended credit to the debtor after the transaction and this credit has not been paid (the defence is limited to the amount of the new credit); the beneficiary can show that it did not know a preference would be created; the beneficiary did not know or could not have known that the debtor had generally ceased making payments; or where cessation of payments is a required element, that the debtor's assets exceeded its liabilities at the time of the transaction.

(d) Security interests

170. [139] While security interests valid under the laws permitting the grant of security to creditors should generally be regarded as valid under insolvency law, they may nevertheless be avoidable in insolvency proceedings on the same grounds that any other transaction might be challenged and avoided - as a fraudulent, preferential or undervalued transaction. For example, the grant of a security interest shortly before commencement of proceedings, although otherwise valid, may be found to have favoured unfairly a certain creditor at the expense of the rest. Where the security interest is granted to secure a prior debt or on the basis of past consideration (permitted in some legal systems, but not in others) it may also be invalid as favouring that particular creditor unfairly. Payments received by a secured creditor might be regarded as preferential (at least in part) if an undersecured creditor is paid in full within the suspect period. The same considerations would apply to a security interest that was not perfected under the relevant secured transactions law and, under some laws, to a security interest perfected within a short period before the commencement of proceedings.

(e) Related person transactions

171. [146] As noted above, one criterion relevant to avoidance of certain transactions is the relationship between the debtor and the counterparty. Where the types of transactions subject to avoidance involve related persons (these may also be referred to as connected persons or insiders), insolvency laws often provide stricter rules, particularly with regard to the length of suspect periods and treatment of any claim by the related person (see Part two, chapter VI.A). [130] A stricter regime may be justified on the basis that these parties are more likely to be favoured and tend to have the earliest knowledge of when the debtor is, in fact, in financial difficulty.

172. Related persons are generally defined by varying levels of connection to the debtor. Most jurisdictions regard those with some form of corporate or family relationship with the debtor as related persons. The legislative approach taken is generally, but not always, prescriptive. With regard to those with some form of business association with the debtor, a narrow approach would focus on the directors or management of the debtor, while a wider definition may extend not only to those who have effective control of the debtor, but may include all employees of the debtor and guarantors of the debts of any person with a business connection to the debtor. Similarly, a family relationship may be defined to include relatives by blood or marriage and even, in some laws, persons living in the same household as the debtor as well as trustees of any trust of which the debtor or a person connected with the debtor is a beneficiary. Relatives of those who have a business association with the debtor are also commonly regarded as related persons. An important element in many jurisdictions is to include as related persons those who had a defined relationship with the debtor in the past or may have a defined relationship in the future.

(f) Void or voidable transactions

173. [147] Where a transaction falls into any of the categories of transactions subject to avoidance, insolvency laws either render it automatically void or make it voidable, depending upon the test that is adopted in respect of each category of transaction. For example, those laws which refer only to transactions occurring within a certain fixed period of time and include no subjective criteria, sometimes specify that relevant transactions will be void. However, even where that approach is adopted the insolvency representative may have to commence proceedings to recover the assets or their equivalent value from the counterparty.

174. [148] In those laws where the transaction is voidable, the insolvency representative will be required to decide whether the avoidance of the transaction will be beneficial to the estate, taking into account the elements of each category of avoidable transaction as well as possible delays in recovering either the assets involved or the value of the assets and the possible costs of litigation. That discretion would generally be subject to the insolvency representative's obligation to maximize the value of the estate, and it may be responsible for its failure to do so.

4. Transactions exempt from avoidance actions

175. Some insolvency laws provide that certain transactions will be exempt from avoidance provisions. These may include transactions that occur either between the application for commencement and commencement or after commencement provided they fall within the ordinary scope of the debtor's business, that are made in good faith by, or with the consent of, the insolvency representative or the court, and are undertaken to further the conduct of the proceedings. Other transactions that it may be desirable to exclude from the scope of avoidance are those transactions that occur in the course of implementing a reorganization plan, where the implementation fails and the proceedings are subsequently converted to liquidation. Finally, certain transactions essential to the functioning of financial markets, (such as close-out netting of securities and derivative contracts) may be exempted from avoidance actions (see Part two, chapter III.F).

5. Establishing the suspect period

176. [140] Most insolvency laws explicitly specify the duration of the suspect period with reference to the particular types of transactions to be avoided and indicate the date from

which the period is calculated retroactively. For example, so many days or months before a particular event such as the making of the application for commencement of proceedings, the commencement of insolvency proceedings or the court's decision as to the date when the debtor ceased paying its debts in the normal way ("cessation of payments"). A related issue is whether suspect periods stipulated in the insolvency law can be extended by the court in appropriate situations, such as where transactions, which occurred outside the specified suspect periods in questionable circumstances, had the effect of diminishing the estate. While a discretionary approach may allow a certain degree of flexibility with respect to the transactions to be caught by the avoidance provisions, it may also lead to delay in the proceedings and does not give a predictable or transparent indication to creditors as to the transactions that are likely to be avoided. If transactions can be unwound where they took place at some unspecified time prior to the commencement of insolvency proceedings and subject to the discretion of the court, there is likely to be less safety in commercial and financial transactions. For these reasons, it is desirable that a discretionary approach be limited to fraudulent transactions, where issues of commercial certainty are of less concern.

177. [141] Some insolvency laws provide one suspect period for all types of avoidable transactions, while others have different periods depending upon whether the basis of avoidance is fraudulent transfer or preference and upon additional factors such as whether the injury to creditors was intentional and whether the transferee was a related person, as discussed above. Because some transactions involve intentionally wrongful conduct, many insolvency laws do not limit the time period within which these types of transactions must have occurred in order for them to be avoided. Other insolvency laws establish a very long limit (examples range from one to ten years) where the suspect period is generally calculated from the date of commencement of proceedings.

178. [142] Where preferential and undervalued transactions involve creditors who are not related persons, the suspect period may be relatively brief, perhaps no more than several months (examples range from three to six months). However, where related persons are involved, many countries apply stricter rules. These rules may include longer suspect periods (for example two years as opposed to three to six months where the transactions does not involve a related person), shifted burdens of proof (see 6(d) below) and dispensing with requirements that the debtor have ceased making payments at the time of the transaction, or was rendered unable to make payments as a result of the transaction.

6. Commencement of avoidance proceedings

(a) Parties who may commence

179. Avoidance of a particular transaction generally requires an application to the court to declare the transaction void. A number of insolvency laws provide that proceedings for the avoidance of specified transactions should be taken by the insolvency representative, although there are some laws that also provide the power to creditors and, in some cases, the creditors committee. The decision to commence such a proceeding, as noted in paragraph (174), will require a number of different considerations to be weighed, depending upon whether avoidance is sought for the benefit of the insolvency estate or, in the case of a creditor, for the benefit of that creditor.[1] Relevant considerations will

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[1] Some laws provide that a creditor has the right to contest individual transactions of the debtor. and that they may personally benefit where the proceeding is successful. Some laws also specify that only creditors whose debt precedes the challenged transaction may initiate such proceedings.

generally relate to cost and likely benefit; in the case of actions to restore assets to the insolvency estate, they will include whether avoidance of the transaction will be beneficial to the estate, the likely cost to the estate, the likelihood of recovering value for the estate, possible delays in recovery and the difficulties associated with proving the elements necessary to avoid a particular transaction.

180. [149] In those laws where the insolvency representative has the power to commence avoidance proceedings and, based on the balance of the considerations noted above, (that is for reasons other than negligence or bad faith, or for no justifiable reason[2]), decides not to commence proceedings to avoid certain transactions, insolvency laws adopt different approaches to the conduct and funding of those proceedings. The manner in which they may be funded may be of particular importance where there are insufficient assets in the insolvency estate to do so. As to the conduct of those proceedings, some laws permit a creditor or the creditor committee to require the insolvency representative to initiate an avoidance proceeding where it appears to be beneficial to the estate to do so or also permit a creditor itself or the creditor committee to commence proceedings to avoid these transactions, where other creditors agree. Where this latter action is permitted, some laws provide that the assets or value recovered by the creditor are to be treated as part of the estate; in other cases whatever is recovered can be applied in the first instance to satisfy the claim of the creditor which takes the action.

(b) Funding of avoidance proceedings

181. [150] As to the manner in which they may be funded, some countries make public funds available to the insolvency representative to commence avoidance proceedings. In other countries, those proceedings are to be funded from the insolvency estate. This latter approach may be appropriate where sufficient funds exist but in some circumstances could operate to prevent the recovery of assets that have been removed from the estate with the specific intention of leaving the estate with few assets from which to fund their recovery through an avoidance proceeding. Some insolvency laws allow the insolvency representative to assign the ability to commence proceedings for value to a third party or to approach a lender to advance funds with which to commence the avoidance proceeding. In support of the use of the latter mechanisms, there are clearly significant differences between countries in the availability of public resources for such funding and where there is no ability to fund avoidance proceedings from the insolvency estate, these alternative approaches may offer, in appropriate situations, an effective means of restoring value to the estate.

(c) Time limits for commencement

182. Some insolvency laws establish specific time limits within which avoidance proceedings should be commenced, while others are silent on this issue. Those laws that do specify time limits provide, for example, that the proceeding should be commenced within a specified period after the date of the application for commencement (such as three or twelve months) or no later than a fixed period (for example, six months) after the insolvency representative is able to assess and pursue claims. If an insolvency law is to establish specific time limits, rather than relying on those applicable under general law, an approach that combines different limits, such as a fixed period after commencement and a

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Other laws limit the right to pursue avoidance actions to the insolvency representative when insolvency proceedings have been commenced.

[2] See chapter IV.B on the rights and obligations of the insolvency representative.

period after the insolvency representative has discovered a certain transaction, would be desirable. Such an approach would provide flexibility sufficient to address those transactions that are concealed from the insolvency representative and discovered only after the expiration of the fixed period after commencement.

(d) Evidentiary issues

183. [151] Insolvency laws adopt different approaches to establishing the elements of an avoidance action. In some laws, the onus is on the debtor to prove that the transaction did not fall into any category of avoidable transactions.

184. [151] Some insolvency laws provide that the insolvency representative or other person permitted to challenge the transaction, such as a creditor, is required to prove the existence of each element of an avoidance action. Where these elements include intent, some laws allow the burden of proof to be shifted to the counterparty where, for example, it is difficult for the insolvency representative to establish that the debtor's actual intent was to defraud creditors except through external indications, objective manifestations, or other circumstantial evidence of such intent. The law may provide a presumption that the transaction was done to harm creditors, and it is up to the counterparty to prove otherwise.

185. Another approach is to provide that the requisite intent or bad faith is deemed or presumed to exist where certain types of transactions are undertaken, for example, within a specified period before the application for commencement or within a number of years before commencement. The types of transactions may include, for example, transactions with related persons, payment of non-matured debts, and payment of gratuitous or onerous transactions. A slight variation is an approach providing that a transaction will be deemed to be voidable where it occurred within a short specified period and had the effect of conferring a preference.

186. Where knowledge of cessation of payments is a required element of avoidance, some insolvency laws provide a presumption that the creditor knew of the poor financial condition of the debtor if the debtor entered into certain transactions with that creditor, such as for repayment of a non-mature debt or repayment in an unusual manner, or where the transaction occurred within a short period before an application for commencement or before commencement.

187. A further approach is to provide that where a certain type of transaction occurred within a specified period and had the effect of conferring a preference, a rebuttable presumption as to intention to prefer will arise. Unless the creditor can rebut the presumption, the transaction is avoided and the insolvency representative can recover the assets involved in the transaction or obtain judgement for the value of the asset involved.

7. Liability of counterparties to avoided transactions

188. [143] Where a transaction is avoided, there is a question of the effect of avoidance on the counterparty. In most insolvency laws the result of avoidance of a transaction is generally that the transaction will be reversed and the counterparty required to return the assets obtained or make a cash payment for the value of the transaction to the insolvency estate. Some insolvency laws provide that the insolvency representative can be awarded judgement for the value of the property involved. Some insolvency laws also stipulate that the counterparty who has returned assets or value to the estate may make a claim as an unsecured creditor in the insolvency to the extent of the assets returned. Where the

counterparty fails to disgorge assets or return value to the insolvency estate, most of remedies available are under non-insolvency law, but some insolvency laws provide that a claim by the counterparty (for amounts owed in addition to those involved in the voidable transaction) cannot be admitted in the insolvency.

8. Post-application and post-commencement contracts

189. As noted above (Part two, chapter III.B.6), some insolvency laws address contracts entered into and transactions implemented between application and commencement of proceedings and after commencement in terms of avoidance provisions when those transactions or contracts are not authorized by the insolvency law or approved, as required, by the court, the insolvency representative or creditors. Some insolvency laws specify the types of these transactions that may be avoided, such as performance of obligations arising before commencement, payment of pre-application debts, creation of security over assets of the estate and disposal of any right or asset forming part of the estate. Other laws provide for avoidance of any unauthorized transaction entered into by the debtor at these times unless the counterparty can provide that the transaction did not impair creditor's rights.

Recommendations

Purpose of legislative provisions

The purpose of avoidance provisions is to:

(a) ~~preserve~~[reconstitute] [reconstruct] the integrity of the estate and ensure the [fair][equitable] treatment of creditors;
(b) provide certainty for third parties by establishing clear rules for the circumstances in which transactions [occurring] prior to the commencement of insolvency proceedings [or unauthorized transactions occurring after [application for] commencement] involving the debtor or the debtor's property may be considered injurious and therefore subject to avoidance;
(c) enable the ~~insolvency representative to~~ commencement of proceedings to avoid those transactions;
(d) facilitate the recovery of money or assets from persons involved in transactions that have been avoided.

Content of legislative provisions

(69) [(56)] The insolvency law should include provisions which apply retroactively and are designed to overturn past transactions[3] [or unauthorized transactions occurring after [application for] commencement] to which the debtor was a party [or which involved the debtor's property] and which have the effect of either reducing the net worth of the debtor or upsetting the principle of [fair] [equitable] treatment of creditors.

[3] [131] The use of the word "transaction" in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, a security, a guarantee, a loan or a release.

Transactions subject to avoidance

(70) [(57)] The insolvency law should provide that the following types of transactions are subject to avoidance ~~the insolvency representative may commence proceedings in court to set aside as void the following types of transactions~~:

(a) transactions intended to defeat, delay or hinder the ability of creditors to collect claims by, for example, the transfer of assets to any third party where the purpose of the transaction was to put assets beyond the reach of a creditor or potential creditor or to otherwise prejudice the interests of that creditor and where the third party knew of the debtor's intent; ~~(fraudulent transactions)~~
(b) transactions where a transfer of an interest in property or the undertaking of an obligation by the debtor was made in exchange for a nominal or less than equivalent value (undervalued transactions) which occurred at a time when the debtor [was insolvent][had ceased making payments] or as a result of which the debtor became [insolvent] [unable to make payments]; and
(c) transactions involving creditors where a creditor obtains more than its pro rata share of the debtor's assets (preferential transactions) which occurred at a time when the debtor had ceased making payments [was insolvent].

Security interests

(71) The insolvency law should provide that although security interests valid under laws permitting the grant of security to creditors are generally valid under insolvency law, they will be subject to avoidance on the same grounds as other transactions.

Related person transactions

(72) [(61)] In relation to transactions of the type referred to in recommendation (70) involving related persons, the insolvency law should provide that ~~insolvency representative may commence proceedings in court to set aside as void undervalued and preferential transactions~~

(a) those transaction are subject to avoidance;
(b) the suspect period for those transactions may be longer than for transactions with unrelated persons; and
(c) there may be presumptions or shifts in the burden of proof that favour the insolvency estate.

(73) The insolvency law should specifically define the categories of persons considered to be sufficiently related to the debtor for the purposes of recommendation (72).

~~(62) The insolvency law should clearly establish the suspect period for the types of transactions referred to in recommendation (61), which would generally be longer than the time periods applicable to both undervalued and preferential transactions that do not involve related persons.~~

Transactions exempt from avoidance actions

(74) The insolvency law should specify the transactions that will be exempt from avoidance. These transactions may include transactions entered into in the ordinary course of business prior to commencement of insolvency proceedings, transactions entered into the course of reorganization proceedings which are subsequently converted to liquidation and certain financial market transactions.

Establishing the suspect period

(75) [(58)] The insolvency law should establish that transactions with the characteristics described in recommendation (70) may be avoided if they occurred within a specified period (the suspect period) [prior to] [calculated retroactively from] the [application for] commencement of the insolvency proceeding. The insolvency law may specify different suspect periods for different types of transactions, but in general the suspect periods for transactions referred to in recommendation (70)(a) and those involving related persons (recommendation (72)) should be longer than for other types of transactions and those not involving related persons.

Commencement of avoidance proceedings

(76) The insolvency law should specify that the insolvency representative [and ..] may commence avoidance proceedings. [4]

Time limits for commencement of avoidance proceedings

(77) [(59)] Following commencement of the insolvency proceedings the period within which an avoidance proceeding may be commenced in respect of a transaction of which the insolvency representative is aware, may be limited by the insolvency law or by applicable procedural law.

Funding of avoidance proceedings

(78) [(64)] The insolvency law may provide alternative approaches to address the funding of avoidance proceedings where the insolvency representative does not pursue the avoidance of particular transactions either on the basis of an assessment that the transactions are not likely to be avoided or that pursuing such transactions will impose [unjustifiable] [excessive] costs upon the insolvency estate. These approaches may include permitting individual creditors or the creditor committee to pursue avoidance and (a) allowing the creditor(s) to retain an amount of any sum recovered towards satisfaction of their claim, (b) paying the costs of the avoidance proceeding from the insolvency estate in the event that the proceeding is successful; or (c) modifying the priority of the claim of the creditor(s) pursuing avoidance.

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[4] Issues relevant to avoidance may also arise in proceedings commenced by a person other than the insolvency representative, where the insolvency representative raises avoidance by way of defence against enforcement.

Evidentiary issues

(79) [(60)] The insolvency law should specify the elements to be proved in order to avoid a particular transaction and possible defences to avoidance.

(80) [(63)] The insolvency law may provide that special evidentiary presumptions apply to the avoidance of certain transactions occurring within specified periods involving certain clearly specified persons [such as related persons] or classes of person.

Liability of counterparties to avoided transactions

(81) The insolvency law should provide that a counterparty to a transaction that has been avoided is bound to return to the estate all material benefits derived from the avoided transaction. Where the counterparty refuses to return those benefits, the insolvency law may provide that the counterparty cannot make a claim in the insolvency proceedings.

~~*Review of decisions concerning avoidance*~~

~~*(65) The insolvency law should permit interested parties to seek judicial review of decisions taken by the insolvency representative with respect to avoidance. Grounds for review may include: […].*~~

F. Setoff, netting and financial contracts

1. General right of setoff

190. [116] An important issue that arises in the design of an insolvency law is the treatment of a creditor who, at the time of the application for commencement of proceedings, also happens to be a debtor of the estate. If the fundamental principle of equality of treatment of similarly situated creditors is applied, the outcome would be relatively straightforward: the insolvency representative will be able to receive the full amount owed by the creditor and the creditor's claim will be satisfied upon the liquidation of the estate or in the reorganization. However, an alternative approach permits the creditor, in these circumstances, to exercise setoff rights against the estate after the commencement of proceedings, with the effect that, depending on the size of the estate's claim on the creditor, the creditor's claim is satisfied in full. The main effect is thus that a creditor with a setoff is in substance "secured" because the debtor's cross-claim can be paid or discharged by setting it off against the creditor's claim. Setoff is not significant until insolvency, because if a counterparty could always pay, there would be no need for setoff.

191. Since claims are a major form of property in modern economies and since creditors are often also debtors to the same counterparty, the law of setoff is important in business and in financial markets (see below). Setoff is prevalent in business transactions because wherever there is a series of contracts between the same parties, there is a potential for setoff. This extends also to mutual trading transactions.

192. [119] The international position with regard to setoff in insolvency reveals considerable diversity. In some countries, setoff is restricted between solvent parties, but is

compulsory on insolvency, in other countries the opposite position exists and it is permitted between solvent debtors, but prohibited on insolvency.

193. [117] There are several reasons why it may be appropriate to include the right of setoff in an insolvency law. The first is that of fairness: notwithstanding the importance of equality of treatment among creditors, it can be considered unfair for a debtor to refuse to make a payment to a creditor but, at the same time, to insist upon payment from that creditor. In addition, since many counterparties are banks, the right of setoff is particularly beneficial to the banking system and, because of the important credit creation role of banks, it is therefore considered to be of general benefit to the economy. By virtue of their core functions (lending and deposit taking) banks that have lent to an insolvent debtor often find that they have financial obligations to the debtor in the form of deposits. A post-commencement right of setoff will allow the banks to offset their unpaid claims with the debtor's deposits even though these reciprocal claims are not yet due and payable. Setoff allows the creditor to escape the difficulties created by the insolvency of the debtor and thus helps to avoid the cascade effect of bankruptcy, as well as reducing exposures and transaction costs and thus the cost of credit. Setoff also avoids circularity of payments and associated costs.

194. [118] Although there are a number of advantages to allowing setoff, these may need to be balanced against some of the arguments against a right of setoff. Insolvency setoff is a violation of the *pari passu* principle because a creditor with a setoff gets paid in full without there being general awareness, unlike publicized security interests, of the existence of reciprocal claims. Setoff can deplete a debtor's assets and inhibit reorganization particularly where the debtor loses access to its bank accounts or cash in its bank accounts.

195. [120] The right of setoff interacts with other provisions of insolvency in a number of important respects. For example, the right of a creditor to claim the benefit of a setoff may be subject to the avoidance provisions (see Part two, chapter IIIE.3(c)). Where an insolvency law generally allows termination clauses to be overridden thus allowing the insolvency representative to continue unperformed contracts, a creditor will only be able to exercise setoff rights regarding mutual monetary claims where the right to override the termination clause includes an exception which expressly allows a creditor to terminate the contract and setoff those claims. This is particularly important in the context of short-term financial transactions.

2. Netting and setoff in the context of financial transactions

196. In addition to its importance in business generally, setoff is also important in financial markets. Some common cases of setoff include setoff by banks of loans against deposits; setoff between institutions in financial markets such as the inter-bank deposit market; and netting of foreign exchange, swaps, futures, securities and repurchase contracts; and setoff in centralized payment systems. The amounts involved are often very large and the reduction in exposures achieved by setoff, with a resulting reduction in credit costs, and cascade risks threatening the integrity of the financial system, are correspondingly large.

197. Netting differs from setoff in that in one form it can consist of the setoff of non-monetary fungibles (e.g. securities or commodities deliverable on the same day – settlement netting) and because in its more important form it generally involves a cancellation by a counterparty of open contracts with an insolvent debtor, followed by setoff of losses and gains either way – close-out netting.

198. The international position with regard to setoff and netting is complex. The minority of countries which have not traditionally accepted insolvency setoff, [119] except for certain transactions and for current account setoffs, still mainly adhere to that position, although a few have widened their transaction setoff and some have introduced netting legislation which applies only to specified contracts. Among those states that traditionally permit insolvency setoff a small number impose a stay in reorganization proceedings, although permitting an exemption for financial contracts. Other insolvency laws do not address the question of setoff.

3. Exceptions or carve-outs for financial contracts

199. [121] Whether it is desirable that an insolvency law include provisions regarding certain types of short-term financial contracts, including derivative agreements (e.g. currency or interest rate swaps) will depend upon how issues relating to the treatment of contracts and setoff rights are addressed. The terms of the increasingly standardized master agreements which govern these individual transactions normally contain provisions that enable close-out netting. Such provisions, which aggregate all independent payment obligations, are normally effective only upon the insolvency of one of the parties if the insolvency law contains two features. First, it must allow for the termination (or “close-out”) of all outstanding transactions under the agreement on the insolvency of a party, and second, it must allow the non-insolvent party to set off its claims against the obligations of the insolvent party.

200. [122] Many insolvency laws do not contain both of these features. As noted above in the discussion of treatment of contracts, some countries allow an insolvency representative to elect to continue the contract in contravention of the termination provisions of the contract. With respect to setoff, a number of countries do not allow for the setoff of independent financial claims that are not mature at the time of commencement.

201. [123] Many countries that do not possess these general rules providing for both termination and setoff, have nevertheless carved out exceptions to the applicable insolvency rules for the specific purposes of allowing “close-out netting” for prescribed eligible financial contracts, including security interests, repurchase agreements and securitizations. The rationale for these exceptions is the increasing importance of these transactions in the global financial market, the need for safety in markets, the complexity of these financial arrangements and the fact that access to such transactions would be restricted if there was no certainty with respect to the availability of netting upon the insolvency of one party. Notwithstanding these important advantages, it should be recognized that such “carve-outs” complicate the law and result in preferential treatment for certain types of creditors.

202. In addition to the exception discussed above, further exceptions may be required for financial contracts from the application of the stay (mentioned in Part two, chapter III.B.3), the operation of avoidance provisions (mentioned in Part two, chapter III.D.6) and from the power of the insolvency representative to continue and reject contracts under which the debtor and its counterparty have not yet fully performed their respective obligations (mentioned in Part two, chapter III.E.4). *[Note: the Working Group may wish to consider the scope of such exceptions and whether additional recommendations should be added to this section cover these issues – see note re recommendations 86-88 below.]*

Recommendations

Purpose of legislative provisions

[Purpose clause to be drafted]

Content of legislative provisions

General right of setoff

[(82)[(67)] The insolvency law should protect a pre-commencement right of set-off existing under general law ~~should be protected during liquidation proceedings and generally should be exercisable by both creditors and the insolvency estate.~~

[(83) The insolvency law should permit post-commencement set-off where the mutual claims arise under the same agreement. ~~In addition, countries may also wish to consider allowing for post-commencement set-off in other circumstances, particularly with respect to mutual financial obligations which derive from financial contracts defined by law.]~~

Netting and financial contracts[5]

(84) [(66) In the context of financial [contracts][master agreements] the insolvency law should provide that netting and close-out arrangements are legally protected and, to the greatest extent possible, should not be unwound in insolvency proceedings.]

Exception to unenforceability of automatic contract termination clauses[6]

(85) [68] Where the insolvency law does not permit post-commencement setoff for mutual financial obligations, or renders unenforceable as against the insolvency representative any contract provision that would provide a right to terminate a contract upon, or identify as an event of default, (a) the application for commencement, or commencement, of insolvency proceedings; (b) the appointment of an insolvency representative; (c) the fact that the debtor satisfies the criteria for commencement of insolvency proceedings; or (d) indications that the debtor is in a weakened financial position, it may be necessary for the insolvency law to provide an exception for financial

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[5] The Working Group may wish to consider whether the term “financial contracts” should be defined, and if so, an appropriate definition. One example might be the definition included in the UNCITRAL Convention on the Assignment of Receivables in International Trade, art. 5(k) which provides: “Financial contract” means any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above.
At the twenty-sixth session of the Working Group (May 2002), the view was expressed that that definition was too broad and should be more narrowly focussed to cover only those transactions which formed part of a broader framework contract (A/CN.9/511, para. 71). No specific drafting was proposed.

[6] See Part two, chapter III, D Treatment of contracts, recommendation (53).

[contracts][master agreements] so that close-out netting provisions contained in those [contracts][agreements] between the debtor and another party can be applied with certainty.

Possible additional recommendations concerning financial contracts

(86) *[Exception to application of stay: chapter III.B.3]*

(87) *[Exception to application of avoidance provisions: chapter III.D.6]*

(88) *[Exception to powers of continuation and rejection of contracts: chapter III.E.4]*

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Draft legislative guide on insolvency law

Note by the Secretariat

Contents

[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Add.3 and Add.4; Chapter III.A-F appear in documents A/CN.9/WG.V/WP.63/Adds.5-9; Chapter IV C and D, and ChaptersV-VII appear in subsequent addenda]

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Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.
Recommendation numbers in [..] refer to relevant recommendations in A/CN.9/WG.V/WP.61 and A/CN.9/WG.V/WP.61/Add.1, the previous version of the recommendations. Additions to the recommendations are indicated in this document by underlined text.

Part Two (continued)

IV. Participants and institutions

A. The debtor

1. Introduction

203. Insolvency laws adopt different approaches to the role the debtor plays in the insolvency proceedings once they have commenced, with a distinction generally being drawn between liquidation and reorganization. Where the business is to be continued (either for sale as a going concern in liquidation or in reorganization) a greater need arises for some form of involvement by the debtor in management. The debtor will also have a role to play in assisting the insolvency representative to perform its own functions and in providing information on the business to the court or the insolvency representative. The debtor will also have certain rights with regard to those proceedings. To ensure the efficient and effective conduct of the proceedings, and provide certainty for those parties involved it is desirable that the insolvency law establishes the extent of the debtor's rights and obligations.

2. Continued operation of the debtor's business

(a) Liquidation

204. [152] Once liquidation proceedings have commenced, the conservation of the estate requires comprehensive measures to protect the estate not only from the actions of creditors (see Part Two, chapter III.B) but also from the debtor or its managers or owners.[1] For this reason, many insolvency laws divest the debtor of all rights to control assets and manage and operate the business in liquidation, and appoint an insolvency representative to assume all responsibilities divested. In addition to the powers relating to use and disposal of assets, these responsibilities may include the right to initiate and defend legal actions on behalf of the estate and the right to receive all payments directed to the debtor. After commencement of the liquidation proceedings, [153] any transaction involving assets of the estate or transfer of those assets which not authorized by the insolvency representative, the court or creditors (as required) generally will be void (or subject to avoidance), and the assets transferred (or their value) subject to recovery for the benefit of the insolvency estate (see Part Two, chapter III.D.7, III.E.8).

205. [153] Where it is determined that the most effective means of liquidating the estate is to sell the business as a going concern, some laws provide that the insolvency representative should supervise and have overall control of the business while permitting the debtor to enhance the value of the estate and facilitate the sale of the assets by continuing to serve and advise the insolvency representative. This approach may be supported by the debtor's detailed knowledge of its business and the relevant market or industry, as well as its ongoing relationship with creditors, suppliers and customers. Depending upon the level of control the insolvency representative exercises over the debtor's activities, the insolvency representative may be made liable for the wrongful acts of the debtor during the period of its control (see Part two, chapter IV.B.7).

(b) Reorganization

206. [154] In reorganization proceedings, there is no agreed approach on the extent to which displacement of the debtor is the most appropriate course of action and, where some level of displacement does occur, on the ongoing role that the debtor may perform. That ongoing role may depend in large part upon the debtor acting in good faith during the reorganization process; where it does not, its continuing role may be of questionable value. Sometimes the solution may depend upon whether the debtor commenced the proceedings voluntarily or whether they were commenced by creditors, in which case the debtor may be uncooperative or even hostile.

(i) Advantages and disadvantages of the debtor's continuing involvement

207. There are a number of potential advantages in providing for the debtor to have an ongoing role. [154] In many circumstances, the debtor will have immediate and intimate knowledge of its business and the industry within which it operates. This knowledge is particularly important in the case of individual businesses and small

[1] Because the insolvency law will cover different types of businesses, whether individuals, partnerships or some form of company, the question of the continuing role of the debtor properly raises questions of the role of the debtor's management or owners, depending upon the circumstances. For ease of reference, the Guide refers only to "the debtor", but it is intended that management and owners should be covered by the use of that term where appropriate.

partnerships and may, in the interests of business continuity, provide a basis for the debtor to have a role in making short term and day-to-day management decisions. It may also assist the insolvency representative to perform its functions with a more immediate and complete understanding of the operation of the debtor's business. For similar reasons, the debtor is often well positioned to propose a reorganization plan for approval by creditors and the court. In such circumstances, total displacement of the debtor, notwithstanding its role in the financial difficulties of the business, may not only eliminate the incentive for entrepreneurial activity, risk-taking in general and for debtors to commence reorganization procedures at an early stage, but also may undermine the chances of success of the reorganization.

208. [155] The desirability of the debtor having an ongoing role may need to be balanced against a number of possible disadvantages. Creditors may have a lack of confidence in the debtor on account of the financial difficulties of the business (and the role that the debtor may have played in these difficulties occurring) and confidence will need to be rebuilt if the reorganization is to be successful. Permitting the debtor to continue to operate the business with insufficient control over its powers may not only exacerbate the breakdown of confidence but may antagonize creditors further. A system which is perceived to be excessively pro-debtor may result in creditors being apathetic about the process and unwilling to participate, which in turn may lead to problems of monitoring the conduct of the debtor where the insolvency law requires that role to be played by creditors. It may also encourage an adversarial approach to the insolvency process, adding to costs and delay. A debtor may have its own agenda which clashes with the objectives of the insolvency regime and in particular with the maximization of returns for creditors. Its overriding goal, for example, may be to ensure that it does not lose control of the business rather than to maximize value for the benefit of creditors. Furthermore, the success of reorganization may depend not only upon instituting change that the debtor may not be willing to accept, but also upon the debtor having the knowledge and experience to utilise the insolvency law to work through its financial difficulties. A related factor to be considered is whether the insolvency proceedings were commenced voluntarily or involuntarily (in which case the debtor may be hostile to creditors).

209. [note to para. 161] A number of insolvency laws draw a distinction, in terms of the debtor's role, between the period from commencement of proceedings to approval of the reorganization plan, on the one hand, and the period following approval, on the other hand. In the first period these laws set out specific rules concerning the debtor's ability to manage and control the day-to-day running of the business and the appointment of an independent insolvency representative Once the plan has been approved, these laws provide that the limits applicable to the debtor's control and management of the business cease to apply and the debtor will be responsible for implementation of the approved plan.

210. [156] Insolvency laws adopt different approaches to balancing these competing considerations in reorganization. These vary between displacing the debtor and appointing an insolvency representative, at one end of the scale, and allowing the debtor to remain in control of the business with minimum supervision at the other. Intermediate approaches provide for an insolvency representative to be appointed to exercise some level of supervisory function, as well as for retention of existing management.

(ii) Possible approaches - total displacement of the debtor

211. [156] The first approach follows the same procedure as in liquidation, removing all control of the business from the debtor and appointing an insolvency representative to

undertake the debtor's functions with respect to management of the business. As noted above, however, displacing the debtor completely may cause disruption to the business and repercussions detrimental to the operation of the business at a critical point in its survival.

(iii) Possible approaches – supervision of the debtor by the insolvency representative

212. [157] Intermediate approaches establish different levels of control between the debtor and the insolvency representative. These generally involve some level of supervision of the debtor by the insolvency representative, such as where the latter broadly supervises the activities of the debtor and approves significant transactions, while the debtor continues to operate the business and take decisions on a day-to-day basis. This approach may need to be supported by relatively precise rules to ensure that the division of responsibility between the insolvency representative and the debtor is clear, and there is certainty as to how the reorganization will proceed. Some insolvency laws, for example, specify that certain transactions, such as entering into new debt, transferring or pledging assets and granting rights to the use of property of the insolvency estate, can be undertaken without the consent of the insolvency representative or the court provided they are undertaken in the normal course of business. If they are not in the normal course of business, consent is required. Monitoring the cash flow of the debtor's business may be an additional tool for policing the debtor and its transactions. Where the debtor fails to observe the restrictions and enters into contracts requiring consent without first obtaining that consent, the insolvency law may need to address the validity of the transactions and provide appropriate sanctions. One insolvency law, for example, provides that in these circumstances the court can dismiss the insolvency proceedings altogether. The appropriateness of this remedy may depend upon whether the proceedings were voluntary or involuntary.

213. The insolvency laws that enumerate the transactions requiring consent establish a relatively clear line of responsibility between the debtor and the insolvency representative or the court. A number of these laws also provide that the insolvency representative can take greater control of the insolvency estate and day-to-day management of the business if required to protect the insolvency estate in a particular case. [158] Appropriate circumstances may include where there is evidence of a lack of accountability on the part of the debtor, or where there is mismanagement or misappropriation of assets by the debtor. Where these circumstances arise, it may be desirable to provide for the debtor to be displaced by the court, on its own motion or on that of the insolvency representative or perhaps on that of the creditors or creditor committee.

214. [157] Creditors may have a role to play in monitoring the management activities of the debtor and ensuring that it carries them out effectively. Where creditors have such a role there may be a need for measures that would prevent possible abuse by creditors seeking to frustrate the reorganization proceedings or to gain improper leverage. The required degree of protection could be achieved by requiring, for example, the vote of an appropriate majority of creditors before allowing creditors to take action to displace the debtor or increase the supervisory role of the insolvency representative.

215. A different approach to the delineation of powers between the debtor and the insolvency representative is one where the insolvency law does not specify the transactions that the debtor may undertake, but allows the court or the insolvency representative to determine which legal acts management can perform with approval and which it cannot.

While allowing some degree of flexibility, this approach may deter debtors from commencing insolvency proceedings as the effect of commencement on their management and control of the business will be unclear.

(iv) Possible approaches – full control by the debtor

216. [159] A further approach to the issue of the debtor's ongoing role is one that enables the debtor to retain full control over the operation of the business, with the consequence that the court does not appoint an independent representative once the proceedings begin (often known as "debtor in possession"). That approach may have the advantage of enhancing the chances of a successful reorganization if the debtor can be relied upon to carry on the business in an honest manner and obtain the trust, confidence and co-operation of creditors. There may be, however, disadvantages which include the process being used in situations where the outcome is clearly not likely to be successful, that is to delay the inevitable with the result that assets continue to be dissipated, and the possibility that the debtor may act irresponsibly and even fraudulently during the period of control, undermining the reorganization as well as the confidence of creditors. These difficulties may be mitigated by adopting certain protections such as a requirement that the debtor report regularly on the conduct of the proceedings to the court, appointment of an insolvency representative to supervise the debtor, giving the creditors a significant role in supervising or overseeing the debtor or a mechanism that allows the court (either on its own motion or at the request of creditors) to replace the debtor with an insolvency representative or to convert the proceedings to liquidation. Nevertheless, this approach is a complex one that requires detailed consideration not only because it depends upon strong governance rules and institutional capacity, but also because it affects a number of other aspects of the design of an insolvency regime (eg. the reorganization plan, exercise of avoidance powers, treatment of contracts).

3. Rights of the debtor

217. [168] To preserve what are regarded in some countries as fundamental rights of the debtor and to ensure its fair and impartial treatment, and perhaps more importantly to encourage debtor confidence in the insolvency process, it is desirable that the role of the debtor in the insolvency proceedings and the rights it will have with respect to the conduct of the proceedings are clearly enumerated in the insolvency law. In many countries, the rights of a natural person debtor in insolvency proceedings may be affected by obligations under international and regional treaties such as the International Covenant on Civil and Political Rights (1976) and the European Convention on Human Rights (1950).

- Right to be heard, to access information and to retain personal property

218. [168] It is desirable, for the reasons indicated above, that the debtor has the right to be heard in the insolvency proceedings and to participate generally in the decision making that is a necessary part of the proceedings, particularly reorganization proceedings. In particular, the debtor should be able to access information relating to the progress of the proceedings in all cases, but especially where the insolvency law provides for some level of displacement of the debtor (whether in liquidation or reorganization) from management and control of the business. This access to information may be particularly important in reorganization where the insolvency law provides for some level of displacement before approval of the plan, but requires the debtor to take responsibility for the plan's implementation. It may also be appropriate, in circumstances where the debtor does not play a role in formulation of the plan, for it to be given an opportunity to express an

opinion on the plan before it is submitted for approval. As noted above in Part two, chapter III.A.3, where the debtor is a natural person, certain assets are generally excluded from the insolvency estate to enable the debtor to preserve its personal rights and that of its family and it is desirable that the right to retain that property be made clear in the insolvency law.

219. [169] There may be situations, however, where the exercise or observance of these rights leads to formalities and costs that impede the course of the proceedings without being of any direct benefit to the debtor. It may be the case, for example, that where the debtor is no longer available in the jurisdiction in which the proceedings are being conducted and refuses or fails to respond to all reasonable attempts by the insolvency representative or the court to establish contact, an absolute requirement to be heard could seriously impede progress of the proceedings, if not make them impossible to undertake. While it may be desirable to provide that all reasonable efforts to allow the debtor to be heard should be made, an insolvency law may need to provide some flexibility to avoid the exercise of the right adversely affecting the proceedings.

4. Obligations of the debtor

220. As noted with respect to the rights of the debtor, it is desirable that the insolvency law clearly identify the obligations of the debtor with respect to the insolvency proceedings, including, as far as possible, the content and terms of the obligations and to whom each obligation is owed. These obligations will need to be adjusted to the role to be played by the debtor in respect of both liquidation and reorganization proceedings, especially with regard to management and control of the business in reorganization. For example, where the debtor remains in control of the business in reorganization, an obligation to surrender control of the assets of the insolvency estate will not be applicable.

(a) Co-operation and assistance

221. [167] To ensure that insolvency proceedings can be conducted effectively and efficiently, some insolvency laws impose on the debtor a general obligation to co-operate with and assist the insolvency representative in performing its duties, and in some laws to refrain from conduct that might be injurious to the conduct of the proceedings. An essential part of the obligation to co-operate will be to enable the insolvency representative to take effective control of the insolvency estate by surrendering assets, the control of assets and business records and books. It may also require the debtor to co-operate with the insolvency representative to prepare a list of creditors and their claims (see Part two, chapter IV.B.4).

(b) Provision of information

222. [162] To facilitate a thorough, independent assessment of the business activities of the debtor including its immediate liquidity needs and the advisability of post-commencement financing, the prospects for the long term survival of the business, and whether management is qualified to continue to lead the business, information concerning the debtor, its assets and liabilities, financial position and affairs generally will be required. To enable that assessment to be undertaken, in both liquidation and reorganization, but particularly in reorganization and where the business is to be sold as a going concern in liquidation, it is desirable that the debtor has a continuing obligation to disclose detailed information regarding its business and financial affairs over a substantial period, not simply the period in proximity to commencement of proceedings. That detailed information may include information concerning assets and liabilities; customer lists;

projections of profit and loss; details of cash flow; marketing information; industry trends; information thought to concern the causes or reasons for the financial situation of the debtor; disclosure of past transactions that may be capable of avoidance under the avoidance provisions of the insolvency law; and information concerning outstanding contracts, transactions involving related persons and ongoing court, arbitration or administrative proceedings, including enforcement proceedings, against the debtor or in which the debtor is involved. A number of insolvency laws also require the debtor to provide information concerning its creditors and to prepare, often in co-operation with the insolvency representative, a list of creditors against which claims can be verified. The debtor may also be required to update the list from time to time as claims are verified and admitted or not admitted.

223. [162] Although it may not be necessary for an insolvency law to exhaustively detail the information that is to be provided by the debtor, such an approach may be useful to provide guidance on the type of information that is expected to be provided. In that regard, some laws have developed standardized information schedules that set out the specific information required. These are to be completed by the debtor (with appropriate sanctions for false or misleading information) or by an independent person or administrator.

224. [163] To ensure that the information provided can be used for the purposes noted above, it needs to be up to date, complete, accurate and reliable and be provided as soon as possible after the commencement of the proceedings. Where the debtor can meet this obligation it may serve to enhance the confidence of creditors in the ability of the debtor to continue managing the business.

225. [164] Where the debtor is not a natural person, the information could be supplied to the insolvency representative by officers and other parties connected with the debtor. An alternative approach would be to require the debtor itself (where it is a natural person) or one or more of the directors of the debtor to be represented at or required to attend a main meeting of creditors to answer questions, except where this is not physically possible when directors are not located in the place in which creditors meetings may be held.

(c) Confidentiality

226. [165] Often the information in question will be commercially sensitive (such as trade secrets, lists of customers and suppliers, research and development information) and may either belong to the debtor or be in the control of the debtor but belong to a third party. It is desirable that an insolvency law include provisions to protect confidential information to prevent abuse of that information by creditors or other parties who are in a position to take advantage of it. The obligation to observe confidentiality may need to apply not only to the debtor, but also to parties connected to the debtor, the insolvency representative, creditor committees and third parties.

(d) Ancillary obligations

227. A number of insolvency laws impose additional obligations that are ancillary to the debtor’s obligation to co-operate and assist. These may include, for example, an obligation (either of the individual debtor or the managers and directors of the debtor entity) not to leave their habitual place of residence (without the permission of the court), to disclose all correspondence to the insolvency representative or the court and other limitations touching upon personal freedom. These limitations may be crucial to avoid disruption to the insolvency proceedings by the common practice of debtors leaving the

place of business and of directors and managers resigning from office upon commencement. Where they are included in an insolvency law, it is desirable that these ancillary duties be proportionate to their underlying purpose and to the overall purpose of the general duty to cooperate; they may also be limited by the application of relevant human rights conventions and agreements as noted above. Some insolvency laws specify these obligations as automatically applicable, while others provide that they may be applied by the court where they are necessary for the administration of the estate. Some laws also distinguish between individual and other types of debtors; where the debtor is an individual, limitations will only apply by order of the court, but where the debtor is a corporation, some limitations may apply automatically, such as in the case of disclosure of correspondence.

(e) Employment of professional to assist the debtor

228. [160] To assist the debtor in carrying out its duties in relation to the proceedings generally, some laws permit the debtor to employ professionals such as accountants, attorneys, appraisers and other professionals as may be necessary, subject to authorization. In some laws, that authorization is provided by the insolvency representative, in other laws by the court or the creditors.

(f) Failure to observe obligations

229. [166] Where the debtor fails to comply with its obligations, the insolvency law may need to consider how that failure should be treated. Where, for example, information is withheld by the debtor, there may be a need for some mechanism to compel the provision of relevant information such as a "public examination" of the debtor by the court or the insolvency representative. In more serious cases of withholding of information a number of countries impose criminal sanctions. Similar approaches may be appropriate for the breach of other obligations. The insolvency law may also need to consider the consequences of actions taken in violation of the obligations and whether or not those actions should be invalid.

5. Debtor's liability

230. [170] When the business entity is solvent, the debtor generally owes its principal obligation to the owners of the business, and its relations with its creditors will be governed by their contractual agreements. When the business becomes insolvent, however, the focus changes and the creditors become the real financial stakeholders in the business, bearing the risk of any loss suffered as the debtor continues to trade. Notwithstanding this change of focus, the conduct and behaviour of owners and management of a business entity is primarily a matter of law and policy outside the insolvency regime. It is not desirable that an insolvency law is used to remedy defects in that area of legal regulation or to police governance policies, although some insolvency laws may include an obligation to commence insolvency proceedings at an early stage of financial difficulty (see Part two, chapter II.B). If the consequence of the past conduct and behaviour of persons connected with an insolvent business entity is damage or loss to the creditors of the entity (for example, by fraud or irresponsible behaviour), it may be appropriate, depending upon the liability regimes applicable for fraud on the one hand and negligence on the other, for an insolvency law to provide for possible recovery of the damage or loss from the individuals concerned.

Recommendations

Purpose of legislative provisions

The purpose of provisions concerning the debtor is to:

(a) establish the rights and obligations [responsibilities] of the debtor ~~[and persons associated with the debtor]~~ during the continuation of the insolvency proceedings;
(b) address the remedies available for failure of the debtor to meet its obligations;
(c) address issues relating to management of the debtor in both liquidation and reorganization.

Content of legislative provisions

Right to be heard

(89) [(69)] The insolvency law should provide that [in both liquidation and reorganization proceedings] the debtor has a right to be heard in the proceedings.

Right to participate and request information

(90) [(70)] The insolvency law should provide that the debtor is entitled to participate in insolvency proceedings, ~~particularly reorganization proceedings~~, and to request information from the insolvency representative and the court. These rights are of particular importance in the context of reorganization proceedings.

Right to retain property to preserve the personal rights of the debtor

(91) Where the debtor is a natural person, the insolvency law should provide that the debtor is entitled to retain assets excluded from the insolvency estate on the basis that they are required to preserve the personal rights of the debtor.[2]

Obligations

(92) [(71)] The insolvency law should clearly identify the debtor's obligations in respect of both liquidation and reorganization proceedings. The debtor's obligations should include:

(a) to co-operate with and assist the insolvency representative to perform its duties [and refrain from conduct injurious to the administration of the proceedings];
(b) to provide accurate, reliable and complete information relating to its financial position and affairs that might reasonably be requested by the court, the insolvency representative or the creditor committee, including:
  (i) information on transactions that took place during the suspect period and involved the debtor or the assets of the debtor;

[2] See Chapter III, A Assets to be affected, recommendation (29)

(ii) information on ongoing court, arbitration or administrative proceedings, including enforcement proceedings;

(c) to enable the insolvency representative to take effective control of the insolvency estate and to surrender to the insolvency representative the assets, or control of the assets, comprising the insolvency estate, whether domestic or foreign[3] and business records;

(d) to prepare a list of creditors and their claims in cooperation with the insolvency representative and revise and amend the list as claims are processed;

(e) in the case of an individual debtor, not to leave its habitual place of residence without the permission of the court.

Confidentiality

(93) [(72)] Where information provided by the debtor is commercially sensitive, appropriate provisions to protect confidentiality should apply, whether set forth in the insolvency law or applicable procedural law. The obligation of confidentiality should apply to information in the control of the debtor, whether owned by the debtor or a third party, including trade secrets.

Continued operation of the debtor's business

(94) [(73)] The law should address the issue of the role to be played by the debtor in the continuing operation of the business [in both reorganization and sale of the business as a going concern in liquidation]. Different approaches may be taken, including:

(a) total displacement of the debtor from any role in the business and the appointment of an insolvency representative;

(b) limited displacement where the debtor may continue to operate the business on a day-to-day basis, subject to the supervision of an appointed insolvency representative, in which event the division of responsibilities between the debtor and the insolvency representative should be specified in the insolvency law; or

(c) retention of full control of the business (debtor-in-possession) with no insolvency representative appointed, but with appropriate protections including varying levels of control of the debtor and provision for displacement of the debtor in specified circumstances.[4]

Sanctions for failure to comply

(95) [(74)] The insolvency law should provide sanctions for the failure of the debtor, whether a natural person or commercial entity, to comply with the specified obligations, including providing that actions taken in contravention of the obligations are invalid.

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[3] See chapter VIII - the Model Law on Cross-Border Insolvency and appointment of a foreign representative

[4] It should be noted that this option relies on a well-developed court structure and the application of protections that operate to displace the debtor in certain circumstances. For a more detailed explanation see paragraphs 204-216 of the analytical commentary.

B. The insolvency representative

1. Introduction

231. [171] Insolvency laws refer to the person responsible for administering the insolvency proceedings by a number of different titles, including administrators, trustees, liquidators, supervisors, receivers, curators, official or judicial managers, or commissioners. The term “insolvency representative” is used in this Guide to refer to the person undertaking the range of functions that may be performed in a broad sense without distinguishing between the different functions that may be performed in different types of proceedings. The insolvency representative may be an individual or, in some jurisdictions, a corporation or other separate legal entity. Whether appointed by creditors, the court, a government department or agency, a public or statutory authority or the debtor, the insolvency representative plays a central role in the effective implementation of the insolvency law, with certain powers over debtors and their assets and a duty to protect them and their value and ensure that the law is applied effectively and impartially. In some jurisdictions the nature of the appointment is seen as that of, or closely resembling a trustee exercising public interest powers and undertaking functions for the benefit of the creditors and the debtor. Where an insolvency representative is appointed on an interim basis by the court before insolvency proceedings commence, the powers and functions of that person generally will be determined by the court. To the extent that they are the same as those of an insolvency representative appointed after commencement of proceedings, the interim insolvency representative should have the same qualifications, liability and remuneration as a representative appointed after commencement.

232. [172] Insolvency laws adopt a variety of approaches to the relationship between the insolvency representative and the court and, in particular, to the delineation of powers between them. Since it normally has the most information regarding the situation of the debtor, the insolvency representative often is in the best position to make informed decisions about the conduct of the insolvency proceedings. That does not mean, however, that the insolvency representative can act as a substitute for the court, as the court would generally be required to adjudicate disputes arising in the conduct of the proceedings and approval of the court is often required at a number of stages of the proceedings. Even in countries where the court plays a more limited role in insolvency, there is a limit to the amount of authority that would normally be conferred upon an insolvency representative. The powers of the insolvency representative may also be affected by the role afforded to creditors under the insolvency law.

2. Qualifications

233. [177] The insolvency representative can be selected from a number of different backgrounds such as from the ranks of the business community, from the employees of a specialized governmental agency or from a private panel of qualified persons (often lawyers, accountants or other professionals). Where the insolvency law provides for the appointment of a public official as insolvency representative, the specific qualifications discussed below generally will not be relevant to that appointment (although they may be relevant to the employment of the official by the government agency).

234. [177] In many countries, the insolvency representative must be a natural person, but some countries do provide that a legal person may also be eligible for appointment, subject to certain requirements such as that the individuals to undertake the work on behalf of the

legal person are appropriately qualified and that the legal person itself is subject to regulation. The complexity of many insolvency proceedings makes it highly desirable that the insolvency representative has knowledge of the law (not only insolvency law, but also relevant commercial and business law), as well as adequate experience in commercial and financial matters. If further or more specialized knowledge is required in a particular case, it can always be provided by hired experts. Some insolvency laws also require that a person to be appointed as an insolvency representative in a particular case have expertise and skills suited to that case.

235. [177] In addition to having the requisite knowledge and experience, it may also be desirable that the insolvency representative possess certain personal qualities, such as integrity, impartiality and independence from vested interests. [180] Conflicts of interest may arise from a number of prior or existing relationships with the debtor. Prior ownership of the debtor, a prior business relationship with the debtor, a relationship with a creditor of the debtor, prior engagement as a representative of the debtor, and a relationship with a competitor of the debtor may be sufficient in some countries to preclude the appointment of a person as an insolvency representative. In other countries, the person may still be appointed provided the conflict of interest is disclosed. In order to enhance the transparency, predictability and integrity of the insolvency system, it is desirable that the insolvency law specify the degree of relationship which may give rise to a conflict of interest and require a prospective insolvency representative to disclose circumstances that may lead to such a conflict or lack of independence. It is generally left to the court to determine whether or not a conflict of interest or a basis for demonstrating lack of independence exists in a particular case.

236. The qualifications required of a person who can be appointed as an insolvency representative may vary depending upon the design of the insolvency regime with regard to the role of the insolvency representative (including whether the proceedings are liquidation or reorganization) and the relative level of supervision of the insolvency representative (and of the insolvency proceedings generally) by the court. They may also vary depending upon the procedure for appointment (see below).

237. [178] Different approaches are taken to ensuring the appropriate qualification of the insolvency representative, including a requirement for certain professional qualifications and examinations; licensing where the licensing system is administered by a government authority or professional body; specialised training courses and certification examinations; requirements for certain levels of experience (generally specified in numbers of years) in relevant areas, for example, finance, commerce, accounting and law, as well as in the conduct of insolvency proceedings. Those systems which require some form of licensing or professional qualification and membership of professional associations often also address issues of supervision and discipline, and an insolvency representative may be subject to regulation by the court, a professional association, a corporate regulator or other body. A number of these systems are relatively complex and it is beyond the scope of the Guide to consider them in any detail.

238. [179] In determining the qualifications required for appointment as an insolvency representative, it is desirable that a balance be achieved between stringent requirements that lead to the appointment of a highly qualified person but which may significantly restrict the pool of professionals considered to be appropriately qualified and add to the costs of the proceedings, and requirements that are too low to guarantee the quality of the service required. Where there is a lack of appropriately qualified professionals, the role

given to the court in appointment and supervision may be an important factor in achieving the required balance.

3. Selection and appointment of the insolvency representative

239. [174] Insolvency laws adopt a number of different approaches to selection and appointment of an insolvency representative. In some jurisdictions, the insolvency law provides that a particular public official (variously titled the Official Trustee, the Official Receiver, the Official Assignee and …) automatically will be appointed to all insolvency cases or to certain types of insolvency cases. In many jurisdictions, it is the court that selects, appoints and supervises the insolvency representative. The selection may be made from a list of appropriately qualified professionals at the discretion of the court, it may be made by reference to a roster or rotation system or by some other means, such as the recommendation of the creditors or the debtor. While ensuring fair and impartial distribution of cases, [176] one possible disadvantage of a roster system is that it may not ensure the appointment of the person most qualified to conduct the particular case. That may depend, of course, upon the manner in which the roster list is compiled and upon the qualifications required of insolvency professionals in order to be included on that list. That disadvantage may not be perceived to be an important issue where the estate has no assets (see Part two, chapter II.B.4(f)).

240. [174] In some jurisdictions, a separate office or institution which is charged with the general regulation of all insolvency representatives selects the insolvency representative after the court directs it to do so. A number of countries have adopted this approach, and it may have the advantage of it allowing the independent appointing authority to draw upon professionals that will have the expertise and knowledge to deal with the circumstances of a particular case, including the nature of the debtor’s business or other activities; the type of assets; the market in which the debtor operates or has operated; the special knowledge required to understand the debtor’s affairs; or some other special circumstance. The use of an independent appointing authority will depend upon the existence of an appropriate body or institution that has both the resources and infrastructure necessary to perform the required functions; otherwise it will require the establishment of an appropriate body or institution.

241. [174] Another approach allows creditors to play a role in recommending and selecting the insolvency representative to be appointed, provided that that person meets the qualifications for serving in the specific case. The approaches that rely upon the independent appointing authority and the creditor committee may serve to avoid perceptions of bias and assist in reducing the supervisory burden placed upon the courts. A different approach permits the debtor to appoint the insolvency representative in those cases where reorganization proceedings are commenced by the debtor. This approach allows discussions to take place between the debtor and other parties, such as secured creditors, before commencement of the proceedings to familiarise the prospective representative with the business and allows the debtor to select an insolvency representative that it considers will be best able to conduct the reorganization. Concerns may be raised, however, as to the independence of the insolvency representative. These may be addressed by permitting creditors, in appropriate circumstances, to replace the insolvency representative appointed by the debtor.

4. Duties and functions of the insolvency representative

242. [173] Insolvency laws often specify the functions that the insolvency representative will have to perform in the proceedings and it is important that the insolvency law provide the insolvency representative with the powers necessary to carry out these functions. Although some of those noted below may be more relevant to liquidation than to reorganization, the insolvency representative's duties and functions may generally include:

(i) taking immediate control of the assets comprising the insolvency estate[5] and the debtor's business records;
(ii) representing the insolvency estate;
(iii.) generally administering the insolvency estate;
(iv) exercising rights for the benefit of the insolvency estate in respect of court, arbitration or administration proceedings underway;
(v) taking all steps necessary to protect and preserve the assets of the insolvency estate and the debtor's business, including preventing unauthorised disposal of those assets and exercising avoidance powers to pursue the recovery of assets disposed of improperly to defeat creditors;
(vi) registering rights of the estate (where registration is necessary to perfect the rights of the estate against bona fide purchasers);
(vii) appointing and remunerating accountants, attorneys and other professionals that may be necessary to assist the insolvency representative in performing its functions;
(viii) obtaining information concerning the debtor, its assets, liabilities and past transactions (especially those taking place during the suspect period) including examining the debtor and any third person having had dealings with the debtor ;
(ix) examination of contracts that are not fully performed with a view to deciding to continue or reject;
(x) dealing with employees and their rights and entitlements, including pension rights;
(xi) in liquidation, selling the assets of the insolvency estate;
(xii) verifying and admitting claims;
(xiii) periodically providing information to the court and to creditors detailing the conduct of the proceedings. The information should include, for example, details of the assets sold during the period in question, the prices realized, the expenses of sale and such information as the court may require or the creditors' committee may reasonably require; receipts and disbursements; assets remaining to be administered; and preparation of the reorganization plan;
(xiv) attending meetings of creditors;
(xv) managing the business in reorganization and in liquidation where the business is to be sold as a going concern;
(xvi) in reorganization, preparing a plan of reorganization or a report as to why reorganization is not possible (where this function is to be carried out by the insolvency representative);
(xvii) supervising approval of the reorganization plan and, where required, the implementation of the plan;

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[5] For a definition of the use of the word "estate" in the Guide, see Part two, chapter III and the glossary in Part one.

(xviii) closing the estate promptly, efficiently and in accordance with the best interests of the various constituencies in the case;

(xix) submitting a final report and accounting of the insolvency estate's administration to the court or the creditors, as required;

(xx) any other matters that may be referred to the insolvency representative by the creditors or determined by the court.

243. In addition to these specific duties and functions, insolvency laws often impose certain general obligations on the insolvency representative. These may include an obligation to maximize the value and protect the security of the insolvency estate, a duty to get the best price reasonably obtainable on the sale of assets of the estate; and [*others?*].

5. Confidentiality

244. The need to impose an obligation of confidentiality on the debtor has been noted above. It may also be appropriate for the insolvency law to impose a duty of confidentiality on the insolvency representative as much of the information that will be obtained concerning the debtor's affairs will be commercially sensitive (such as trade secrets, research and development information and customer information) and should not be disclosed to third parties who may be in a position to take unfair advantage of it. Observation of confidentiality may be particularly important where the insolvency representative has the power to compel disclosure of information and documents in the course of an examination of the debtor. Some of this information may come from third parties and be subject to privacy protection provisions and secrecy provisions, such as those applicable to banks. It is desirable that the insolvency representative be permitted to use that information only for the purposes of the insolvency procedure in the context of which the examination was permitted, unless the court decides otherwise. This issue may also be relevant to the provision and obtaining of information in the context of criminal proceedings against the debtor. A similar obligation of confidentiality should apply to agents of the insolvency representative (see below) and to other parties as ordered by the court.

6. Remuneration of the insolvency representative

(a) Determination of quantum

245. In addition to the reimbursement of the proper expenses incurred in the course of administration of the estate, the insolvency representative will be entitled to receive remuneration for its services. That remuneration should be commensurate with the qualifications of the insolvency representative and the tasks it is required to perform, and achieve a balance between risk and reward in order to attract appropriately qualified professionals. Several methods are adopted for calculating that remuneration. It could be fixed by reference to an approved scale of fees produced by a government agency or professional association; determined by the general body of creditors, the court or some other administrative body or tribunal in a particular case; based upon the time properly spent by the insolvency representative (and the various categories of person who are likely to work on the insolvency administration from office staff through to the principal appointee) on administration of the estate; or it could be based upon a percentage of the quantum of the assets of the estate which are realized or distributed or a combination of both (calculated at the end of the procedure when the assets have been sold and the value determined). This may a fixed percentage and include provision for increase or decrease depending upon the particular case.

(i) Time-based systems

246. An advantage of a time-based method is that often there will be a high level of uncertainty at the outset as to how complex and resource-intensive a particular administration may be, at least until some preliminary work has been carried out. A disadvantage is that although it may encourage a very thorough administration, a time-based system may also operate in some cases as an incentive to maximise the time spent on administration without necessarily achieving a proportional return of value to the estate.

(ii) Commission-based systems

247. An advantage of the commission system, at least from the creditors' perspective, is that at least some, if not a substantial proportion, of the assets recovered will be distributed to them. From the insolvency representative's point of view, however, it may be an uncertain method of calculation because the amount of work involved in an administration is not necessarily proportional to the value of assets available for distribution. It may also encourage an approach of "maximum return for minimum cost" and provides little incentive for undertaking functions which are not directly related to increasing returns to creditors, such as reporting obligations to both the court and to creditors, and assisting regulatory authorities with investigations into the debtors affairs and possible misconduct.

(iii) Involvement of creditors

248. In some countries, the general body of creditors (or the creditors' committee on their behalf) may be required to play a role in fixing or approving the remuneration, having regard to factors such as the complexity of the case, the nature and degree of the responsibilities of the insolvency representative and the effectiveness with which these have been discharged, as well as the value and nature of the assets of the estate. The involvement of creditors may serve to overcome some of the difficulties discussed above as creditors would be more aware of the issues involved and have the opportunity to participate in fee setting and approval. Fees could also be reviewed periodically during the course of the proceedings, with any problems arising being addressed and resolved, perhaps by arbitration or some other form of dispute resolution between the insolvency representative and the creditors.

249. It is highly desirable that the insolvency law establish a mechanism for fixing the insolvency representative's remuneration that is clear and transparent to avoid disputes and to provide some level of certainty as to the costs of insolvency proceedings. However calculated, it is also desirable that the insolvency law recognize the importance of according priority to payment of the insolvency representative's remuneration.

(b) Means of payment

250. Payment of the remuneration of the insolvency representative is often a source of complaint from unsecured creditors as the most common source of available funds is often unsecured assets and may often leave nothing for distribution to those creditors. While it would be unfair to draw the conclusion that the costs of administration were excessive simply because they exceeded the unsecured assets available to pay them, the occurrence of unsecured creditors seeing most, if not all of the available assets being used to cover the costs of the administration, and perceptions of unfairness relating to the total

cost of administration compared to the value of assets recovered, do point to the need to give this issue careful consideration. Different approaches can be taken to payment of the insolvency representative. For example, where the estate includes unsecured assets, remuneration could be paid from these; a surcharge could be levied against assets to pay for the administration or sale of those assets where the administration was of benefit to the creditors; a surcharge also could be levied on creditors on the making of an involuntary application to cover at least initial costs and performance of basic functions (see Part two, chapter II.B.5).

(c) Review of remuneration

251. Depending upon the manner in which the insolvency representative's remuneration is fixed, it may be desirable to provide for a review process to address dissatisfaction of the insolvency representative itself or creditor dissatisfaction. Where remuneration is fixed by a meeting of creditors, the court will generally have the power to review the amount on the application of the insolvency representative or of a specified percentage or number of creditors, for example creditors representing 10 per cent of the issued share capital or with at least 10 per cent or 25 percent of the total debts. Where the remuneration is set by the court in the first instance, the insolvency representative may or may not have a right to appeal that decision; some insolvency laws provide that the debtor cannot make an application for review. Where the insolvency representative is required to be a member of a professional organization or to be licensed, the professional organization or the licensing authority may also have powers with respect to review of the fees charged by their members and may provide informal dispute resolution mechanisms.

7. Duty of care [Liability]

252. [181] The standard of care to be employed by the insolvency representative and its personal liability are important to the conduct of insolvency proceedings. Establishing a measure for the care, diligence and skill with which the insolvency representative is to carry out its duties and functions requires a standard that will take into account the difficult circumstances in which the insolvency representative finds itself when fulfilling its duties and a balance of that standard against an appropriate level of remuneration and the desirability of attracting qualified persons to act in that capacity. The liability of the insolvency representative may often involve the application of law outside of insolvency.

253. [182] Different approaches may be taken in an insolvency law to setting that measure, although the measure adopted will depend upon the how the insolvency representative is appointed and the nature of the appointment (e.g. a private practitioner as opposed to a government employee). One approach may be to require the insolvency representative to observe a standard no more stringent than would be expected to apply to the debtor in undertaking its normal business activities in a state of solvency, that of a prudent person in that position. Some countries, however, may require a higher standard of prudence in such a case because the insolvency representative is dealing with assets belonging to another person, not its own assets. A different formulation is one based upon an expectation that the insolvency representative act in good faith for proper purposes. A further approach may be based upon the standard of care required in negligence. In determining the applicable standard, a balance is desirable between a standard that will ensure competent performance of the duties of the insolvency representative and one that is so stringent that it invites law suits against the insolvency representative and raises the costs of its services. Where the insolvency representative is a member of a professional organization, the professional standards of the organization may be relevant.

254. [183] One means of addressing the issue of liability for damages may be to require the insolvency representative to post a bond to cover loss of assets of the estate or provide insurance coverage against possible damages payable as a result of a breach of its duties. A number of insolvency laws require a bond and insurance, while others require only insurance. In some cases the level of the bond required relates to the book value of the assets, in others both the value of the bond and the amount of insurance cover required are established in the rules of the relevant professional association or regulatory body. These solutions, however, may not be available in all countries. In designing a solution to this issue, a balance may be desirable between controlling the costs of the service and distributing the risks of the insolvency process among the participants, rather than placing it entirely upon the insolvency representative on the basis of availability of personal indemnity insurance.

8. Agents of the insolvency representative

255. [185] Some insolvency laws require court authorization for the insolvency representative to retain accountants, attorneys, appraisers and other professionals that may be necessary to assist the insolvency representative in carrying out its duties. Other laws do not require court authorization. It is desirable that an insolvency law establishes some criteria relating to the employment of such professionals in terms of their experience, knowledge and reputation, as well as the need for their services to be of benefit to the estate. In terms of remuneration of these professionals, some laws require an application to and approval by the court, while another approach may be to require approval of the creditor body. Professionals may be paid periodically during the proceedings, or may be required to wait until the proceedings are completed. The requirements for disclosure of conflict of interest that apply to the insolvency representative may also apply to professionals employed by the insolvency representative. Obligations of confidentiality are also relevant.

256. [184] Where losses are sustained by the estate as a result of the actions of agents and employees of the insolvency representative, an insolvency law may need to address the liability of the insolvency representative for those actions. Some insolvency laws provide that the insolvency representative is not personally liable except where it fails to exercise the proper degree of supervision in the performance of its duties.

257. Different approaches may be adopted towards payment of the professionals employed by the insolvency representative. Under some insolvency laws, the insolvency representative will pay the professional and seek reimbursement from the estate. In others the professional will have an administrative claim against the estate.

9. Removal of the insolvency representative

258. [186] Some insolvency laws permit the insolvency representative to be removed in certain circumstances which may include that the insolvency representative had violated or failed to comply with its legal duties under the insolvency law, that it had demonstrated gross incompetence or gross negligence, that it had not disclosed a conflict of interest, that it had engaged in illegal conduct, or for less serious reasons such as that the proceedings require a particular or different competency that the appointed representative does not possess. Different approaches provide that removal may occur on the basis of a decision of the court, acting on its own motion or at the request of an interested party, or a decision taken by an appropriate majority of unsecured creditors. In cases where the insolvency

representative is subject to professional or regulatory supervision, they may be removed as the result of an investigation and review, which may also result in a licence or other authorization being taken away.

10. Replacement of the insolvency representative

259. [186] In the event of the resignation or removal of the insolvency representative or the occurrence of any other event which might cause the insolvency representative to be unable to perform its duties, such as death or serious illness, disruption of the proceedings and the delay that may be occasioned by failure to provide for succession may be avoided by providing for the appointment of a successor insolvency representative, either by the court or by creditors. Where an insolvency law provides for replacement of the insolvency representative, it may also need to address issues relating to substitution and succession to either title or control (as appropriate) of the assets of the estate (see Part two, chapter III.A) as well as handing over to the successor the books, records and other information relating to the debtor. An insolvency law may also need to consider the issue of the validity of the acts undertaken in the conduct of the proceedings by the insolvency representative that has been replaced.

Recommendations

Purpose of legislative provisions

The purpose of provisions concerning the insolvency representative is to:

(a) specify the qualifications required for appointment as an insolvency representative;
(b) establish a mechanism for the appointment of insolvency representatives;
(c) define the powers and functions of the insolvency representative;
(d) provide for the remuneration, liability, removal and replacement of an insolvency representative.

Content of legislative provisions

Qualifications

(96) [(75)] The insolvency law may specify the qualifications and personal qualities required for appointment as an insolvency representative. Relevant criteria include that the insolvency representative is independent and impartial, has the requisite knowledge of relevant commercial law and experience in commercial and business matters.

Appointment

(97) [(76)] The insolvency law should establish the mechanism for appointment of the insolvency representative on commencement of the proceedings. Different approaches may be taken, including appointment by the court; by an independent appointing authority; on the basis of a recommendation by creditors or the creditor committee; by the debtor; or by

operation of law, where the insolvency representative is a government or administrative agency or official.

(98) Where the insolvency law provides for appointment of an insolvency representative to administer an assetless estate, the insolvency law should also provide a mechanism for appointment and remuneration of that representative. That mechanism may include appointment of a government official or appointment by reference to a roster system, and remuneration by the State or […].

Conflict of interest

(99) [(77)] The insolvency law should require a person proposed for appointment as an insolvency representative to disclose circumstances that may lead to a conflict of interest or lack of independence [from other interests]. The insolvency law should also require that persons employed by the insolvency representative are required to disclose circumstances that may lead to a conflict of interest or lack of independence [from other interests].

~~Powers and functions~~ Duties and functions of the insolvency representative

(100) [(78)] The insolvency law should provide that the insolvency representative has a general obligation to maximize the value and protect the security of the insolvency estate. The insolvency law should clearly identify the insolvency representative's specific ~~powers and~~ duties and functions. These should include:

(a) taking control of the assets comprising the insolvency estate and the debtor's business records including those in the possession of third parties;
(b) generally administering the estate;
(c) controlling the collection, sale and distribution of assets;
(d) obtaining information concerning the debtor, its assets, liabilities, past transactions (especially those taking place during the suspect periods), including conducting an examination of the debtor (whether under oath or some equivalent procedure);
(e) ensuring the debtor's compliance with its obligations;
(f) assisting the debtor to prepare a list of creditors and their claims and ensuring that the list is revised and amended as claims are admitted;
(g) exercising avoidance powers;
(h) exercising rights for the benefit of the insolvency estate in respect of court, arbitration or administration proceedings underway and to which the stay and suspension apply;
(i) verifiying and admitting claims;
(j) managing the business in reorganization and in liquidation where the business is to be sold as a going concern;
(k) providing information and reporting to creditors and the court on a regular basis on the conduct of the proceedings;
(l) appointing and remunerating professionals to assist the insolvency representative;
(m) in a reorganization, preparing (or co-operating in the preparation of) a plan of reorganization or a report as to why reorganization is not possible (where this is a function of the insolvency representative);

(n) other matters as determined by the court or referred to the insolvency representative by creditors or the creditors committee.

Liability

(101) [(79)] The insolvency law should address the consequences, including possible personal liability for, or arising from, the insolvency representative's failure to perform or the performance of its duties ~~powers~~ and functions [as set forth in recommendations (99) and (100)].[6] Issues of the insolvency representative's liability may also involve the application of non-insolvency law.

Removal and replacement

(102) [(80)] The insolvency law should establish the grounds for removal of the insolvency representative and the procedure for removal. These grounds may include:

(a) incompetence, negligence, failure to perform or failure to exercise the proper degree of care in the performance of its powers and functions;
(b) lack of a particular or specialized competency required by a specific case;
(c) engaging in illegal acts or conduct; or
(d) conflicts of interest or a demonstrated lack of independence arising in circumstances that would justify removal.

(103) [(81)] The procedure for removal of the insolvency representative will reflect the manner in which the insolvency representative was appointed, but may include removal by the court on an application by creditors or the creditors' committee; removal by the court on its own motion; removal by the creditors where the creditors have appointed the insolvency representative and […].

(104) [(82)] In the event of the death, resignation, inability to perform or removal of the insolvency representative, the insolvency law should provide for appointment of a successor.

Remuneration

(105) [(83)] The insolvency law should provide for the remuneration of the insolvency representative, specify a mechanism for fixing that remuneration and establish priority for payment of that remuneration.

~~***Judicial review***~~

~~(84) [A general provision for review of decision taken by the insolvency representative e.g. on treatment of contracts, avoidance actions, admission of claims etc: see footnote 14]~~

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[6] At the twenty-sixth session of the Working Group (May 2002), some support was expressed in favour of including more detail in terms of the liability arising from the functions set forth in recommendations (99) and (100). The Working Group may wish to consider this issue further and make specific proposals as to what should be included in recommendation (101).

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Draft legislative guide on insolvency law

Note by the Secretariat

Contents

[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Add.3 and Add.4; Chapter III.A-F appear in documents A/CN.9/WG.V/WP.63/Adds.5-9; Chapter IV.A-B appears in document A/CN.9/WG.V/WP.63/Add 10; Chapters V-VII appear in subsequent addenda]

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* This document was submitted late because of the need to complete consultations and finalise consequent amendments.

Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.
Recommendation numbers in [..] refer to relevant recommendations in A/CN.9/WG.V/WP.61 and A/CN.9/WG.V/WP.61/Add.1, the previous version of the recommendations. Additions to the recommendations are indicated in this document by underlined text.

Part Two (continued)

IV. Participants and institutions

C. Creditors

1. Classes of creditors

260. [213] There are many diverse and competing interests in an insolvency proceeding. For the most part, creditors are creditors by virtue of having entered into a legal and contractual relationship with the debtor prior to the insolvency. There are creditors, however, who have not entered into such an arrangement with the debtor, such as taxing authorities (who will often be involved in insolvency proceedings) and tort claimants (whose participation will generally be less common). Accordingly, [214] the rights of creditors will be governed by a number of different laws.

261. [214] While many creditors may be similarly situated with respect to the kinds of claims they hold based on similar legal or contractual rights, others may have superior claims or hold superior rights. Even within the same class of creditor, there will be competing rights such as secured creditors that have better security than others. For these reasons, insolvency laws generally rank creditors by reference to their claims, an approach not inconsistent with the objective of equitable treatment. In developing these categories, it is desirable that a balance be reached between the legal and commercial rights of creditors based upon fairness and the commercial reasonableness of their relative positions, at the same time observing the objective of equality of treatment, preserving legitimate commercial expectations and fostering predictability in commercial relationships. There is, however, a limit on the extent to which these goals can be achieved, given the balance that is desirable in an insolvency law between these competing objectives and other public policy considerations. To the extent that these broader public interests compete with private interests, they may lead to a distortion of normal commercial incentives. Where these public interests are given priority, and equality of treatment based upon the classification of claims is not observed, it is desirable that the policy reasons for establishing that priority be clearly stated in the insolvency law. In the absence of equality of treatment, this approach will at least provide an element of transparency and predictability in the area of claims (see Part two, chapter VI.A) and distribution (see Part two, chapter VI.C).

262. [216] Creditors of an insolvent debtor generally fall into categories of secured creditors, preferred or priority creditors, and unsecured or ordinary creditors. In some insolvency laws, employees are treated as a separate interest group.

[NOTE TO THE WORKING GROUP: The Working Group may wish to consider whether the Guide should provide information on the different types of creditors and their interests. Would it be useful, for example, if this part of the Guide were to include a summary of the ways in which secured creditors may be affected by insolvency proceedings? A discussion of the ranking of claims appears in chapter VI.C]

2. Participation of creditors in insolvency proceedings

(a) Introduction

263. [192] Creditors have a significant interest in the debtor's business once an insolvency proceeding is commenced. As a general proposition, these creditor interests are safeguarded by the appointment of an insolvency representative. In addition, many insolvency laws provide for creditors to be directly involved in the proceedings in different ways and for a number of reasons. As the party with the primary economic stake in the outcome of the proceedings they may lose confidence in a process where key decisions are made without consulting them by individuals who may be perceived by creditors as having limited experience or expertise in the debtor's type of business or a lack of independence, depending upon the manner in which the representative is appointed. Creditors are often in a good position to provide advice and assistance with respect to the debtor's business and to monitor the actions of the insolvency representative, providing a check against possible abuse of the insolvency process and excessive administrative costs.

(b) Extent of involvement of creditors in the decision-making process

264. [194] There are varying possible degrees of involvement of creditors in decision-making in insolvency proceedings and insolvency laws adopt a wide range of approaches and mechanisms for creditor participation. An approach which allows only a low level of participation is reflected in those insolvency laws which provide that the insolvency representative makes all key decisions on uncontested general matters of administration, with the creditors playing a marginal role and having little influence. Lack of creditor participation in this model may be balanced against the key obligations of the insolvency representative one of which is to protect the value and security of the insolvency estate, ultimately for the benefit of creditors generally. Such an approach may be effective where an experienced insolvency representative is appointed to the proceedings because it avoids potential delays and the costs involved in managing the participation of creditors, and where the insolvency system provides a high level of regulation of the process and its participants.

265. [195] Other approaches afford creditors greater participation in the proceedings. This participation may range from participation at an initial meeting where certain matters are considered, to an ongoing role which may require creditors to perform only an advisory function or to approve certain acts and decisions of the insolvency representative. These may include the sale of significant assets, verification of claims and approval of the insolvency representative's final report and accounting, or may even hold primary responsibility for some administrative functions. Creditors may also be able to seek the dismissal and replacement of the insolvency representative by the court for failure to perform its functions and duties or for negligence. Creditors may also have a role in

requesting or recommending action from the court, for example, a recommendation that the reorganization be converted to liquidation or that an avoidance action be commenced by the insolvency estate or by creditors on behalf of the estate. In terms of costs, the creditors may also be given a role in monitoring the administrative expenditure and remuneration of the insolvency representative.

266. [196] Some insolvency laws draw a distinction between liquidation and reorganization in setting the level of creditor participation. In liquidation, although generally it may not be important for creditors to intervene in the process or participate in decision making, they can provide a valuable source of expert advice and information on the debtor's business, particularly where it is to be sold as a going concern. It may be desirable for creditors to receive reports on the conduct of the liquidation to ensure their confidence in the process, as well as its transparency. In reorganization, however, the input of creditors is both useful and necessary, as they will generally determine whether the reorganization plan will be supported and successful or not.

267. In terms of the mechanisms for participation, some insolvency laws allow creditors to participate as a general body of creditors. Other laws provide for the formation of a committee (on which creditors sometimes may share representation with shareholders and possibly other interested parties) to facilitate the participation in the administration of the estate. The committee will generally be a smaller number of creditors (in some laws, a specified number). A further approach is to provide for the appointment of a single person to represent certain groups of creditors (such as groups holding at least ten percent of the debt). In one law where this approach has been adopted the rationale is to facilitate more orderly and timely participation and avoid the delays and disputes previously encountered.

268. [198] An important issue that may need to be considered where an insolvency law allows creditors to participate actively in the process is how to overcome creditor apathy and encourage participation in the proceedings. It is not uncommon for creditors to adopt the view, even where the insolvency law provides for active participation, that nothing will be gained from such participation, especially where the return to creditors is unlikely to be significant and where participation may in fact require further expenditure of time and money. This common concern can be addressed to some extent by the overall balance that an insolvency law strikes between the different interests of the parties involved in the proceedings (see for example, Part two, chapter IV.A.2) and by specific measures relating, for example, to selection of the creditors committee and the functions to be performed by that committee (or by creditors generally where there is no committee) (see below).

(c) General body of creditors [assembly of creditors]

269. Where the general body of creditors is required or permitted to participate in the insolvency proceedings, an insolvency law should clearly establish the powers and functions of that body and establish the manner in which meetings of creditors in general may be convened. It is also desirable that an insolvency law determine the extent to which secured creditors can or should participate at meetings of the general body of creditors; for example, some insolvency laws require secured creditors to surrender their security before they can participate in the proceedings and vote as a member of the creditor body.

(i) Functions

270. As noted above, the functions to be performed by creditors vary widely between insolvency laws. In some cases, they perform a general advisory function and the insolvency representative may refer matters to the creditors, but will not be bound by any decision they take. Under other laws, the creditors may have specific functions to perform with regard to the conduct of the proceedings, which may involve co-operation and co-ordination with the insolvency representative. The insolvency representative may be required to consult with creditors on those matters before taking its decision or the decision-making power may reside with creditors. Other functions required the creditors to oversee the acts and decisions of the insolvency representative. Some of the issues in respect of which creditors may have an interest may include some or all of the following: continuation of the business in liquidation; post commencement financing; verification of claims; compensation of professionals, including the insolvency representative; treatment of judicial proceedings to which the debtor was a party at the time of commencement; consideration and approval of a reorganization plan; appointing a committee or representatives of creditors; supervising the acts of the insolvency representative; distribution of assets; and consideration (and approval) of the insolvency representative's final report and accounting.

271. Where the insolvency representative is not bound to follow the decision of creditors, insolvency laws often provide that for certain acts the insolvency representative must seek the prior approval of the court, or that creditors may apply to the court to give binding instructions to the insolvency representative (or to seek replacement of the insolvency representative where the insolvency representative fails to meet its obligations or otherwise acts to the detriment of creditors). In the event of a dispute between the creditors and the insolvency representative, many laws give precedence to the decision at a meeting of creditors. A similar intention is found in the requirements for creditors to be consulted on any decisions that require court approval.

272. Whatever functions are to be performed by the creditors, it is desirable that an insolvency law clearly states whether the general body of creditors is required to undertake each of its specified functions, or whether certain functions are discretionary, and the manner in which creditors are to interact with the insolvency representative in the performance of those functions.

(ii) Creditor meetings

273. Many insolvency laws provide for the functions of creditors to be undertaken via general meetings of creditors (as opposed to meetings of a committee that might be appointed to undertake functions on behalf of the general body). As noted above (see Part two, chapter II.B), an insolvency law should require creditors to be notified (whether by personal notice, advertisement or some other means) of the commencement of insolvency proceedings and for that notification to include advice on a number of matters, including details of an initial meeting of creditors, to be convened by the court or the insolvency representative within a prescribed period of time after commencement (examples of time limits range from five days to one month from the date of commencement).

274. Insolvency laws take different approaches to subsequent meetings of the general body of creditors. Under a number of insolvency laws, the initial meeting is the only meeting of creditors that will take place. Under other laws further meetings are to be convened by the court or the insolvency representative for specific purposes, while yet other laws include provision for creditors or the insolvency representative, and in some limited cases the debtor, to convene meetings on an ad hoc basis, as required. Where the insolvency law allows creditors to convene a meeting, the law may include certain limitations on when a meeting can be called or conditions that must be fulfilled before a meeting can be called. These conditions may include the passing of a defined period of time after a certain step in the proceedings was to be taken, or upon the completion of defined acts or decisions of the insolvency representative or where the insolvency representative fails to act. Some laws also provide that only creditors holding a specified percentage of the total claims are entitled to call a meeting (examples include ten percent of creditors by value, creditors with no less than 25 percent of total claims or at least 25 percent of unsecured claims). A further approach allows any interested party the right to apply to the court to summon a meeting of creditors.

275. It is desirable that all creditors have the right to be heard on matters to be discussed at a creditor meeting. Where a vote of the general body of creditors is required, it is desirable that an insolvency law establishes the relevant voting requirements and mechanisms. It may also be desirable for an insolvency law to provide for creditors to establish rules governing the conduct of creditor meetings where this would facilitate creditor participation, and where it would be appropriate to the role to be played by creditors in the proceedings.

(d) Creditor committee

276. [193] In some insolvency proceedings the formation of a creditor committee or the election of a creditor representative can provide a mechanism to facilitate creditor participation in the proceedings, whether liquidation or reorganization. A creditor committee (or similar form of creditor representation) may not be required in all insolvency cases, but may be appropriate where there is a very large number of creditors, where creditors have very diverse interests, or where other features of the case indicate that such an approach is desirable or necessary (e.g. to limit time and monetary costs). Some insolvency laws provide for creditors to determine whether or not they will appoint a committee, while other laws provide for the court to appoint a committee to help supervise the acts of the insolvency representative. Where a creditor committee is formed, it will be necessary to consider the extent to which the insolvency estate will pay the costs of the committee; some insolvency laws allow creditors to form unofficial committees which are not formally recognized by the court or the insolvency representative and whose costs are not reimbursed by the insolvency estate, and other laws provide that creditors may appoint a representative, but must bear the associated costs. A number of laws provide that the costs of the creditor committee are to be borne by the estate. This question is closely linked to the role of the committee, the extent to which the functions specified under the insolvency law to be performed by the creditors can be performed by a committee and the factors determining whether a committee is to be formed in any particular proceeding.

(i) Creditors that may be appointed to a committee

277. [199] Different approaches are taken to the composition of creditor committees. As an initial issue, an insolvency law may need to consider which creditors will be entitled to be appointed to a creditor committee. Some insolvency laws provide, for example, that only creditors whose claims have been admitted (by the court or the insolvency representative, depending upon the admission procedure) can be appointed, while other laws provide for appointment of a provisional committee, for which all creditors are eligible, until all claims have been verified and admitted. Other insolvency laws impose restrictions on the location of creditors who may serve on a creditors committee. [205] To ensure equality of treatment of creditors, however, it may be desirable for creditors such as those whose claims have only been provisionally admitted and foreign creditors to be eligible for appointment to the committee.

278. A second issue relates to the types of creditors to be represented. [199] Although creditor committees generally represent only unsecured creditors, some laws recognize that there may be cases where a separate committee of secured creditors is justified. Those systems base this approach on the fact that the interests of the different types of creditors do not always converge and the ability of secured creditors to participate in, and potentially affect, the outcome of decisions by the committee may not always be appropriate or in the best interests of other creditors.

279. [200] Other insolvency laws provide for both types of creditors to be represented on the same committee. The rationale of this approach is that since the creditor committee is responsible for participating in the decision-making process and for making important decisions, secured creditors should participate otherwise they are excluded from the making of important decisions which may affect their interests. A further approach may be for an insolvency law not to specify which creditors should be represented in a given case, but to allow creditors to collectively choose their own representatives on the basis of willingness to serve (to address the problem of creditor apathy which is not uncommon) and to provide for enlargement or reduction of the size of the committee as required. Where the types of creditors requiring representation are too diverse to accommodate their interests within a single committee, such as may be the case for special interest groups such as tort claimants and shareholders, an insolvency law could provide for different committees to represent different interests. It is desirable, however, that this mechanism only be used in special cases, in order to avoid unnecessary costs and the possibility of the creditor representation mechanism becoming unwieldy.

280. [201] The participation of shareholders or owners of the debtor and creditors related to the debtor may be controversial, especially where the creditor committee has the power to affect the rights of secured creditors or where the shareholders or owners are involved with the management of the debtor. There will be cases, however, where the shareholders have no direct knowledge of, or involvement with, the management of the debtor, such as where the shareholders are investors with no direct association with or access to management. In such cases, there may be compelling reasons for allowing the shareholders to participate through their own committee. Other creditors who may have a conflict of interest (such as competitors of the debtor who may have a personal interest with the potential to affect their impartiality in carrying out the functions of the committee) may also need to be excluded from participation in a committee in order to ensure that the

committee is able to perform its functions on behalf of the general creditor body impartially and independently.

281. [202] A similar question of participation may arise in respect of parties who purchase the claims of creditors. Such purchasers may be related to the debtor or may be third parties who have no particular interest in the business of the debtor. Third party purchases may give rise to concerns about access to sensitive, confidential information that may be of value in the secondary debt market, while related party purchases raise the question of whether the related party should be entitled to claim the original face value of the claim or only the amount actually paid for it (where there is a difference between the two), which may affect the ability to vote where it is directly related to the value of claims.

282. [203] To address any potential problem, an insolvency law could adopt the approach of stipulating which parties are not entitled to participate in a creditor committee or vote on particular matters, such as selection of an insolvency representative or approval of a reorganization plan.

(ii) Formation of a creditor committee

283. [204] Where the law provides for the formation of creditor committees, details of the manner in which the committee is to be formed, the scope and extent of its duties, its governance and operation, including voting eligibility and powers, quorum and conduct of meetings, as well as replacement and substitution of members are often also addressed. It may be desirable to include such provisions in an insolvency law not only to avoid disputes and ensure confidentiality, but also to provide transparent and predictable procedures.

284. [206] A number of different approaches are taken to appointing the members of the committee, which depend to a large extent on the functions to be performed by the particular committee. In many cases, it is the general body of creditors that appoints the committee, normally at the initial meeting of creditors, or upon the provision by the insolvency representative of preliminary information regarding the debtor. Appointment of the committee by creditors may encourage both creditor confidence and participation in the insolvency process. Some jurisdictions allow the court to appoint a creditors committee, either at its own instigation or upon application by creditors or the insolvency representative. The disadvantages of this approach may include perceptions of bias, and a lack of equity and transparency; creditors may not have confidence in a system that does not encourage or allow them to play a role in selecting their own representatives and it may not serve to overcome the widespread problems of creditor apathy. On the other hand, such an approach may serve to simplify the procedure for establishing a creditor committee and reduce the scope for disputes between creditors. The choice between these different approaches may depend upon the extent to which the court supervises the insolvency proceedings and is involved on a day-to-day basis, and the extent to which creditors are required to undertake an active role in performing functions that require more than the provision of advice to the insolvency representative.

285. [205] To facilitate administration and oversight of the committee, some insolvency laws specify the size of the committee - generally an odd number in order to ensure the achievement of a majority vote, and in some cases no more than three or five persons. Where the committee represents only unsecured creditors, membership of the committee is

sometimes limited to the largest unsecured creditors. These creditors can be identified by a number of means, including requiring the debtor to prepare a listing of its largest creditors. [207] To ensure that it fulfils its duty to fairly represent creditors, oversight of the committee may be desirable where the insolvency law provides for the committee to undertake a significant role and could be undertaken by the insolvency representative, or by the court.

(iii) Functions of a creditor committee

286. As a general proposition, a creditor committee will perform its functions on behalf of the general body of creditors and those functions will therefore be related directly to the functions of the general body of creditors. The powers and functions given to a creditors committee should not impair the rights of the creditors as a whole to participate or otherwise act in the insolvency proceeding. In general, insolvency laws provide for a creditors committee to advise, consult with or possibly supervise the insolvency representative, and [208] undertake a number of specific tasks including monitoring the progress of the case (which may include requiring the provision of information by the insolvency representative); consulting with other principals in the proceeding, especially an insolvency representative and the existing management of the debtor; and advising the insolvency representative on the wishes of the creditor body on issues such as the sale of significant assets and formulation of the reorganization plan. To perform its functions, the committee may require administrative and expert assistance. This can be addressed by providing that the committee can seek permission from the insolvency representative or the general body of creditors to hire a secretary and, if circumstances warrant, consultants and professionals. Some insolvency laws provide that such costs will be paid by the insolvency estate, while other laws provide that creditors must meet their own costs of participation in the insolvency process.

(iv) Liability of the creditor committee

287. [209] The committee’s duty would be to the general body of creditors. It would not have any liability or fiduciary duty to the owners of the insolvent business. It may be desirable to require the committee to act in good faith and to provide that members of the committee would be immune from liability in respect of actions and decisions taken by them as members of the committee unless they were found to have acted improperly or to have breached a fiduciary duty to the creditors they represent. This might include, for example, deriving profit from the administration; or acquiring assets forming part of the estate without prior approval of the court. In considering the question of the liability of the committee, a balance may need to be struck between setting too high a level of responsibility which will promote creditor apathy and effectively discourage creditors from participating, and too low a level which may lead to abuse and prevent the committee from functioning efficiently as a representative body.

(v) Removal and replacement of members of the committee

288. An insolvency law may need to give some consideration to the grounds upon which removal of a member of the creditor committee might be justified and to establishing a mechanism for replacement. The procedure for such removal and replacement may be related to the procedure for appointment of a creditor committee in the first instance, whether by the court or election by the general body of creditors. a

mechanism for replacement of members of the committee will also be relevant where members of the committee resign or are unable to continue performing the required functions, such as in cases of serious illness or death.

(e) Voting of creditors

289. An insolvency law may need to consider distinguishing between the matters on which a vote of the general body of creditors is required and those matters on which a creditor committee may make a decision, as well as establishing the applicable voting requirements in each case. It may also need to consider what will constitute a valid meeting of a creditor committee in terms of number of members (or quorum) required to attend, although the need for such a provision may depend upon the functions to be performed by the committee.

290. [210] Where actions to be taken in the course of the proceedings will have a significant impact on the creditor body, it is desirable that all creditors (as opposed to just the creditor committee) are entitled to receive notice of, and to vote on, those actions. These actions may include voting to select the insolvency representative where an insolvency law provides creditors with this role; on approval of the reorganization plan; on other significant events such as sale of substantial assets; and post-commencement finance.

291. A number of different approaches can be taken with respect to achieving that vote, depending upon the nature of the matter to be decided. Some laws provide that voting should occur in person at a meeting of creditors, while other laws provide that where a large number of creditors are involved or where creditors are not local residents, voting may take place by mail or by proxy. It may also be desirable to recognize that voting may take place using electronic means.

292. [211] Different approaches are taken to the type of voting result that is required to bind creditors to different decisions, [212] with some insolvency laws distinguishing between different types of decisions to be made. More important decisions, such as approval of a reorganization plan, may require a vote that includes both a proportion of value of claims as well as a number of creditors (see Part two, chapter V). Some laws require a majority in value for most decisions and for decisions such as election or removal of the insolvency representative and hiring of particular professionals by the insolvency representative, a majority in value and number is required. Other laws provide that a simple majority is sufficient on issues such as election or removal of the insolvency representative. Some laws also distinguish between matters requiring the support of both secured and unsecured creditors; secured creditors will only participate in the vote on specified matters such as selection of the insolvency representative and matters affecting their security.

293. Jurisdictions also take a variety of approaches to establishing a voting mechanism for the committee. These approaches reflect those that are used for the general body of creditors. It is most important, however that some rules be established to govern the decision making of the creditor committee, including rules relating to majorities and voting.

(f) Resolution of disputes between the general body of creditors and the creditor committee

294. As noted above with regard to disputes with the insolvency representative, many insolvency laws give precedence to decisions made in a meeting of the general body of creditors. As the primary decision-making organ for creditors, express decisions of the general body of creditors should over-ride decisions made on the same matter by a creditor committee.

(g) Confidentiality

295. As noted above (Part two, chapter IV.A and B), it is desirable that an insolvency law imposes obligations of confidentiality on both the debtor and the insolvency representative. For similar reasons, it may be appropriate to also consider the circumstances in which creditors should be required to observe confidentiality. In the course of the administration of an insolvency proceeding, creditors generally will be in a position to obtain significant amounts of information concerning the debtor and its business, much of which may be commercially sensitive. While the consequences of liquidation suggest that there may not be much opportunity for creditors to take unfair advantage of that information (or that harm to the debtor will result), that may not be true of reorganization, and there may be circumstances where creditors can use that information to affect the successful implementation of an agreed plan. For these reasons, it may be appropriate to impose on creditors an obligation of confidentiality that permits the use of information obtained in the course of the proceedings only for the purposes of administration of the proceedings, unless the court decides otherwise.

Recommendations

Classes of creditors

Purpose of legislative provisions

The purpose of provisions on classes of creditors is to: […].

Content of legislative provisions

(106) The insolvency law should clearly identify the different classes of creditors that will be affected by the insolvency law and the manner in which those classes will be treated under the law [in terms of claims, priority and distribution].

Participation of creditors in insolvency proceedings

Purpose of legislative provisions

The purpose of provisions on participation of creditors in insolvency proceedings is to:

(a) establish the functions and responsibilities of the general body of creditors;

(b) provide for the participation in insolvency proceedings of the general body of creditors by the appointment of a creditor committee;
(c) provide a mechanism for the appointment of a committee;
(d) establish the functions and responsibilities of the creditor committee.

Content of legislative provisions

General body of creditors [assembly of creditors]

(107) [(85)] The insolvency law should establish the powers and functions of the general body of creditors. These should include:

(a) approval or rejection of a reorganization plan;
(b) [involvement in] [advising on] issues referred by the insolvency representative, including advising on continuation of the business in liquidation, post-commencement financing, verification of claims, compensation of professionals, treatment of judicial proceedings to which the debtor was a party at the time of commencement, distribution of assets and […].

- Voting of the general body of creditors

(108) [(86)] The insolvency law should specify the matters on which a vote of the general body of creditors is required and establish the relevant voting requirements.

- Right to be heard

(109) [(87)] Creditors should have the individual right to be heard in the insolvency proceedings on matters relating to […].

- Participation of secured creditors

(110) [(90)] The insolvency law should clearly indicate the extent to which secured creditors [may] [should] participate in both liquidation and reorganization proceedings. Where secured creditors rely on secured assets to pay part or all of their claims, the insolvency law [may][should] limit their participation in the proceedings to the extent that their claim is secured. Where secured creditors have surrendered their security to the insolvency representative, the insolvency law should enable them to participate in the proceedings to the same extent as ordinary unsecured creditors. Where a secured creditors claim is to be restructured under a reorganization plan, the secured creditor should be entitled to participate in the reorganization proceedings.

- Convening meetings of the general body of creditors

(111) Meetings of the general body of creditors may be convened [by the court] [by the insolvency representative] [at the request of creditors [holding (*specify a percentage of the total value of)* [unsecured] claims].

Creditor committee

(112) [(88)] The insolvency law should provide [a mechanism] for the general body of creditors to actively participate in the insolvency proceedings [such as] through a creditor committee. Where the interests and categories of creditors involved in the insolvency proceeding are diverse and participation will not be facilitated by the appointment of a single committee, the insolvency law may provide for the appointment of different creditor committees.

(113) Where the insolvency law provides for a creditor committee to be appointed the relationship between the general body of creditors and the creditor committee should be clearly stated. In particular, the insolvency law should specify: whether a committee is required in all insolvency cases, the distribution of functions and powers between the general body of creditors and the creditor committee, the mechanism for resolution of disputes between the general body of creditors and the creditor committee and […].

- Creditors that may be appointed to a creditor committee

(114) [(89)] The insolvency law should specify the categories of creditors that may or may not be appointed to the committee, including whether or not a creditor's claim must be admitted [whether provisionally or otherwise] before it is entitled to be appointed to a committee. The creditors who [may] [should] not be appointed to the creditor committee would include related persons such as creditors related to the debtor (whether personally or as a director, manager or advisor of the debtor) and creditors with a personal interest in the affairs of the debtor where that interest has the potential to affect the creditor's impartiality in carrying out the functions of the committee (e.g. a competitor of the debtor).

- Mechanism for appointment to a creditor committee

(115) [(91)] The insolvency law should establish the mechanism for appointment of the creditor committee. Different approaches may include selection of the creditor committee by the general body of creditors or appointment by the court or other administrative body.

- Functions of a creditor committee

(116) [(92)] The insolvency law should establish the powers and functions of the creditor committee including:

(a) in both liquidation and reorganization proceedings, a general advisory function, providing advice and assistance to the insolvency representative;
(b) a supervisory function with respect to development of the reorganization plan, the sale of significant assets and in other matters as directed by the court or determined in co-operation with the insolvency representative;
(c) the right to be heard in insolvency proceedings.

- Employment and remuneration of professionals by a creditor committee

(117) [(93)] The insolvency law should permit the creditor committee, subject to approval by [the court] [the general body of creditors], to employ and remunerate professionals that may be needed to assist the creditor committee to perform its functions.

- Liability of members of a creditor committee

(118) [(94)] The insolvency law should provide that members of the creditor committee are exempt from liability for their actions in their capacity as members of the committee unless they are found, for example, to have acted fraudulently.

- Removal and replacement of members of a creditor committee

(119) [(95)] The insolvency law should provide for removal and replacement of members of the creditor committee and specify the grounds, including [gross] negligence, [lack of the necessary skills], [incompetence or inefficiency].

- Procedural rules for a creditor committee

(120) [(96)] The insolvency law may provide for the establishment of rules to govern the performance of the functions and decision making of the creditor committee, including rules relating to majorities and voting.

D. Institutional framework

296. An insolvency law is a part of an overall commercial legal system and is heavily reliant for its proper application not only on a developed commercial legal system, but also on a developed institutional framework for administration of the law. The choices made in developing or reforming an insolvency law will therefore need to be closely linked to the capacities of existing institutions. The insolvency system will only be effective if the courts and officials responsible for its implementation have the necessary capacity to provide the most efficient, timely and fair outcome to those for whose benefit an insolvency systems exists. If that institutional capacity does not already exist, it is highly desirable that reform of the insolvency law is accompanied by institutional reform, where the costs of establishing and maintaining the necessary institutional framework are weighed against the benefits of providing a system that is efficient, effective and in which the public have confidence. Although a detailed discussion of the means by which this institutional capacity can be developed or enhanced is beyond the scope of this Guide, a number of general observations can be made.

297. In most jurisdictions, the insolvency process is administered by a judicial authority, often through commercial courts or courts of general jurisdiction or, in a few cases, through specialized bankruptcy courts. Sometimes judges have specialized knowledge and responsibility only for insolvency matters, while in other cases insolvency matters are just one of a number of wider judicial responsibilities. In a few jurisdictions non-judicial or quasi-judicial institutions fulfil the role that in other jurisdictions is played by the courts.

298. In designing the insolvency law it may be appropriate to consider the extent to which courts will be required to supervise the process and whether or not their role can be limited with respect to different parts of the process or balanced by the role of other participants in the process, such as the creditors and the insolvency representative. This is of particular importance where the insolvency law requires judges to deal quickly with difficult insolvency issues (which often involve commercial and business questions) and the capacity of the judiciary is limited, whether because of its size, a general lack of

resources in the court system or a lack of specific knowledge and experience of the types of issues likely to be encountered in insolvency.

299. To limit the role to be played by the court, an insolvency law can provide that the representative, for example, is authorized to make decision on a number of issues, such as verification and admission of claims, the need for post-commencement funding, surrender of secured assets of no value to the estate, sale of major assets, commencement of avoidance actions, and treatment of contracts, without the court being required to intervene, except in the case of a dispute. Creditors also can be authorized to provide advice to, or to approve certain decisions of, the insolvency representative, such as approving the sale of important assets or obtaining post-commencement finance, without requiring the court to intervene, except in the case of dispute. An insolvency law can specify those procedures that will require court approval, such as the provision of a priority ranking above the rights of existing secured creditors to secure post-commencement finance.

300. The court's capacity to handle the often complex commercial issues involved in insolvency cases is often not only a question of knowledge and experience of specific law and business practices, but also a question of that knowledge and experience being current and regularly updated. To address the issue of judicial capacity, a special focus on the education and ongoing training of court personnel, not only of judges but also of clerks and other court administrators, will assist in supporting an insolvency regime that has the ability to respond effectively and efficiently to its insolvency caseload.

301. A further consideration related to the court's capacity to supervise insolvency cases is the balance in the insolvency law between mandatory and discretionary components. While mandatory elements, such as automatic commencement or automatic application of the stay, may provide a high degree of certainty and predictability for debtor and creditors as well as limiting the matters requiring consideration by the courts, it amy also lead to rigidity of there are too many of these type of elements. A discretionary approach allows the court to weigh facts and circumstances, taking into account precedent, community interests, and those of persons affected by the decision and market conditions. It may also impose a burden on the court where it does not have the knowledge or experience required to weigh these considerations or the resources to respond in a timely manner. Where the insolvency law provides for confirmation of a reorganization plan by the court, for example, it is not desirable to ask the court to undertake complex economic assessments of the feasibility or desirability of the plan, but rather to limit its consideration to the conduct of the approval process and other specified issues. Where an insolvency law requires the exercise of discretion by a decision-maker, such as a court, it is preferable that adequate guidance as to the proper exercise of that discretion is also included, particularly where economic or commercial issues are involved. This approach is consistent with a general objective of an insolvency regime of transparency and predictability.

302. The adequacy of the legal infrastructure and in particular, the resources available to courts dealing with insolvency cases, may be a significant influence on the efficiency with which insolvency cases are handled and the length of time required for insolvency proceedings. This may be a relevant consideration in deciding whether the insolvency law should impose time limits for the conduct of certain parts of the process. If the court infrastructure is not able to respond to the demands placed upon it in a timely manner to ensure that time limits are observed by the parties and the insolvency process moves quickly along, the inclusion of such provisions in the law will not achieve the goal of an effective and efficient insolvency regime. Procedural rules will also be of importance

to the conduct of cases and well-developed rules will assist courts and the professionals handling insolvency cases to provide an effective and orderly response to the economic situation of the debtor, minimising the delays that can result in diminution in value of the debtor's assets and impair the prospects of a successful insolvency proceedings (whether liquidation or reorganization). Such rules will also assist in achieving a degree of predictability and uniformity of treatment from one case to the next.

303. Implementing an insolvency system depends not only on the court, but also on the professionals involved in the insolvency process, whether they are insolvency representatives, legal advisers, accountants, valuation specialists or other professional advisers. The adoption of professional standards and training may assist in developing capacity. It may be an appropriate to assess which insolvency functions are truly public in nature and should be performed in the public sector in order to ensure the level of trust and confidence required to make the insolvency system effective, and those functions which can be performed by the creation of adequate incentives for private sector participants in the insolvency process. The insolvency representative might be one example.

Recommendations

[NOTE TO THE WORKING GROUP: The Working Group may wish to consider whether recommendations on the institutional framework required for an effective and efficient insolvency regime should be added to the Guide and if so, what those recommendations should include.]

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Draft legislative guide on insolvency law

Note by the Secretariat

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[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Adds.3-4; Chapter III.A-F appear in documents A/CN.9/WG.V/WP.63/Adds.5-9; Chapter IV.A-D appear in documents A/CN.9/WG.V/WP.63/Adds.10-11; and ChaptersVI-VII appear in subsequent addenda]

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Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.
Recommendation numbers in [..] refer to relevant recommendations in A/CN.9/WG.V/WP.61 and A/CN.9/WG.V/WP.61/Add.1, the previous version of the recommendations. Additions to the recommendations are indicated in this document by underlined text.

Part Two (continued)

V. Reorganization

A. The reorganization plan

1. Introduction

304. [261] Insolvency laws generally address a number of issues in relation to the reorganization plan, such as the nature or form of the plan; when the plan is to be prepared; who is able to prepare the plan; what is to be included in the plan; how the plan is to be approved and the effect of the plan.

305. [262] Reorganization plans perform different functions in different types of proceedings. In some, the plan may be the tailpiece of the reorganization proceedings, dealing with the pay-out of a dividend in full and final settlement of all claims (also referred to as a composition or a scheme of arrangement) and the final structure of the business after the reorganization is complete or it may be proposed at the commencement of the proceedings and set out the way the debtor and the business should be dealt with during the reorganization period, much like a business plan, as well as expected dividends and dates of payment. There may also be circumstances where a plan, like a plan of reorganization, is prepared in liquidation where the business is to be sold as a going concern and may address the timing and mechanics for interim distributions. The following discussion focuses upon the issues that would be relevant to a plan proposed on commencement, addressing the conduct of the business in reorganization and the transformation of legal rights proposed to address the debtor's financial situation. These will also be relevant, although not necessarily in their entirety, to other types of plans.

2. Nature or form of a plan

306. [263] The purpose of reorganization is to maximize the possible eventual return to creditors, providing a better result than if the debtor were to be liquidated and to preserve viable businesses as a means of preserving jobs for employees and trade for suppliers. With different constituents involved in the reorganization process, each may have different views of how that objective can best be reached. Some creditors, such as major customers or suppliers, may prefer continued business with the debtor to rapid repayment of their debt. Some creditors may prefer an equity stake in the business, while others will not. Typically, therefore, there is a range of options from which to select in a given case and if an insolvency law adopts a prescriptive approach to the range of options available or to the choice to be made in a particular case, it is likely to circumvent achievement of the goal of maximizing value. It is desirable that the law does not, for example, permit only a plan that is designed to fully rehabilitate the debtor; nor provide that debt cannot be written off; nor provide that a minimum amount must eventually be paid to creditors; nor prohibit exchange of debt for equity. [264] Such a non-intrusive approach is likely to provide the flexibility sufficient to allow the most suitable (in terms of the particular entity) of a range of possibilities to be chosen. Some insolvency laws adopt an approach of listing some of the possibilities that may be adopted, but it is not intended that the list be exclusive of other approaches.

307. [263] These possibilities could include a choice of a simple composition (an agreement to pay creditors a percentage of their claims); the continued trading of the business and its eventual sale as a going concern (and for the debtor to then be liquidated); transfer of all or part of the assets of the estate to one or more existing businesses or to businesses that will be established; a merger or consolidation of the debtor with one or more other business entities; a sophisticated form of restructuring of debt and equity or some other solution. The determination of what is the most appropriate solution may best be left to the market place, where an effective one exists, or at least to negotiations among the debtor, the insolvency representative, creditors and other persons with economic interests.

308. [264] Even if it does not adopt a prescriptive approach to the form or nature of the plan, an insolvency law may establish some limits, such as that the priorities afforded to creditors in liquidation should be maintained in reorganization, that the effect of the plan should not be such that the debtor remains insolvent and is returned to the market place in that condition and that the reorganization plan comply with limitations set forth in other

laws (where the insolvency law does not amend those limitations), for example foreign exchange controls.

3. Preparation of a plan

309. [265] Two important issues to be considered in relation to preparation of a reorganization plan are the stage of the proceedings at which it should be prepared and the party or parties that would be capable of preparing, or could be authorized to prepare, a plan. A number of different approaches can be taken to each of these issues.

(a) Timing of preparation

310. [266] As to the first issue, timing of preparation, the approach adopted may depend upon the purpose or objective of the particular reorganization, or relate to the manner in which the reorganization proceedings commenced. Some laws, for example, provide that the plan for reorganization should be filed with the application for reorganization proceedings (where the application may be called a "proposal" for reorganization) where those proceedings are voluntary proceedings commenced by the debtor. Potential difficulties with this approach may include delaying the debtor's ability to commence proceedings and obtain timely relief by way of the stay; the difficulty of knowing, at this early stage, exactly what the plan should accomplish; and if the plan has been prepared without consultation with creditors and other interested parties but is intended to be a final, definitive plan, it may not be a plan that could feasibly be implemented and could thus operate to pre-empt the proceedings and cause delay. Many other laws provide for the plan to be prepared after commencement of reorganization proceedings. This may be a more flexible option, allowing for consultation and negotiation of an acceptable reorganization plan while the debtor has the protection of the stay. These benefits may need to be balanced against possible misuse of the insolvency regime by debtors who have no intention of, or ability to, file a plan but are seeking to obtain only the benefits of the stay.

(b) Parties capable of preparing [permitted to prepare] a plan

311. [267] With regard to the second issue, participants in the reorganization proceedings may have different capabilities and responsibilities with regard to preparation of the reorganization plan, depending upon the manner in which the insolvency law is designed and in particular the respective roles assigned to the insolvency representative, debtor and creditors. For example, in some insolvency laws, these parties have a positive obligation to co-operate in preparing the plan. In determining which party should be permitted to prepare, or which parties are capable of preparing, the plan, a balance may be desirable between the freedom accorded to the different parties to prepare the plan (e.g. should all parties be able to prepare a plan, should they be able to do so at the same time or should preparation by different parties be sequential and dependant upon the acceptability of a plan proposed), and the restraints necessarily attached to the process in terms of approval (voting) requirements (e.g. should all creditors play a role in formulating a plan they have to approve), time limits for preparation, provision in the insolvency law for amendment of the plan and other procedural considerations. A flexible approach, as opposed to a prescriptive approach, is likely to ensure that this balance is achieved, although in the interests of efficiency, certainty and predictability and the timely progress of the proceedings, it is desirable that an insolvency law provide sufficient guidance to ensure that a viable plan is prepared.

(i) Preparation by the debtor

312. [268] Some insolvency laws provide for the debtor to prepare the reorganization plan, sometimes specifying that it should do so in co-operation with other parties such as the insolvency representative, the creditors, an attorney, an accountant or other financial advisors. An approach which involves the debtor may have the advantages of encouraging debtors to commence reorganization proceedings at an early stage and of making the best use of the debtor's familiarity with its business and knowledge of the steps necessary to make the insolvent entity viable (although the freedom accorded to the debtor may need to be balanced against the need to ensure creditor confidence in the debtor and its proposal). The opportunity provided to the debtor could be made exclusive or exclusive only for a specified period, with the court having the power to extend the period if it will be of advantage to the reorganization proceedings, and with another party able to prepare a plan where the period expires without a plan being proposed. Where the plan is to be prepared before commencement, it would generally be prepared by the debtor, but may involve negotiation with one or more classes of creditors, not necessarily all, who may negotiate and agree on a plan, subject to its acceptance by other creditors or its imposition on remaining classes.

(ii) Creditor participation

313. [269] Where creditor approval of the plan is required, there is always a risk that reorganization will fail if the plan presented by the debtor is not acceptable. For example, creditors may only wish to approve a plan that deprives the debtor's shareholders of a controlling equity interest in the insolvent entity and may also deprive the incumbent management of any management responsibilities. If the debtor is given the exclusive opportunity to prepare the plan and refuses to consider such an arrangement, there is a danger that the reorganization will fail, to the detriment of the creditors, the employees, and the debtor. There are benefits to be derived from providing for debtor participation in preparation of the plan, even if it does not have principal responsibility. These benefits may be clear particularly where the plan envisages the ongoing operation of the debtor's business and key management personnel are necessary to the success of that business (such as for reasons of its complexity) or will be difficult to replace in the short term. To address these concerns, some insolvency laws provide that, if the debtor fails to provide an acceptable plan before the end of an exclusive period, the creditors are given the opportunity to propose a plan (which could be achieved through a creditor committee (see Part two, chapter IV.C). This option may provide the leverage necessary to reach a compromise between the participating parties.

(iii) Participation by the insolvency representative

314. [270] Another approach adopted by many insolvency laws is to give the insolvency representative an opportunity to prepare the plan, either as an alternative to preparation by the debtor or the creditors or as a supplementary measure. Given that the insolvency representative will have had some opportunity to become knowledgeable about the debtor's business after commencement of the proceedings, it may be well placed to determine what measures are necessary for the business to be viable. It may also be well placed to facilitate negotiations on the plan between the debtor and creditors. The importance of providing for participation by the insolvency representative or the creditors depends upon the design of the law. In circumstances where approval by the requisite majority of creditors is a necessary condition for effectiveness of the plan, a plan that takes account of proposals that will be acceptable to creditors has a greater likelihood of being

approved than one which does not. This consideration will not apply where creditor approval is not necessary or can be overruled by the court. Where the plan is only to be approved by the court, substantial legal input may be required to ensure that the plan presented will be approved.

(iv) Preparation by multiple parties

315. [270] Some insolvency laws provide that a number of parties have the opportunity to prepare a plan. These may include management of the debtor, shareholders of the debtor, the insolvency representative, and creditors or the creditors committee. It may be desirable where such a provision is included that some procedure is adopted to ensure that a number of competing plans are not prepared simultaneously. Although in some cases this approach may promote the preparation of a mutually acceptable plan, it may also have the potential to complicate the process and lead to inefficiency and delay.

316. [271] Some laws provide for the court to consider the opinions of third parties on the plan, such as governmental agencies and labour unions. Although in particular cases this may assist in the preparation of an acceptable plan, it also has the potential to lengthen the duration of the process, and may be desirable only if it is likely to be beneficial in a particular case, where the process is carefully monitored and time limits are specified.

(c) Time limits for preparation of a plan

317. Some insolvency laws include a time limit within which the plan is to be prepared. This limit may specifically apply to preparation of the plan by the debtor or to preparation of the plan generally. One law, for example, provides a 120-day limit for preparation of the plan by the debtor; once that has expired any other party may submit a plan without any time limit being imposed. Examples of time limits generally applicable to preparation and submission of a plan include from 35 to 120 days from commencement, with some laws including provision for that time limit to be extended or shortened by the court in certain circumstances. Although the imposition of time limits may be helpful in ensuring that the reorganization proceedings proceed without delay, that advantage may need to be balanced against the risk that the deadlines may be too inflexible and impose an arbitrary restraint, particularly in large cases where preparation of the plan may take more than 12 months, or that the limits will not be observed, especially in the absence of appropriate sanctions, or that the insolvency infrastructure is unable to manage deadlines (for reasons such as lack of resources). An advantage of time limits which can be extended by the court is that they require the party seeking an extension to demonstrate to the court that the extension is warranted - that is, for example, that there is no improper reason for the delay, that the delay will not be harmful to the proceedings and that there is a prospect for a successful reorganization.

4. The plan

318. [273] The question of what is to be included in the plan is closely related to the procedure for approval of the plan (for example, which creditors are required to approve the plan, the level of support required for approval and the procedure for court confirmation, if any) and the effect of the plan once approved (and confirmed by the court, where required) (for example, will it bind dissenting creditors and secured creditors, who will be responsible for implementation of the plan and for ongoing management of the debtor). The outcome of the plan rests on what is feasible, in other words whether, on the basis of known facts and circumstances and reasonable assumptions, the plan and the

debtor are more likely than not to succeed. Determination of whether a plan is likely to succeed raises two related issues. The first is the content of the plan itself, or in other words what is proposed by the plan. The second is the manner in which those proposals are presented and explained to creditors in order to elicit their support.

(a) Content of a plan

319. [272] Many insolvency laws include provisions addressing the content of the reorganization plan. Some laws address the content of the plan by reference to general criteria, such as that the reorganization plan adequately and clearly disclose to all parties information regarding both the financial condition of the insolvent entity and the transformation of legal rights that is being proposed in the plan, or by reference to minimal requirements such as that the plan must make provision for payment of certain preferred claims.

320. Other laws set out more specific requirements as to what information is required in relation to the debtor's financial situation and the proposals included in the plan. [272] Information on the financial situation of the debtor may include asset and liability statements; cash flow statements; and information relating to the causes or reasons for the financial situation of the debtor.

321. [272] Information relating to what is proposed by the plan may include details of classes of claims; claims impaired under the plan and the treatment to be accorded to each class under the plan; the continuation or termination of contracts that are not fully executed; the treatment of un-expired leases; measures and arrangements for dealing with the debtor's assets (e.g. transfer, liquidation, retention); the sale of secured assets; the disclosure and acceptance procedure; the rights of disputed claims to take part in the voting process and provisions for disputed claims to be resolved; arrangements concerning personnel of the debtor; the role to be played by the debtor in implementation of the plan and identification of those to be responsible for future management of the debtor's business; financing implementation of the plan; remuneration of management of the debtor for its services; the settlement of claims and how the amount that creditors will receive will be more than they would have received in liquidation; payment of interest on claims; possible changes to the form of the debtor (changes to by-laws, articles of association etc.); the basis upon which the business will be able to keep trading and can be successfully reorganized; supervision of the plan; and the period of implementation of the plan, including in some cases a statutory maximum period.

322. [274] The content of the plan also raises issues related to other laws. For example, to the extent that national company law precludes debt-for-equity conversions, a plan that provides for such a conversion could not be approved. Since debt-for-equity conversion can be an important feature of reorganization, it would be necessary to eliminate the prohibition, at least in the insolvency context, if such provisions were to be included in a plan and approved. Similarly, if a plan is limited by the operation of other law to debt forgiveness or the extension of maturity dates, it may not receive adequate support from creditors for it to be successful. Some insolvency cases raise similarly straightforward and uncontroversial issues of the relationship between the insolvency law and other laws. Other cases may raise more complicated questions. These may include limits on foreign investment and foreign exchange controls (especially in cases where many of the creditors are non-residents), or the treatment of employees under relevant employment laws where, for example, the reorganization may raise questions of modification of collective bargaining agreements, or questions related to taxation law. Some insolvency laws allow

certain limitations contained in other laws, for example those relating to disposition of the debtor's assets and priority of distribution, to be overruled in specified circumstances, such as where creditors agree, and it is desirable, in order to ensure transparency and predictability, that an insolvency law specifically address the question of its relationship with other laws.

(b) Information to accompany the plan

323. [273] When voting on a plan, creditors need to be able to assure themselves that what is proposed by the plan is feasible and not based, for example, on faulty assumptions, and that implementation of the plan will not leave the debtor overburdened with debt. To facilitate that evaluation, creditors will need to be provided with information explaining what the plan proposes and the impact of those proposals on both the debtor and creditors. For these purposes, the plan can be accompanied by a report of a qualified professional who can be expected to provide a credible and unbiased assessment of the measures proposed by the plan or by a full disclosure of information from which creditors can evaluate the plan. Where creditors do not agree with the professional evaluation, or do not believe that the disclosed information is persuasive, those views could be taken into account either in voting on the plan, by a mechanism allowing for amendment of the plan, or by the court when it confirms the plan (where that is a required element of the process).

324. [272] A number of insolvency laws include provisions addressing the information that is to be provided to creditors to enable them to properly assess the plan, whether it is to be included in the plan itself or in a separate statement. Where the reorganization plan is to be accompanied by such a statement, the insolvency law may specify what information it should include. Provision of this information supports the key objective of transparency and can assist in ensuring creditor confidence in the insolvency process. It may need to be balanced, however, against confidentiality concerns arising from creditor access to potentially sensitive financial and commercial information relating to the debtor, even where that information may ultimately enter the public domain through approval or confirmation of the plan by a court. It may also need to be balanced against the provision of information that is irrelevant to the purpose of evaluating the plan; the focus should be upon the information required in a particular case to evaluate the specific proposals contained in the plan.

5. Approval of a plan

325. [275] Designing the provisions of an insolvency law with regard to the approval of the plan requires a balance to be achieved between a number of competing considerations, which will be particularly important where the plan does not receive the support of all creditors or classes of creditors. On the one hand, it will be essential to provide a way of imposing an agreed plan upon a minority of dissenting creditors within a class in order to increase the chances of success of the reorganization. It may also be necessary, depending upon the mechanism that is chosen for voting on the plan and whether creditors vote in classes, to consider whether the plan can be binding upon dissenting classes of creditors. To the extent that a plan can be approved and enforced upon dissenting creditors, there may be a need to ensure that the content of the plan provides appropriate protection for those dissenting creditors and, in particular, that their rights cannot be unfairly affected. On the other hand, to the extent that the approval procedure results in a significant impairment of creditors' claims without their consent (particularly secured creditors), there is a risk that the willingness of creditors to provide credit in the future may be undermined. The

mechanism for approval of the plan, and the availability of appropriate safeguards, is therefore of considerable importance to the protection of these interests.

(a) Procedures for approval

326. [275] Many insolvency laws provide for a special meeting of creditors to be called for the purpose of voting on the reorganization plan, and require that the plan (and the information or disclosure statement where that document is also to be provided) be made available to the creditors within a certain period of time before that meeting is called. [210] Some laws provide that voting should occur in person at a meeting of creditors, while other laws provide that voting may take place by mail or by proxy. It may also be desirable to recognize that voting can take place using electronic means.

327. Other issues to be considered with regard to approval of the plan include the types of claims (in terms of admission or provisional admission of those claims) that will be considered in determining whether the requisite majority has been reached, whether secured creditors are required to vote; whether the votes of priority claims will be considered in determining the requisite majority, and the manner in which abstaining creditors will be treated. In some cases, for example, abstaining voters are treated as votes not to accept a plan, [280] while many countries adopt the approach of calculating the percentage of support on the basis of those actually participating in the voting and absentees and abstaining voters are considered to have little interest in the proceedings. The latter approach requires adequate notice provisions and their effective implementation, especially where creditors are non-residents.

328. Some insolvency laws also make use of presumptions regarding votes. Where, for example, a plan cancels a creditor’s claim or owner’s equity interest (and that party receives nothing under the plan), a vote against the plan can be presumed. In contrast, where a plan leaves a claim unimpaired or provides that it will be paid in full, a vote in favour of the plan can be presumed. Such presumptions may simplify the voting procedure, and lessen the need to provide notice and information to relevant creditors.

(b) Approval by secured and priority creditors

329. [276] In many cases, secured claims will represent a significant portion of the value of the debt owed by the debtor and different approaches may be taken to approval of the plan by secured and priority creditors. As a general principle, however, the extent to which a secured creditor is required to vote will depend upon the manner in which the insolvency regime treats secured creditors, the extent to which a reorganization plan can affect the secured interest of the secured creditor and the extent to which the value of secured asset will satisfy the claim of the secured creditor.

330. Under one approach, where the insolvency law ensures that an approved plan will not preclude secured creditors from exercising their rights against the secured assets, there is generally no need to give these creditors the right to vote since their security interests will not be impaired by the plan. Priority creditors are in a similar position under this approach—the plan cannot impair the value of their claims and they are entitled to receive full payment. The limitation of this approach, however, is that it may reduce the chances for a successful reorganization, especially where the secured assets are vital to the success of the plan. If the secured creditor is not bound by the plan, the election by the secured creditor to exercise its rights, such as by repossessing and selling the secured asset, may make the plan impossible to implement. Similarly, in certain

circumstances, the only way in which the plan may succeed is to provide that priority creditors receive less than the full value of their claims upon approval of the plan. Thus, the prospects for reorganization may improve if priority creditors will accept payment over time and if secured creditors will acquiesce when the terms of the security are modified over time.

331. To the extent that the value of the secured asset will not satisfy the full amount of the secured creditor's claim, a number of insolvency laws provide for them to vote with ordinary unsecured creditors in respect of the unsatisfied portion of the claim. In some legal systems, this raises difficult questions of valuation in order to determine whether and the extent to which all secured creditors are in fact secured. For example, where three creditors hold security over the same asset, the value of that asset may only support the claim first in priority and part of the second in priority. The second creditor may therefore be required to vote in respect of the unsecured portion of its claim, while the third creditor will be totally unsecured. The valuation of the asset is therefore crucial to the determination of whether or not a creditor is secured and the extent of its security, a determination which becomes important where secured creditors are not required to vote on a plan (but where they do vote can be bound by the plan), but where unsecured creditors are required to vote.

332. [277] There are a variety of different approaches to secured creditor voting on a reorganization plan. Some insolvency laws provide for secured and priority creditors to vote as separate classes on a plan that would impair the value or terms of their claims or to otherwise consent to be bound by the plan. This approach recognises that the respective rights and interests of these creditors differ from those of unsecured creditors, and from each other. Where secured creditors vote in classes, some insolvency laws provide that to the extent that the requisite majority votes to approve the plan, dissenting members of the class will be bound by the terms of the plan. The requisite majority would generally be the same as that required for approval by unsecured creditors, although there are examples of laws that require different majorities depending upon the manner in which secured creditors rights are affected (e.g. a three-quarter majority is required where the maturity date is extended and a four-fifths majority where the rights are otherwise impaired). Other insolvency laws provide that the plan cannot be imposed upon secured creditors unless they consent to such imposition.

333. A further approach is those insolvency laws which provide that dissenting secured creditors are entitled to receive at least as much as they would have received under liquidation and only where that occurs can they be bound by the plan. An alternative provides that they may be bound if the plan makes provision for them to be paid in full to the extent of the value of their security, with interest, within a certain period of time. Some insolvency laws also provide that secured creditors may be bound by the plan where the court has the power to order that they are bound, provided it is satisfied as to certain conditions. These may include that enforcement of the security by the secured creditor will have a material adverse effect on achieving the purposes of the plan and that the security interests of the secured creditor will be sufficiently protected under the plan and that the position of the secured creditor will not further deteriorate under or as a result of the plan (for example, payments of future interest will be made and the value of the secured interest will not be affected).

334. In determining which approach should be taken to this issue, it will be important to assess the effect of the desired approach upon the availability and cost of

secured transaction financing and to provide as much certainty and predictability as possible.

(c) Approval by ordinary unsecured creditors

335. [278] Different mechanisms may be used to ensure that ordinary unsecured creditors have an effective means for voting on a plan. Whichever mechanism is chosen it is desirable that it be as simple as possible and be clearly set out in the insolvency law to ensure predictability and transparency.

(i) Classes of unsecured creditors

336. A number of insolvency laws do not provide for unsecured creditors to be divided into different classes, rather they vote together as a single group. Other insolvency laws do provide for division into classes where there is a large number of unsecured creditors or where unsecured creditors have different interests based upon the nature of their claims. Where there is a small number of unsecured creditors or where their interests are similar, there may be no need for creditors to vote on approval of the plan in different classes, thus simplifying the voting procedure.

337. [281] Countries that have established classes for secured and priority creditors often also provide for the division of ordinary unsecured creditors into different classes, based upon their varying economic interests. The creation of these classes is designed to enhance the prospects of reorganization in at least three respects by providing: a useful means of identifying the varying economic interests of unsecured creditors; a framework for structuring the terms of the plan; and a means for the court to utilize the requisite majority support of one class to make the plan binding on other classes which do not support the plan. Since the creation of different classes has the potential to complicate the voting procedure, it may be desirable only where there are compelling reasons for special treatment of some ordinary unsecured creditors, such as a lack of common economic interests. Criteria that may be relevant in determining commonality of interest may include: the nature of the debts giving rise to the claims; the remedies available to the creditors in the absence of the reorganization plan and the extent to which the creditors could recover their claims by exercising those remedies; the treatment of the claims under the reorganization plan; and the extent to which the claims would be paid under the plan.

(ii) Determination of classes

338. Some insolvency laws specify the manner in which classes of ordinary unsecured creditors or claims are determined for the purposes of approval of the reorganization plan. One approach is for the plan to place claims or interests into a particular class on the basis of common interest or substantial similarity or on the basis of the value of the claim. Where the test is commonality or similarity of interest, the person who prepares the plan may have some flexibility in assigning claims to a particular group. Another approach provides for the insolvency representative to make recommendations to the court before the creditors vote on approval. A further approach provides that the classes are determined in the first instance by the debtor, who will have some limited flexibility as to the composition of each class; unsecured creditors who are unsatisfied by the composition of the class can seek to have the issue determined by the court.

(d) Approval by shareholders

339. [283] Some insolvency laws provide for the approval of reorganization plans by shareholders of the debtor, at least where the corporate form, the capital structure or the membership of the debtor will be affected by the plan. Shareholders may also be expected to vote where some shareholders will receive a distribution under the plan. Where the debtor's management proposes a plan, the terms of the plan may already have been approved by the shareholders (depending upon the structure of the debtor in question, this may be required under its constitutive instrument). This is often the case where the plan directly affects shareholders such as by providing for debt-for-equity conversions, either through the transfer of existing shares or the issuance of new shares.

340. [284] In circumstances where the insolvency law permits creditors or an insolvency representative to propose a plan, and the plan contemplates debt-for-equity conversion, some insolvency laws allow the plan to be approved over the objection of shareholders, irrespective of the terms of the constitutive instrument of the entity. Such plans may result in existing shareholders being entirely displaced without their consent, subject to some protections. Where, for example, the reorganization plan provides for some return to shareholders, they cannot be displaced.

(e) Related person creditors

341. [285] Some insolvency laws provide that related persons should not vote with other creditors on approval of the plan or that their votes will not count for certain purposes such as determining that an impaired class of creditors has accepted the plan (when that is a requirement of approval). Many insolvency laws, however, do not include provisions dealing specifically with this issue. Where the insolvency law makes no special provision, related persons should vote in the same manner as other creditors. They will generally be subject, however, to the provisions of non-insolvency law for their personal dealings with the debtor and its business.

(f) Majorities required for approval of the plan

342. [279] Many insolvency laws identify the minimum threshold of support required from creditors for the plan to be approved. The requisite majority can be calculated in a number of different ways, depending upon whether or not creditors vote in classes, and how those classes are treated in determining the majority. Where creditors do not vote in classes, the majority may be fixed by reference to the support of a proportion or percentage of the value of claims or a number of creditors, or a combination of both. Some laws require, for example, that the plan be supported by at least two-thirds or three quarters of the total value of the debt and more than one-half or two-thirds of the number of creditors. While these proportions generally apply to creditors voting on approval of the plan, there are laws which determine these proportions by reference to the total value of debt and total number of creditors, irrespective of whether or not they vote. Other combinations are also used.

343. [279] Where creditors do vote in classes, a wide variety of different approaches are taken to determining when a plan will be approved. Some insolvency laws require a majority of each class of creditors based upon a percentage or proportion of the value of claims or a number of creditors, or a combination of both. Other laws establish the requisite majority of creditors within a class, as well as what will constitute a majority of classes. For example, a simple majority of the classes may be required, or where less than

a majority of classes support the plan, the plan may nevertheless be made binding on dissenting creditors, both within a class that otherwise supports the plan and where a class does not support the plan, provided the court is satisfied certain conditions are met (see Binding dissenting creditors and Court confirmation below). One law, for example divides claims into three classes and provides that the plan must be approved by at least two of those classes, and that at least one of the approving classes would not recover the full mount of their claims if the debtor were to be liquidated. Another variation requires that at least one of the classes approving the plan will have its rights impaired under the plan, to ensure that the plan is not only supported by those creditors whose rights are not impaired. Other laws provide that support by classes of unsecured creditors cannot force approval of plan if secured creditors oppose the plan.

344. [279] Although increasing the difficulty of achieving approval, a procedure which includes both value of claims and number of creditors may be justified on the basis that it protects the collective nature of the proceedings. For example, if a single creditor holds a majority of the value, such a rule prevents that creditor from imposing the plan on all other creditors against their will. Equally, such a provision may prevent a large creditor from imposing its lack of support for the plan on other creditors to their detriment, although there are examples of laws that do provide creditors holding more than a certain percentage of the total value of claims with a power to veto approval or to force an improvement of the terms of the plan for the benefit of all creditors. A voting procedure which combines the value of claims with a number of creditors will also prevent a large number of very small creditors from imposing their decision on a few creditors who hold very large claims. Some insolvency laws include provisions to the effect that even where a majority of the number of creditors support a plan, where those creditors represent less than a certain percentage of value of the total claims (e.g. around 25 or 30 percent), the court will be reluctant to approve or confirm the plan. This procedure may also be justified on the basis that it helps to ensure the support for the plan is sufficient to enable it to be successfully implemented.

6. Where the plan is submitted to creditors for approval but is not approved

(a) Modification of a plan

345. [291] Where a vote on a reorganization plan fails to achieve the level required for the plan to be approved, an insolvency law may adopt a mechanism that could lead to modification and reconsideration of the plan by creditors. One approach, for example, may be to allow a majority of creditors to vote to adjourn the decision meeting to enable further disclosure, if it appears that some further negotiation on a plan may produce a favourable result or to address unresolved disputes and issues. As with all areas of the insolvency process, however, it is desirable that that adjournment be available in limited circumstances or at least a limited number of times, with perhaps time limits being included to facilitate speedy resolution of the renegotiations and avoid abuse.

(b) Conversion of proceedings

346. [294] In cases where a reorganization plan is not approved and modification of the plan will not resolve the difficulties encountered, an insolvency law may adopt different approaches to the further conduct of the proceedings. Some insolvency laws provide that the failure by creditors to approve the plan should be taken as an indication that they favour liquidation and the reorganization proceedings can be converted to liquidation. This approach may operate to encourage debtors to propose an acceptable plan, safeguards to

prevent abuse in cases where liquidation is not in the interests of all creditors may be appropriate. Where reorganization proceedings are converted to liquidation, an insolvency law will need to consider the status of any actions taken by the insolvency representative prior to approval of the plan, as well as the continued application of the stay, particularly to secured creditors when the insolvency law contains a time limit (see Part two, chapter III.B.4(c) and recommendation (40)). Other insolvency laws provide that the reorganization proceedings should be dismissed. This approach has the disadvantage of leaving the debtor in a state of financial difficulty, where further debts may accrue and the value of the assets diminish, and postponing the commencement of the liquidation proceedings that may be inevitable.

7. Binding dissenting creditors

347. [282] A few countries that provide for voting by secured and priority creditors and for the creation of different classes of unsecured creditors also include a mechanism that will enable the support of one or more classes to make the plan binding on other classes (including, under some laws, classes of secured and priority creditors) which do not support the plan. This is sometimes referred to as a "cram-down" provision. Where such provisions are incorporated in the insolvency law, the law also generally includes conditions that are aimed at ensuring the protection of the interests of those dissenting classes of creditors. Since it is generally the court that is required to consider whether these conditions have been satisfied, they are discussed in the following section.

8. Court confirmation of a plan

348. [287] Not all countries require the court to confirm a plan that has been approved by creditors; approval by the requisite majority of creditors is all that is required for the plan to be effective and dissenting creditors will bound by virtue of the operation of the insolvency law. In those systems, the court, however, may have role to play with regard to review of the plan where minority creditors challenge the plan itself or the means by which it was procured.

(a) Objections to approval of the plan

349. Many insolvency laws provide for objections to the approval of the plan to be made at the confirmation hearing, and a number establish the grounds for objection. [290] These may include that approval of the plan was obtained by fraud (e.g. false or misleading information was given or material information was withheld with respect to the reorganization plan); that there was some irregularity in the voting procedure (e.g. related persons participated where this is not permitted under the insolvency law or the resolution approving the plan was not consistent with the interests of creditors generally); that there was some irregularity in the conduct of the meeting at which the vote was taken; that the proposals contained in the plan were put forward for an improper purpose; that the plan is not feasible (e.g. secured assets are required for successful implementation of the plan, but secured creditors are not bound by the plan and no agreement has been reached with relevant secured creditors concerning enforcement of their security interests); that the plan does not satisfy the requirements for protection of dissenting creditors within a class (e.g. they will not receive as much under the plan as they would have received in liquidation, unless they have agreed to receive lesser treatment under the plan); or that the proposals unfairly prejudice the interests of the objector. Since all creditors are likely to be prejudiced to some degree by reorganization proceedings, a level of prejudice or harm that exceeds the prejudice or harm suffered by other creditors or classes of creditors would

generally be required. Where the creditor challenging the plan voted in favour of the plan, the grounds for challenge may be limited, for example, to fraud and other impropriety. Where the challenge to the plan is successful, an insolvency law may provide that the plan can be reconsidered by creditors or set aside.

(b) Steps required for court confirmation

350. [288] Where the insolvency law requires the court (or in some countries an administrative authority) to confirm a plan, it would normally be expected to confirm a plan that has been approved by the requisite majority of creditors (whether voting in classes or otherwise). Many countries enable the courts to play an active role in "binding in" creditors by making the plan enforceable upon a class of creditors that has not approved the plan. This may require the court to undertake a role that is in the nature of a legal formality; it does not require the court to examine the commercial basis upon which the plan was approved but to ensure that the decision of the creditors was properly obtained (i.e., there is no evidence of fraud in the approval process) and that certain conditions were satisfied. These conditions may include, for example, that those classes of creditors objecting to the plan will share in the economic benefits of the plan, that no creditor will receive more than the full value of their claim, that normal ranking of claims is recognized by the plan and that similarly situated creditors are treated equally (of course, some insolvency laws provide that creditors can agree to dispense with normal ranking and to different treatment of similarly situated creditors). Under some laws, the court may also be required to assess additional matters, such as that the plan is fair in respect of those classes which have accepted the plan, but whose interests are impaired by the plan, and that the interests of dissenting classes of creditors have been adequately protected (because, for example, they will receive as much under the plan as they would have received in liquidation, unless they have agreed to receive lesser treatment under the plan).

351. [289] Some insolvency laws also give the court the authority to reject a plan on the grounds that it is not feasible or impossible to implement. This may be justified, for example, where secured creditors are not bound by the plan but the plan does not provide for full satisfaction of the secured claims of these creditors. The court may reject the plan in such a case if it considers that secured creditors will exercise their rights against the secured assets, thus rendering the plan impossible to perform. The risk of this occurring can be addressed in provisions relating to preparation and approval of the plan.

352. The more complex the decisions the court is required to make in terms of approval or confirmation, the more relevant knowledge and expertise is required of the judges, and the greater the potential for judges to interfere in what are essentially commercial decisions of creditors to accept or reject a plan. [289] It is desirable, in particular, that the court not be asked to review the economic and commercial basis of the decision of creditors unless it has the competence and experience to do so, nor that it be asked to review particular aspects of the plan in terms of their economic feasibility, unless they have the competence to do so. For these reasons, it is desirable that the requirements for approval of the plan are carefully designed to minimise potential problems arising after these requirements have been satisfied.

9. Effect of a plan

353. [286] Where the plan is approved by the requisite majority of creditors and, where required, confirmed or approved by the court, insolvency laws generally provide that it will be binding upon all affected ordinary unsecured creditors, including creditors who

voted in support of the plan, dissenting creditors and creditors who did not vote on the plan. Some insolvency laws also provide that the plan will bind directors, shareholders and members of the debtor, and other parties as determined by the court. Some insolvency laws stipulate that the parties who are bound will be prevented from applying to the court to have the debtor liquidated (except where implementation fails or the debtor fails to perform as required under the plan), to start or continue legal proceedings against the debtor or to pursue enforcement without approval of the court. Some laws also provide that once the plan is approved by creditors and approved or confirmed by the court (where that is required), the property of the insolvency estate returns to the control of the debtor for implementation of the plan and a debtor may obtain a discharge of debts and claims pursuant to the plan.

10. Challenges to a plan after confirmation

354. [290] Many insolvency laws provide for the plan to be challenged subsequent to the confirmation hearing (in some cases within a specified time period). The grounds for challenge after confirmation may be narrower than the grounds for challenge at the time of confirmation and be limited, for example, to fraud. Where a challenge to a plan that has already been confirmed is successful, an insolvency law may adopt one of a number of possible options, for example that the plan be set aside and the proceedings converted to liquidation or that the debtor be left in its state of financial difficulty and the assets returned to its control. The latter approach does not resolve the debtor's financial difficulty and may simply delay commencement of liquidation proceedings and lead to further diminution of the value of the debtor's assets. In determining the most appropriate action to be taken in these circumstances, consideration will need to be given to the extent to which the plan has already been implemented and how steps taken in the implementation, such as payments to creditors, are to be treated.

11. Modification of a plan after approval by creditors (and confirmation by the court)

355. [292] An insolvency law may include provision for a plan to be modified after it has been approved if its implementation breaks down or it is found to be incapable of performance. Of those insolvency laws that allow modification, some provide for the plan to be modified if the modifications proposed will be in the best interests of creditors. Other laws provide that the plan can be modified if circumstances warrant the modification and if the plan, as modified, continues to satisfy the requirements of the insolvency law concerning, for example, content, classes of creditors and notice to creditors.

356. Depending upon the nature of the modification it may not be necessary to obtain the approval of all classes of creditors but only those affected by the modification. Since in some cases obtaining this approval may prove difficult, an alternative approach may be appropriate. These alternatives may include providing that small modifications can be approved by the court or that creditors who supported approval of the plan should be notified of the proposed modification and can object to that modification within a specified time period or otherwise be deemed to have accepted the modification. The same approach may be taken to creditors who did not approve of the plan. Where the modification proposed is significant, the approval of all creditors may be required. [292] Where the court has confirmed the original plan, it may also be required to confirm the modification to the plan.

12. Implementation of a plan

357. [293] Many plans can be executed by the debtor without the need for further intervention by the court or the insolvency representative. But sometimes it may be necessary for the implementation to be supervised or controlled by an independent person. Several insolvency laws provide that the court has an ongoing role in supervision of the debtor after approval and confirmation of the plan, pending completion of implementation. This may be important where issues of interpretation of the performance or obligations of the debtor or others arise. Some countries permit the court to authorize continued supervision of the affairs of the debtor, to varying degrees, by a supervisor or insolvency representative after the confirmation of the plan.

13. Where implementation fails

358. Where the debtor defaults in performing the plan or implementation of the plan breaks down for some other reason, some insolvency laws provide that the plan will be terminated, and the debtor liquidated. In that liquidation, insolvency laws generally provide that creditors claims which might have been compromised in the reorganization will be reinstated to the full amount. Other laws provide that the plan will only be terminated in respect of the obligation breached (it otherwise remains valid). The creditor in question is not bound by the plan and will have its claim restored to the full amount. In some cases, this will only occur where the debtor has fallen significantly into arrears[1] in the performance of the plan. In some countries, the consequences of default may be set out in the plan itself.

359. [295] Conversion to liquidation will provide certainty as to the ultimate resolution of the proceedings, although it may lead to further delay and diminution of value if the liquidation proceedings are required to commence as if they were new proceedings. A further approach may be to regard the insolvency proceedings as at an end and allow creditors to take individual actions. This approach does not resolve the financial difficulties of the debtor and could lead to a race for assets that the commencement of collective proceedings was intended to avoid. A compromise approach may be to allow the proposal of a different plan by creditors within a specified deadline and only in situations where no plan can be prepared would liquidation follow. It must be recognized that at some point the balance between achieving the best outcome for all creditors and achieving what is feasible tips in favour of pursuing what is feasible, and it is desirable that an insolvency law be sufficiently flexible to allow this to occur.

14. Conversion to liquidation

360. [296] A number of circumstances may arise in the course of a reorganization proceeding where it may be desirable for an insolvency law to provide a mechanism to convert the proceedings into liquidation. In addition to circumstances where the reorganization plan cannot be approved or where the debtor defaults in implementation of the plan, it may be appropriate to consider conversion where it is determined that there is no reasonable likelihood of the business being successfully reorganized; where it is apparent that the debtor is misusing the reorganization process either by not co-operating with the insolvency representative (e.g. withholding information) or otherwise acting in bad faith (e.g. making fraudulent transfers); where the business continues to incur losses or

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[1] In one law, this requires a demand from the creditor for payment of the due liability and failure by the debtor to comply within a minimum period of time of at least 2 weeks.

where administrative expenses are not paid. Because it is the party that, after the debtor or its management, has the greatest knowledge of the debtor's business, and so often learns at an early stage whether or not the debtor's business is viable, the insolvency representative can play a key role in the conversion process. In addition, it may be reasonable to allow creditors or the creditor committee (where one has been appointed), to request the court to convert the proceedings on similar grounds. The court could also be given the power to convert on its own motion where certain conditions are met, for example […].

Recommendations

Purpose of legislative provisions

The purpose of provisions relating to the reorganization plan is to:

(a) facilitate the rescue of ~~financially troubled~~businesses subject to the insolvency law, thereby protecting investment and preserving employment;
(b) facilitate maximization of the value of the insolvency estate;
(c) facilitate the negotiation and approval of a reorganization plan and establish the effect of approval, including a mechanism to make an approved plan binding on all creditors and other interested parties ;
(d) address the consequences of a failure to propose an acceptable reorganization plan or inability to have the plan approved by creditors, including conversion of the proceedings to liquidation in certain circumstances;
(e) provide for the implementation of the reorganization plan, including discharge of debts and claims, and the consequences of failure of implementation.

Content of legislative provisions

Preparation of the plan - timing

(121) [(125)] The insolvency law should provide that the reorganization plan is [prepared] [filed] on or after the making of an application to commence insolvency proceedings, or within ~~but no later than the end of~~a specified time period after commencement of the insolvency proceeding.

(a) The time period should ~~may~~ be ~~set by the court or alternatively~~fixed by the insolvency law.
(b) The court should be authorized to extend the time period in appropriate circumstances.

Preparation of the plan – parties [permitted] [capable]

(122) [(126)] The insolvency law should ~~specify~~identify the parties ~~responsible~~[permitted to propose] [capable of proposing] ~~for the preparation of the~~ a reorganization plan for approval by creditors.

(123) [(127)] In providing for the preparation of the reorganization plan, the insolvency law should adopt a flexible approach that potentially involves all parties central to the insolvency proceedings, i.e. the debtor, the creditors [although a plan need not impair or alter the rights of every class of creditor] and the insolvency representative. The insolvency law may combine different elements:

(a) An exclusive period may be given to one party to propose a plan. To encourage debtors to apply for commencement of proceedings at an early stage of financial difficulty, it [may] [should] be the debtor that is given that opportunity. The party provided with the exclusive period may be required to consult with other parties in order to ensure that the most acceptable plan will be proposed;

(b) Where no ~~acceptable~~ plan is forthcoming within the exclusive period, other parties, such as the insolvency representative, creditors or the creditors committee in collaboration with the insolvency representative may be given the opportunity to propose a plan, or the court may extend the exclusive period if the party which has the exclusive period can show that an extension is warranted [such as by showing that the delay is justified and that there is a real prospect for reorganization].

Content of the plan

(124) [(128)] The insolvency law should specify the minimum contents of a reorganization plan, which should include:

(a) Detail as to the classes of creditors and the treatment provided for each class by the plan (e.g. how much they will receive and the timing of payment);

(b) the terms and conditions of the plan, including;

(i) treatment of contracts, including ~~employment~~labour contracts;

(ii) the debtor's role in implementation of the plan, including control over assets;

(c) means for the implementation of the plan which may include:

(i) the possibility of sale of all or any part of the debtor's business;

(ii) proposed changes in the capital structure of the debtor's business;

(iii) amendment of the debtor's charter;

(iv) merger or consolidation of the debtor with one or more persons;

(v) extension of a maturity date or a change in an interest rate or other term of outstanding securities;

(vi) distribution of all or any part of the assets of the insolvency estate among those having an interest in those assets;

(vii) identification of those responsible for future management of the entity;

(viii) supervision of the implementation of the plan.

[Explanatory] [disclosure] statement

(125) [(129)] The insolvency law should require a reorganization plan submitted for the approval of creditors to be accompanied by a [explanatory] [disclosure] statement that will enable creditors to make an informed decision about the plan. The statement should be prepared by the same party as prepares the reorganization plan, be submitted to creditors at the same time as submission of the reorganization plan and include:

(a) information relating to the financial situation of the debtor including asset and liability and cash flow statements;
(b) a comparison of the treatment afforded to creditors by the plan and what they would otherwise receive in liquidation;
(c) the basis upon which the business would be able to keep trading and could be successfully reorganized; and
(d) information showing that, having regard to the effect of the plan, the assets of the debtor will exceed its liabilities and the debtor will have the cash flow to pay its [matured debts] [its debts as provided in the plan].

Submission of the plan and [explanatory] [disclosure] statement

(126) The insolvency law should provide a mechanism for submission of the reorganization plan and [explanatory] [disclosure] statement to creditors.

Voting mechanisms

(127) [(130)] The insolvency law should establish a mechanism for voting on approval of the reorganization plan. This mechanism should address the creditors who are required to vote on the plan; the manner in which the vote can be conducted, either at a meeting of creditors convened for that purpose or by mail or other means, including electronic means and the use of proxies; and whether or not creditors should vote in classes according to their respective rights or as a general body of creditors.

Approval of the plan by creditors of a particular class

(128) [(131)] The insolvency law should establish the majority required for approval of the reorganization plan by a particular class of creditors. Where the required majority of creditors in that class supports the plan, that class of creditors will be regarded as supporting the plan. The majority should be limited to those creditors actually voting, whether in person or by proxy. A majority based on unanimity or a simple majority of the number of creditors voting is not recommended. Alternative approaches may include a combination of the number of creditors voting and the amount of claims, in proportions such as a simple majority of the number of creditors voting combined with a simple or greater (for example, two-thirds) majority in amount of the claims of those voting.

Approval by majority of classes of creditors

(129) Where creditors vote on approval of the reorganization plan in classes, the insolvency law may require approval by a specified majority of classes.

(130) [(132)] The insolvency law should address the treatment of those classes of creditors which do not vote in support of the reorganization plan in those cases where the plan satisfies the requirements for approval and is approved by the requisite majority.

Objections to approval

(131) [(135)] The insolvency law should allow interested parties, including the debtor, to object to the approval of the reorganization plan before it is confirmed or otherwise becomes binding on creditors ~~and specify the time at which that challenge may be made~~. The law may include criteria against which the challenge can be assessed, including that*:*

> (a) the approval process was improperly conducted;
> (b) creditors will not receive at least as much under the plan as they would have received in liquidation, unless they agree to receive lesser treatment; or
> (c) the plan contains provisions forbidden by law.

Effect of the plan

(132) The insolvency law should provide that an approved reorganization plan will bind the debtor, creditors, stakeholders and any other person [specified in the plan], either by operation of the insolvency law or through confirmation of the plan by the court.

Confirmation of the plan

(133) [(133)] Where the insolvency law provides for the court to confirm the reorganization plan, the court should ~~refuse to~~confirm the plan if:

> (a) requirements of the insolvency law for notice of commencement of proceedings; preparation and submission of the plan and disclosure statement; and approval of the plan ~~process was improperly conducted~~are met;
> (b) the plan does not contain provisions forbidden by law;
> (c) creditors will receive at least as much under the plan as they would have received in liquidation, unless they have agreed to receive lesser treatment.

Post-approval [post-confirmation] amendment of the plan

(134) [(136)] The insolvency law should include limited provision for amendment of the reorganization plan, specifying the parties that may propose amendments and the time at which the plan may be amended. The limited circumstances in which the plan may be amended may include where, after approval [and confirmation], implementation of the plan breaks down or the plan is found to be incapable of implementation in whole or in part, and the matter can be ~~easily~~remedied.

Approval of amendments

(135) [(136)] The insolvency law should address the mechanism for approval of amendments to the plan. ~~The amended plan should be subject to~~ That mechanism may require notice to and approval by the creditors and satisfaction of the rules for confirmation, or [*other requirements?*].

Challenges to the plan after confirmation [during implementation]

(136) The insolvency law may provide for the plan to be challenged once it has been confirmed on the basis of improper conduct of the approval process, obtaining of the approval by fraud or [*other grounds?*].

Supervision of implementation

(137) [(137)] The insolvency law may establish a mechanism for supervising implementation of the plan, including supervision by the court, or by a court appointed supervisor, by the insolvency representative, or by a creditor-appointed supervisor.

Failure of implementation

(138) [(138)] The insolvency law should provide that where implementation of the reorganization plan fails and the plan cannot be amended, the proceedings should be converted to liquidation. Payments made in the course of the implementation of the plan should be protected from the operation of avoidance powers in any subsequent liquidation.

~~(a) the plan can be terminated; and~~
~~(b) if the reorganization proceedings have not closed, the proceedings can be converted to liquidation.~~

~~*Closing [and reopening] of proceedings*~~

~~(139) After an insolvency estate is fully administered [and the insolvency representative discharged] the court should close the proceedings.~~

~~(140) [*reopening*]~~

B. (Expedited) reorganization proceedings [Recognition of a reorganization plan negotiated and agreed prior to commencement of reorganization proceedings]

1. Introduction

361. As discussed above in Part one of the Guide, reorganization can take one of several forms including, principally, reorganization conducted under the formal supervision of a court or administrative body (the main form of reorganization discussed in this Guide) and informal or out-of-court reorganization (sometimes referred to as voluntary reorganization) which requires little or no court involvement and essentially depends upon the agreement of

the parties involved. Because many of the costs, delays and procedural and legal requirements of a formal reorganization proceedings can be avoided where out-of-court reorganization procedures are used, they often can be the most cost efficient means of resolving a debtor's financial difficulties. [A/CN.9/507, para. 244] As such these types of procedures can be valuable tools in the range of insolvency procedures available to a country's commercial and business sector.

362. [507/para. 244] Encouraging the use of out-of-court reorganization need not stem from the fact that a country's formal insolvency system is poor, inefficient or unreliable, but rather from the advantages such reorganizations can offer as an adjunct to a formal insolvency system which delivers fairness and certainty.

2. Out-of-court reorganization

(a) Creditors typically involved

363. [507/para. 244] An out-of-court reorganization typically involves negotiations between the debtor and one or more classes of creditors, such as lenders, bondholders and shareholders. They also frequently involve major non-institutional creditors, typically where such creditors' involvement is so considerable that an effective restructuring is not possible without their participation. These types of creditors often find it advantageous to participate in out-of-court reorganization because there is a potential to reduce the loss that they would otherwise suffer under full court-supervised insolvency proceedings.

364. The limited classes of creditors that would normally participate in out-of-court proceedings makes them easier to accomplish than full court supervised reorganization, which typically affect all claims, including trade, employee and governmental claims. [507/para. 244] It is usual in out-of-court reorganization for these types of non-institutional creditors to continue be paid in the ordinary course of business. On that basis, these creditors are not likely to have any objection to the proposed restructuring and therefore do not need a voice in the process. Where, however, such creditors were not, or ceased to be, paid in the ordinary course of business, they would have the right to commence full proceedings under the insolvency law.

(b) Impediments to achieving consensus

365. Out-of-court reorganization is often impeded by the ability of individual creditors to take enforcement action and by the need for unanimous creditor consent to alter the repayment terms of certain existing classes of debt. These problems are magnified in the context of complex, multinational businesses, where it is especially difficult to obtain consents from all relevant parties. To assist the conduct of out-of-court reorganization, the International Federation of Insolvency Professionals (INSOL) developed the *Principles for a global approach to multi-creditor workouts*. [A/CN.9/WG.V/WP.55, para. 10) The Principles are designed to expedite out-of-court processes and increase the prospects of success by providing guidance to diverse creditor groups about how to proceed on the basis of some common agreed rules (for the text of the Principles see …).

366. Out-of-court reorganization can also be impeded by a minority of affected creditors who may refuse to agree to a reorganization that is in the best interests of most creditors in order to take advantage of their position to extract better terms for themselves at the expense of other parties (often referred to as "holding out"). Where these hold-outs occur, the negotiated agreement can only go ahead if by some means the contractual rights

of these dissenting creditors can be modified without their consent. [507/para. 244] Under most existing legal systems, such a modification of contractual rights requires the out-of-court reorganization to be converted to a full court-supervised reorganization proceeding under the insolvency law, involving all creditors and including standards of treatment that appropriately protect the interests of dissenting creditors. Timing is typically critical in business reorganization and delay (usually inherent in full court-supervised insolvency proceedings) can frequently be costly or even fatal to an effective reorganization. It is therefore important that the court be able to take advantage of any negotiations and work done prior to the commencement of reorganization proceedings under the insolvency law and that the insolvency law permits the court to expedite those reorganization proceedings.

3. Proceedings to recognize a reorganization plan negotiated and agreed out-of-court

367. Where an insolvency law provides for recognition of a plan negotiated and agreed before commencement of a reorganization proceeding under the insolvency law and also provides for expedition of that reorganization proceeding, consideration may need to be given to defining the debtors to whom it might apply and the parties that can be affected by such a proceeding.

(a) Eligible debtors

368. This type of proceeding may be available, for example, on the application of any debtor which is in a position of imminent insolvency but has not generally ceased making payments, in a position of temporary insolvency, or in a position where it can continue paying trade creditors in the ordinary course of business but has a moratorium agreed to allow for a reorganization of financial debt. Where the insolvency law establishes an obligation to commence insolvency proceedings where the debtor meets specified criteria concerning its financial position (e.g. that it has generally ceased making payments), it may be necessary to consider providing an exception for the type of proceeding described in this section or to provide a temporary moratorium which will enable the debtor to avoid meeting those criteria (and thus avoid the sanctions for failure to meet the obligation to apply for commencement). [Where there is a pre-petition plan negotiated and accepted between the debtor and creditors, there is no need to consider providing for a creditor application for commencement of such proceedings.]

(b) Obligations affected

369. As noted above, the types of obligations typically involved in out-of-court reorganization relate to borrowed money indebtedness, both institutional and public whether secured or unsecured, and other similar financial obligations. Secured debt would be included in such reorganizations with the agreement of the secured creditors. Indebtedness held by other creditors, such as trade creditors and employees would not generally be affected unless they individually agreed to adjustment of their claims. The specific obligations to be affected in any given case would be those identified in the plan which is to be enforced under this type of proceeding.

(c) Application of the insolvency law

370. In addition to identifying eligible debtors and determining who may apply for commencement of this type of proceeding, a regime providing for this type of proceeding will need to identify those provisions of the insolvency law applicable to full court-supervised proceedings that will apply to these proceedings, particularly if any changes are

to be made in the manner in which they apply. So, for example, the provisions which would generally apply to this type of proceedings in the same manner as for full court-supervised proceedings (unless specifically modified) might include provisions on: application procedures; commencement; application of the stay; requirements for preparation of a list of all creditors (in order to inform the court, and provide notice and certainty as to who is affected by the plan and who is not); requirements for approval of the plan (including notice to affected creditors, determination of classes of creditors, creditor committees, criteria and majorities required for approval); effect and confirmation of the plan; and discharge of claims.

371. Provisions of the insolvency law that might not apply to this type of proceeding would include those relating to: the requirement for general cessation of payments or insolvency; appointment of the insolvency representative, unless there is provision for such an appointment in the plan; making of claims; requirements for notice and time periods for plan approval (where included in the insolvency law); and voting on the plan. A further and important exception to the application of the insolvency law would be that creditors not affected by the plan could continue during the proceedings to be paid in the ordinary course of business.

372. The application for commencement of this type of proceeding may need to be somewhat different to an application for full court-supervised proceedings to take account of the different background considerations. The application could include, for example, additional information concerning the negotiations that have already been conducted and the voting of affected classes of creditors, and the protections afforded to dissenting creditors within accepting classes. An insolvency law may also need to address the question of whether the application will function as an automatic commencement of the proceedings or whether the court will be required to consider the application; if court consideration is required it is desirable that the time for such consideration be as brief as possible.

(d) Expedition of the proceedings

373. In order to take full advantage of the agreement negotiated out-of-court and avoid the delays that may make that agreement impossible to implement, an insolvency law may need to consider how this type of proceeding can be handled more quickly than full court-supervised reorganization proceedings. [507/para. 244(a)] For example, if a plan and other documentation that complies with the formal requirements of the insolvency law has been negotiated informally and is supported by a substantial majority, it may be possible for the court to order an immediate meeting or hearing as applicable, saving time and expense. [507/para. 244(b)] It may also be possible for an exemption to be granted from part of the formal process. For example, if an informally negotiated plan has been agreed by a sufficient majority of creditors of a particular class to approve a reorganization plan under the voting requirements of the insolvency law – typically the institutional creditors – and the rights of other creditors will not be impaired by the implementation of the plan, it might be possible for the court to order a meeting or hearing of that particular approving class of creditors only.

374. [507/para.244] Even though the insolvency law may provide for eligible cases to be treated expeditiously, it is highly desirable that it does not afford less protection for dissenting [non-assenting] creditors and other parties under such a procedures than the insolvency law provides for such dissenting creditors in full court-supervised reorganization proceedings. The procedural requirements for such (expedited)

reorganization proceedings would therefore include substantially the same safeguards and protections as provided in full court-supervised reorganization proceedings.

375. [507/para. 244] Other laws may need to be modified to encourage or accommodate both out-of-court reorganization and this type of (expedited) reorganization proceedings. Examples of those laws might include those that require unanimous consent to adjust indebtedness outside of insolvency proceedings, that expose directors to liability for trading during the period when an out-of-court reorganization is being negotiated, that do not recognize obligations for credit extended during such a period or subject those obligations to avoidance provisions, and that restrict conversion of debt to equity.

Recommendations

Purpose of legislative provisions

The purpose of provisions relating to insolvency procedures which combine out-of-court negotiation and acceptance of a reorganization plan with an expedited procedure conducted under the insolvency law for court approval of that plan is to:

(a) recognize that out-of-court reorganization, which typically involves restructuring of the debt due to lenders and other institutional creditors, and major non-institutional creditors where their participation is crucial to the restructuring, but not involving all categories of creditors, is a cost effective, efficient tool for the rescue of financially troubled businesses;

(b) encourage and facilitate the use of out-of-court reorganization;

(c) develop a procedure under the insolvency law that will:

(i) preserve the benefits of out-of-court reorganization negotiations where a majority of each affected class of creditors [and equity holders] agree to a reorganization plan;

(ii) minimise time delays and expense and ensure that the agreement reached in out-of-court negotiations is not lost;

(iii) bind those minority members of each affected class of creditors [and equity holders] who do not accept the reorganization plan negotiated out-of-court;

(iv) be based upon the same procedural requirements, but shortened time periods, as full reorganization proceedings under the insolvency law, including essentially the same safeguards for dissenting affected creditors;

(d) recognize that requirements in other laws may prevent or inhibit the use of procedures which do not invoke the insolvency law, such as requirements for unanimous consent for adjustment of indebtedness outside of insolvency proceedings, liability for directors where the debtor continues to trade during the period when the out-of-court reorganization is being negotiated, that do not recognize obligations for credit extended during such a period, and that restrict conversion of debt to equity.

Content of legislative provisions

Commencement of (expedited) reorganization proceedings

(139) [(141)] ~~A debtor [which is eligible under the insolvency law] may file an application to commence expedited reorganization proceedings [to implement]~~ The insolvency law should provide that this type of proceeding is available on the application of any debtor [which is not a natural person] that will be unable to pay its debts as they mature (but has not generally ceased making payments) where a plan of reorganization has been negotiated and accepted by the vote of a majority of each affected class of creditors [and equity holders] and by each affected creditor not part of a voting class prior to the application to commence reorganization proceedings.

Application requirements

(140) [(142)] The insolvency law should provide that where the debtor can satisfy the requirements of recommendation (139) and the jurisdictional requirements for commencement of full reorganization proceedings under the insolvency law, the application for commencement of this type of proceeding should be accompanied by the following additional materials:

(a) the reorganization plan and [explanatory] [disclosure] statement;
(b) a description of the out-of-court reorganization activity that preceded the making of the application for commencement, including [evidence] that appropriate notice was given to all members of affected classes of creditors and that adequate information was provided to affected creditors [and equity holders] to enable them to make an informed decision about the plan [or a summary of that information];
(c) certification that unaffected creditors are being paid in the ordinary course of business and that the plan does not modify or impair the rights or claims of [fiscal][tax] authorities or employees;
(d) a report of the votes of affected classes of creditors [and equity holders] demonstrating that those classes have accepted the reorganization plan by the majorities specified in the reorganization law;
(e) a report of the acceptance of any individual creditors which are not members of an affected class;
(f) a financial analysis prepared by [the debtor] [an independent expert] [or other evidence acceptable to the court] which demonstrates that the reorganization plan is feasible [and that dissenting creditors will receive at least as much as they would have received in a liquidation proceeding under the insolvency law]; and
(g) a list of the members of any creditor committees formed during the course of the out-of-court reorganization.

Effect of commencement

(141) [(143)] The insolvency law should provide that the application for commencement will [function as automatic commencement of proceedings] [be acted upon by the court as expeditiously as possible] and that:

(a) the effects of commencement should be limited to the debtor, individual creditors and classes of creditors [and equity holders] [those parties] whose rights are modified or who are affected by the plan;
(b) any creditor committee formed during the course of the out-of-court reorganization should be treated as a creditor committee appointed under the insolvency law;
(c) provisions of the insolvency law that apply to full reorganization proceedings shall also apply to this type of ~~expedited~~reorganization proceeding unless identified as not being applicable[2]; and
(d) a hearing on the confirmation of the reorganization plan should be held as expeditiously as possible.

Notice of commencement

(142) [(144)] The insolvency law should provide that notice of the commencement of this type of reorganization proceeding should promptly be provided to all known creditors [and equity holders] and should indicate:

(a) the amount of each affected creditor's claim according to the debtor;
(b) the time period for submitting a claim in a different amount if the affected creditor disagrees with the debtor's statement of claim, and specify the place where the claim can be submitted; and
(c) the time and place for the hearing on confirmation of the reorganization plan, and for the submission of any objection to confirmation.

Confirmation of the plan

(143) [(145)] The insolvency law should provide that the court ~~should~~ will confirm the reorganization plan where it determines that:

(a) the plan satisfies the requirements for confirmation of a plan in a full court-supervised ~~non-expedited~~ reorganization proceeding, in so far as those requirements apply to affected creditors [and equity holders];
(b) the notice given and the information provided to affected creditors [and equity holders] during the out-of-court reorganization was sufficient to enable them to make an informed decision about the plan [and any pre-commencement solicitation of acceptances to the plan complied with applicable non-insolvency law];
(c) the financial analysis submitted with the application is satisfactory and demonstrates that the reorganization plan is feasible [and that dissenting creditors [and equity holders] will receive as much under the reorganization plan as they would in a liquidation proceeding under the insolvency law];

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[2] Provisions of the insolvency law that would not be applicable would include: the requirement for insolvency of the debtor; full claim filing; notice and time periods for plan approval; mechanics of voting; no insolvency representative would be appointed unless required by the plan; provisions on amendment of the plan after confirmation; and […].
An exception to the insolvency law would be that creditors not affected by the reorganization plan would be paid in the ordinary course of business during the implementation of the plan.

(d) unaffected creditors are being paid in the ordinary course of business and the plan does not modify or impair [rights] [claims] of [fiscal][tax] authorities or employees.

Effect of a confirmed plan

(144) The insolvency law should provide that the effect of a plan confirmed by the court under this type of reorganization proceeding should be limited to those creditors who took part in the negotiation and approval process.

Failure of implementation of the plan

(145) The insolvency law should provide that where the debtor fails to meet the obligations of the plan confirmed in accordance with recommendation (143), the plan should be terminated and creditors may exercise their rights at law, as modified by the plan.

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Draft legislative guide on insolvency law

Note by the Secretariat

Contents

[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Add.3 and Add.4; Chapter III.A-F appear in documents A/CN.9/WG.V/WP.63/Adds.5-9; Chapter IV.A-D appear in documents A/CN.9/WG.V/WP.63/Adds.10-11, Chapter V appears in document A/CN.9/WG.V/WP.63/Add.12; Chapter VI.B-E and Chapter VII appear in subsequent Addenda]

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* This document was submitted late because of the need to complete consultations and finalise consequent amendments.

Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.
Recommendation numbers in [..] refer to relevant recommendations in A/CN.9/WG.V/WP.61 and A/CN.9/WG.V/WP.61/Add.1, the previous version of the recommendations. Additions to the recommendations are indicated in this document by underlined text.

Part Two (continued)

VI. Management of proceedings

A. Treatment of creditor claims

1. Introduction

376. [215] Claims by creditors operate at two levels in insolvency proceedings—firstly, for purposes of determining which creditors may vote in the proceedings and how they may vote (according to the class of creditor into which they fall) and secondly, for purposes of distribution (see Part two, chapter VI.C). The procedure for submission of claims and their admission or non-admission is therefore a key part of the insolvency procedure and consideration should be given to determining which creditors should be required to submit claims, the procedures applicable to the submission of claims, the procedure for verification and admission (or non-admission) of claims, the consequences of failure to make a claim, and review of decision concerning the admission or non-admission of claims. An insolvency law should also address the effect of submission and admission of claims, as this will be key to creditor participation. For example, submission of a claim may entitle a creditor to participate at the first meeting of creditors, while admission, or at least provisional admission, may be essential to enable a creditor to vote on various matters in the proceedings.

2. Submission of creditor claims

(a) Creditors who may be required to submit claims

377. The principal issue with regard to deciding which creditors will be required to submit a claim relates to the treatment of secured creditors, since unsecured creditors (irrespective of whether the debt is contingent or liquidated) are generally required to submit a claim (unless of course, the claims procedure provides that not all creditors are required to file claims).

378. Under those insolvency laws which do not include secured assets in the insolvency estate and allow secured creditors to freely enforce their secured interest against the secured assets, secured creditors may be excluded from the requirements to submit a claim to the extent that their claim will be met from the value of the sale of the secured asset. To the extent that the value of the secured asset is less than amount of the secured creditor's claim, the creditor may be required to submit a claim as an ordinary unsecured creditor. The value of the unsecured claim depends upon the value of the secured asset and the time at which that value is determined and the method of valuation used, and unless

clear rules apply to valuation, there is the potential for some uncertainty, particularly in terms of deciding voting rights.

379. Other insolvency laws allow secured creditors to surrender the security to the insolvency representative and to submit a claim for the total value of the secured interest. A further approach requires secured creditors to submit a claim for the total value of the secured interest (irrespective of the surrender of the security), a requirement which in some laws is limited to the holders of certain types of security, such as floating charges, bills of sale, or security over chattels. Where secured creditors are required to submit a claim, the procedures for submission and verification are generally the same as for unsecured creditors. The approach of requiring secured creditors to submit claims has the advantage of providing information to the insolvency representative as to existence of all claims and the amount of the outstanding debt. Whichever approach is chosen, it is desirable that an insolvency law includes clear rules on the treatment of secured creditors for the purposes of submission of claims.

(b) Limitations on claims that can be submitted

(i) Post-commencement debt

380. [234] As a general principle, claims can only be submitted in respect of debt incurred prior to commencement. How debt incurred after commencement is treated will depend on the nature of the proceedings and what is provided in the insolvency law – many laws provide that they are payable in full as costs of the proceedings (see Part two, chapter VI.C.1(b)).

(ii) Types of excluded claims

381. [246] For a variety of public policy reasons, an insolvency law may seek to exclude certain types of claims. Examples include foreign tax claims, fines and penalties, claims relating to personal injury, claims relating to negligence and gambling debts. Other insolvency laws provide that such claims can be submitted but they may be subject to special treatment, such as subordination to other unsecured claims. It is highly desirable that an insolvency law identifies those claims that are to be excluded from the insolvency process (or subjected to special treatment –see Part two, chapter VI.C).

382. [247] Foreign tax claims are currently excluded by many countries, and it is generally recognized that such an exclusion does not violate the objective of equal treatment of foreign and domestic creditors. Despite this general view, however, there are no compelling reasons why such claims cannot be admitted if a country wishes to do so. Where foreign tax claims are admitted, they can be treated in the same manner as domestic tax claims or as ordinary unsecured claims. Article 13(2) of the UNCITRAL Model Law on Cross-Border Insolvency recognizes these different approaches, providing that the requirement of equal treatment of foreign and domestic creditors is not affected by the exclusion of foreign tax and social security claims or by their ranking on the same level as general non-preference claim or lower if equivalent local claims have that lower ranking.

383. [248] Where gambling debts are treated as excluded claims it is generally on the basis that they arise from an activity that is itself illegal. Rather than focussing upon the specific types of claims that may be excluded as illegal, an insolvency law may exclude, as a general category, those claims that arise from illegal activity and are thus unenforceable.

384. [249] With respect to fines and penalties, an insolvency law may distinguish between those which are of a strictly administrative or punitive nature (such as a fine imposed as the result of an administrative or criminal violation) and those of a compensatory nature. It may be argued that the first category should be excluded on the basis that they arise from some wrongdoing on the part of the debtor and unsecured creditors should not be made to bear the burden of that wrongdoing by seeing a reduction in the assets available for distribution. In comparison, there would seem to be no compelling reason for excluding the second category, particularly where it relates to recompense for damage suffered by another party, except to the extent that exclusion may also be justified as a means of increasing the assets available to unsecured creditors. An alternative approach would be to admit claims based on fines and penalties because otherwise they will remain uncollected [*other reasons?*].

(c) Procedure for submission of claims

(i) Timing of submission of claims

385. [236] To ensure that claims are submitted in a timely fashion and that the insolvency proceedings are not unnecessarily prolonged, deadlines for submission of claims can be included in an insolvency law, or be determined by the court or by the insolvency representative. Some insolvency laws provide, for example, that the court, when deciding to commence proceedings, will establish a deadline for the making of claims; in some cases that deadline is to be within a range established by the insolvency law, and examples range from 10 days to three months. Other insolvency laws do not establish any deadlines for submission, and may provide for the insolvency representative to determine the timing of submission of claims, or provide for claims to be filed at any time up until the final report and accounting by the insolvency representative. Some insolvency laws provide for different time limits depending upon the method of notification of commencement; where the creditor is a known creditor and receives personal notification of the commencement of proceedings the time limit may be shorter than where the creditor has to rely on public notification of commencement.

386. While these deadlines may assist in ensuring that the claims process does not impose unnecessary delay on the proceedings, they [236] may operate to disadvantage foreign creditors who in many cases may not be able to meet the same deadlines as domestic creditors. To ensure the equal treatment of domestic and foreign creditors, and to take account of the international trend of abolishing discrimination based upon the nationality of the creditor, it may be possible to adopt an approach that either allows claims to be submitted at any time prior to distribution, or sets a time limit which can be extended or waived where a creditor has good reason for not complying with the deadline, or where the deadline operates as a serious impediment to a creditor. Where the claim is submitted late and causes costs to be incurred, those costs could be borne by the creditor.

(ii) Burden of submitting and proving claims

387. [235] Many insolvency laws place the burden of submitting and proving their claim upon creditors. Generally they will be required to produce evidence as to the amount of the claim, the basis of the debt and any preferences or security claimed. In some cases this information is to be provided by way of a standard claim form, but in any event the claim generally is to be accompanied by supporting documentation. Many laws provide that the insolvency representative is entitled to request the creditor to provide more information or documentation to prove their claim. Some insolvency laws provide that creditors do not

have to prove their claim in all cases, such as where the insolvency representative is able to ascertain, from the debtor's books and records, which creditors are entitled to payment. Those creditors may be required, however, to notify the insolvency representative of their claim.

388. [253] An approach which does not require creditors to submit a claim in all cases may be facilitated where the insolvency law requires, as an initial step in the proceedings, that a list of creditors and claims is prepared, either by the court or by the debtor, with the assistance of the insolvency representative. Preparation of such a list by the debtor takes advantage of the debtor's knowledge about its creditors and their claims and gives the insolvency representative an early indication of the state of the business. An alternative would be to require the insolvency representative to prepare that list, an approach that may serve to reduce the formalities associated with the process of verification of claims, but may add to expense and delay, as it would rely upon the insolvency representative obtaining accurate and relevant information from the debtor. Once the list is prepared, it could be used to assess which creditors should be invited to make their claims to the insolvency representative for purposes of verification or for the purposes of ensuring that all relevant creditors have submitted claims. The list can also be revised and updated over time to provide an accurate indication of the level of the debtor's indebtedness.

(iii) Formalities for submission of foreign claims

389. [238] An issue of particular importance to foreign creditors is whether the claim must be submitted in the language of the jurisdiction in which the insolvency proceedings have commenced, and whether the claim is subject to certain formalities, such as notarization and translation. To facilitate the access of foreign creditors, consideration may be given to whether these requirements are essential or may be relaxed as in the case of other procedural formalities discussed in respect of article 14 of the UNCITRAL Model Law on Cross-Border Insolvency (see Part two, chapter VIII).

(iv) Conversion of foreign currency claims

390. [250] The valuation of claims is of particular relevance to foreign creditors who will generally make their claims in currencies other than that of the country of the insolvency proceedings. For verification and distribution purposes, these claims are normally converted into the domestic currency. The date of conversion may have been agreed in the contract between the debtor and creditor, or it may be set by reference to the stages of the proceedings, such as commencement or some later time. If the date of conversion is set at the date of commencement of the insolvency proceedings, and the currency depreciates or appreciates in the period before distribution (which could occur at a significantly later time), the amount of the claim will also fluctuate. An alternative approach is to make a provisional conversion at the time of commencement for the purposes of voting, but if the exchange rate fluctuates more than a given percentage (which may be stipulated in the insolvency law) in the period before distribution, then the conversion can be made at the time of distribution or an appropriate adjustment made to the earlier calculation.

(v) Party authorized to receive claims

391. Insolvency laws generally adopt one of two approaches to this question. Some laws require the claim to be submitted to the court, while others provide for claims to be submitted to the insolvency representative. The reason for the difference generally

relates to the process of verification and whether it is conducted by the court or the insolvency representative.

(d) Failure to submit claims

(i) Failure to submit within a stipulated time period

392. Different approaches are taken in respect of those claims not submitted within the specified time limit (where the insolvency law, the court or the insolvency representative imposes such a limit). Some insolvency laws adopt a flexible approach providing that notwithstanding the application of a deadline, claims still can be filed at any time up to the insolvency representative's final report and accounting in liquidation, but the creditor must bear any additional costs associated with submitting a claim at such a late stage. One consequence of late submission may be that the creditor cannot participate in interim distributions occurring before submission (or admission) of the claim, although there are examples of laws which provide for the creditor to receive previous interim dividends once the claim has been admitted. A further consequence is the loss of the right to vote at meetings of creditors.

393. Another approach is to adhere strictly to submission deadlines, and some laws provide that failure to file a claim may result in the debt being extinguished or security rights being waived or forfeited. It should be noted, however, that in the case of one law which follows this approach, the law requires creditors protected by registered security rights and leasing agreements to be personally notified of commencement of proceedings and of the need to submit a claim. Other laws require the creditor who has failed to submit its claim to petition the court to admit its claim. Where admitted, the creditor will only share in future dividends.

(ii) Failure to submit a claim before conclusion of the proceedings

394. The failure of a creditor to submit a claim before the final report and accounting may lead to different results depending upon other provisions of the insolvency law. Where the insolvency law provides for a discharge of the debtor upon conclusion of the insolvency proceedings, some of those laws provide that unsubmitted claims are forfeited [*are there other approaches?*]

3. Procedure for verification and admission

(a) List of submitted claims

395. Many insolvency laws require the court or the insolvency representative, depending upon requirements for submission, to prepare a list of submitted claims, either after expiry of the deadline for submission of claims or on a continuing basis in cases where there is no deadline. Where the insolvency law requires preparation of a list of creditors (see para. 388), the list of claims would update that earlier list of creditors. The list of claims can be used as the basis of verification and admission of claims and for notification as to the receipt, admission or non-admission of claims, depending upon the applicable admission procedure. [239] Many insolvency laws provide that all identified and identifiable creditors are entitled to receive notice of claims that have been made. This will enable creditors to see what claims have been submitted and to object to the claims of other creditors (where this is permitted under the insolvency law). The notification may be given

personally, by publishing notices in appropriate commercial publications or by filing the list with the court.

(b) Procedures for verification and admission

396. [241] Verification involves not only an assessment of the underlying legitimacy and amount of the claim, but also classification of a claim for purposes of voting and distribution (e.g. secured or unsecured claims; pre-commencement or post-commencement claims, priority and so on).

(i) Deadline for verification and admission

397. A number of insolvency laws impose time limits for verification and admission of claims, requiring that a decision be provided to creditors within a short period such as 30 days after the expiry of the deadline for submission. Other laws make no provision for time limits.

(ii) Admission procedure

398. Where claims are submitted to the insolvency representative, insolvency laws provide that those claims will be admitted by the insolvency representative, or the insolvency representative will be required to convene a meeting of creditors to scrutinise those claims. Where claims are submitted to the court, the court will convene that meeting or hearing. One issue that may be of concern to foreign creditors is the requirement in some insolvency laws for them to attend such meetings in person in order for their claims to be admitted. Such a requirement has the potential to frustrate the goal of equal treatment of similarly situated creditors, and it is desirable that claims of foreign creditors can be admitted on the basis of documentary evidence without the additional formality of personal appearance.

399. [242] Many insolvency laws provide that where the claim is to be submitted to the insolvency representative, it is for the insolvency representative to verify the claims and decide whether or not the claims should be admitted, whether in whole or in part. The creditor will be notified of the insolvency representative’s decision and where the claim is not admitted, or admitted only in part, the insolvency representative is generally required to provide reasons for that decision (often required to be given in writing). Such a requirement is likely to enhance the transparency of the procedure and potentially its predictability for creditors. Some insolvency laws provide that the insolvency representative’s decisions on admission of claims are to be updated on the list of claims that is filed with the court or made public in some other way in order to facilitate consideration by other creditors and the debtor. Where following appropriate notification the insolvency representative does not receive any objections to claims proposed to be admitted, a number of insolvency laws provide that the claim is deemed to be admitted.

400. Under some insolvency laws the insolvency representative is required to convene a meeting of creditors to consider submitted claims on the basis of the list prepared by the insolvency representative. That list may be required to include recommendations as to admission, value and priority of individual claims. Where no objections to admission of claims are made at that meeting, the insolvency representative’s recommendations may be deemed under the insolvency law to be approved or the claims admitted. A similar procedure is followed where claims are submitted to the court.

401. [243] With a view to minimising the formalities required for verification and admission of claims, an alternative approach to those outlined above may be to provide that claims outstanding at the time of commencement do not require verification and can be admitted on an automatic basis unless the claim is challenged. This approach will require some mechanism for determining the existence of claims, and it may not be sufficient to rely upon the books and records of the debtor to identify all claims as these may not provide a sufficiently reliable or complete source of information. If an approach of automatic admission is adopted, it may be desirable to combine it with a mechanism aimed at ensuring that adequate information as to the claims admitted on that basis is available to all interested parties. Automatic admission of claims may avoid many of the difficulties associated with the insolvency representative having to make a precise assessment of the situation at the outset of the proceedings to enable creditors to participate in and vote at meetings held at an early stage of the proceedings. Automatic admission of claims may be assisted by requiring claims to be submitted in the form of a declaration, such as an affidavit, to which sanctions would attach in the event of fraud. It could also be assisted by admitting claims that are supported by properly maintained accounting records or allowing creditors to accept as correct the amount of their claim as shown in the records of the debtor that are kept in the ordinary course of business. It may be desirable for an insolvency law to address the question of false claims and the applicable sanctions.

(iii) Provisional admission of claims

402. [240] Creditors claims may be of two types: those that involve a determined amount and those where the amount owed by the debtor has not been or cannot presently be determined. Such claims may be either contractual or non-contractual in nature and may arise in respect of both secured and unsecured claims. Claims may also be conditional, contingent and not mature at the time of commencement (the latter would generally be subject to a deduction for the unexpired period of time before maturity).

403. [240] Where the amount of the claim cannot be or has not been determined at the time the claim is to be submitted, many insolvency laws provide for a claim to be admitted provisionally or to be given a provisional value. Admission of provisional claims raises a number of issues. These concern valuation of the claim and the party to undertake that valuation (the insolvency representative, the court or some other appointed person); voting of provisional creditors on important issues such as determining whether the case is one of liquidation or reorganization or approval of the reorganization plan; and whether, as minority creditors, they can be bound by a plan to which they have not agreed (see Part two, chapter V). Where an insolvency law provides for provisional admission of claims, it may be necessary to consider whether such claims will be subject, in the first instance, to the same procedure as other claims. For example, where admission involves a hearing before the court or a meeting of creditors to be called, claims that might be provisionally admitted could be subject to that procedure, or they could first be admitted by the insolvency representative, without prejudice to the right of a dissenting party to dispute that claim, and be subject to some procedure for approval at a later stage.

(c) Disputed claims

404. [245] Where an insolvency law allows a claim submitted in the insolvency proceedings to be disputed, whether as to its value, priority, or basis, it may also indicate which parties are entitled to initiate such a challenge. Some laws allow claims to be disputed only by the insolvency representative, while other laws permit other interested parties, including creditors and the debtor, to dispute a claim. Depending upon the

procedures for submission and admission of claims, the dispute may be raised with the insolvency representative, or before or at the court hearing or creditors meeting held to examine claims. Where such a meeting or hearing is held, the preparation of a provisional list of admissions, either by the court or by the insolvency representative and the provision of that list to all creditors before the hearing or meeting will facilitate the consideration of claims. Where claims are the subject of a dispute outside of the insolvency proceedings, they may generally fall into one or other of the categories of claims that may be provisionally admitted in the insolvency proceedings, depending upon the nature of the claim.

405. [245] Where claims are disputed, whether by a creditor, the insolvency representative or the debtor, a mechanism for quick resolution of the dispute is essential to ensure efficient and orderly progress of the proceedings. If disputed claims cannot be quickly and efficiently resolved, the ability to dispute a claim may be used to frustrate the proceedings and create unnecessary delay. Most insolvency laws provide for disputes to be resolved by the court to ensure finality of the decision.

(d) Effect of admission of a claim

406. [244] Admission of a claim of a creditor will establish the right of the creditor to attend a meeting of creditors, and the amount for which the creditor is entitled to vote at such a meeting, whether on the election of an insolvency representative or approval of a reorganization plan. It will also fix the amount that the insolvency representative must take into account in making a distribution to creditors. Provisional admission of a claim will generally entitle the creditor to participate in the proceedings to the same extent as other creditors, except that they may not be entitled to participate in distributions until the value of the claim is finally fixed and the claim admitted. Where, however, the claim is not ultimately fully admitted, any previous votes by the creditor in the proceedings may be discounted.

(e) Setoff of mutual claims *[to be co-ordinated with chapter III.F]*

407. As noted above in chapter III.F, a number of insolvency laws make provision for mutual money obligations between the debtor and creditors to be setoff in insolvency proceedings, provided certain conditions are met. These may include, for example, requirements that the claims existed and were due and payable at the time of commencement of the proceedings; that the creditor acquired the claim without fraud or was not aware of the financial situation of its debtor; that the creditor did not acquire the claim during the suspect period; that the creditor has declared its intention to seek a setoff to the insolvency representative; and that the claims were related. A very few insolvency laws provide for mandatory setoff in insolvency, while a number of other laws do not permit setoff on the basis that it violates the *pari passu* principle.

(f) Claims requiring special treatment

(i) Administrative claims

408. [220] Insolvency proceedings often require the assistance of professionals, such as the insolvency representative and advisors to the debtor or insolvency representative. Expenses may be incurred by creditor committees and also for the purposes of operating the business and carrying out the proceedings, including many or all post-commencement debts, such as claims of employees, lease costs and similar claims.

409. [221] Notwithstanding the importance of providing appropriate remuneration to those involved in the conduct of the insolvency proceedings, administrative expenses have the potential for a significant impact on the value of the insolvency estate. While to some extent that impact will depend upon the design of an insolvency law and its supporting infrastructure, consideration of how that impact can be minimised may be desirable. An insolvency law can provide, for example, precise but flexible criteria relating to the allowance of those expenses. These criteria may include providing that allowance of the expenses is conditional upon the utility of the expense to increasing the value of the estate for the general benefit of all constituents, or that the expenses be not only reasonable and necessary, but also consistent with the key objectives of the process. Reasonableness of the expense may be assessed by reference to the amount of resources available to the proceedings and to the possible effect of the expense on the proceedings. [*Note to the Working Group: Are there examples of laws which include such criteria?*]

410. [222] Different approaches may be taken to conducting that assessment. One approach may be to require authorization by the court prior to the cost being incurred, or authorization by the court of all costs falling outside the scope of the ordinary course of business. A second approach may be to provide that the assessment be made by creditors, to facilitate the transparency of the proceedings, subject to recourse to the court in the event that the assessment of the creditors is disputed.

(ii) Related persons

411. [233] A category of creditors that may require special consideration is those persons related to the debtor, whether in a familial or business capacity (discussed above, see Part two, chapter III.E.3(e)). Special treatment of the claims of these persons is often justified on the basis that they are more likely to have been favoured and tend to have had early knowledge of the financial difficulties of the debtor and [*other?*]. While they do not properly fall within classes of excluded claims, it may be appropriate to consider whether they should be admitted and treated in the same way as other creditors or be admitted subject to special treatment. The mere fact of a special relationship with the debtor, however, may not be sufficient in all cases to justify special treatment of a creditor’s claim. In some cases these claims will be entirely transparent and should be treated in the same manner as similar claims made by creditors who are not related persons, in other cases they may give rise to suspicion and will deserve special attention. An insolvency law may need to include a mechanism to identify those types of conduct or situations in which claims will deserve additional attention, such as where the debtor is under-capitalized or where there has been self-dealing. In those cases, the claim may be restricted in the amount allowed or the claim may be subordinated, or the voting rights of the related creditor restricted (such as in selection of the insolvency representative).

(iii) Claims for interest (see Part two, chapter VI.C.1(g))

Recommendations

Purpose of legislative provisions

The purpose of provisions on treatment of creditor claims is to:

(a) define the claims that can be submitted and the treatment to be accorded to those claims;
(b) enable persons who have a claim against a debtor to make claims against the insolvency estate;
(c) establish a mechanism for verification and admission or non-admission (in full or in part) of claims;
(d) provide for review of disputed claims.
(e) ~~establish the treatment of particular claims, including those of secured creditors, foreign creditors, creditors whose claims are in a foreign currency, conditional or non-monetary claims, claims for interest, and claims in respect of non-mature liabilities.~~

Content of legislative provisions

(146) The insolvency law should establish a mechanism for creditors to file claims, for the admission or non-admission of claims and for the treatment of claims.[1] The insolvency law may also provide a mechanism by which undisputed claims can be automatically admitted, by reference to for example [*the books and records of the debtor…*]. The insolvency law should minimise the formalities associated with submitting a claim.

(147) [(99)] The insolvency law should provide that claims that may be submitted should include all rights to payment which arise from acts or omissions of the debtor prior to commencement of the insolvency proceedings, whether mature or not, whether of a determined [liquidated] or undetermined [unliquidated] amount, whether fixed or contingent. The insolvency law should identify claims, if any, that will not be affected by the insolvency proceedings.[2]

Secured claims

(148) The insolvency law should clearly indicate the treatment of secured claims – whether all secured creditors are required to make claims or only where they are under-secured – and specify the consequences of making or failing to make a claim.[3]

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[1] The insolvency law should address claims that may require special treatment, for example claims of foreign and other creditors where they are denoted in foreign currency, conditional or non-monetary claims, claims for interest, and claims in respect of immature liabilities.

[2] Some insolvency laws provide, for example, that claims such as [government] fines and penalties and taxes will not be affected by the insolvency proceedings. Where a claim was to be unaffected by the insolvency proceedings it would continue to exist and would not be included in any discharge.

[3] See UNCITRAL Model Law on Cross-Border Insolvency, art. 14(3) and para. 111 of the Guide to Enactment. See also recommendation (24), chapter II.B

Equal treatment of similarly situated creditors

(149) [(100)] The insolvency law should provide that all similarly situated creditors, including foreign creditors, are treated equally with respect to the submission and treatment of claims.

Timing of claims

(150) [(101)] The insolvency law should establish the time in which claims can be submitted, either:

(a) within a specified time after [the commencement of proceedings] [notice of commencement of proceedings]; or
(b) at any time prior to final distribution or at a specified time prior to the consideration of a reorganization plan.[4]

Consequences of failure to claim

(151) [(102)] The insolvency law should address the consequences that apply where a claim is not submitted within the specified time, or is not submitted before a final distribution is made and the proceedings concluded.

Foreign currency claims

(152) [(103)] In respect of foreign currency claims, the insolvency law should indicate the time at which the claim will be converted into local currency. This time may be determined by reference to any agreement in a contract between the debtor and the claiming creditor as to the date of conversion or by reference to the time of the application for, or the commencement of, insolvency proceedings [or some other time in the insolvency proceedings].

Evidence of claims

(153) [(104)] The insolvency law should provide that a creditor may be required to provide evidence of its claim to the court or alternatively, to the insolvency representative without having to personally appear.

Admission or non-admission of claims

(154) [(105)] The insolvency law should provide for admission or [non-admission] of any claim, in full or in part, by the insolvency representative. Where the insolvency representative does not admit a claim it should be required to give reasons.

(155) [(105)] The insolvency law should provide that creditors whose claims have not been admitted or which are disputed in the insolvency proceedings should have a right to review

[4] Where the insolvency law adopts option (b), and a claim is not filed until late in the proceedings, the creditor may be required to accept that it may not participate in any distributions made prior to the filing of the claim.

of their claim by the court. The insolvency law should also provide that an interested party may seek review by the court of the admission of any claim.

(156) The insolvency law should permit the insolvency representative, in verifying claims, to decide on the question of setoff.

Provisional admission

(157) [(106)] The insolvency law should provide that, to facilitate the conduct of the proceedings and in particular the voting of creditors, claims of undetermined value, secured claims and claims disputed in the insolvency proceedings can be provisionally admitted by the insolvency representative pending valuation of the claim, or resolution of the dispute by the court.

(158) [(107)] The insolvency law should provide that the valuation of a claim may be undertaken by the insolvency representative or by the court. Where the valuation is made by the insolvency representative, it should be subject to review by the court where disputed by an interested party.

Effects of admission

(159) [(108)] The insolvency law should establish the effect of admission, including provisional admission, of a claim. These effects may include:

(a) permitting the creditor to vote at a meeting of the general body of creditors, including on approval or disapproval of a reorganization plan;
(b) determining the ~~[class in which the creditor is entitled to vote]~~ the priority to which the creditor's claim is entitled;
(c) determining the amount for which the creditor is entitled to vote;
(d) except in the case of provisional admission of a claim, permitting the creditor to participate in a distribution.[5]

Claims by related parties

(160) [(109)] The insolvency law should specify that claims by related parties should be subject to scrutiny and where justified by reference, for example, to undercapitalization of the debtor or self-dealing, then:

~~(a) subjection of the claim to careful scrutiny;~~
(b) the voting rights of the related party may be restricted;
~~(c) subordination of the claim;~~
(d) the amount of the claim of the related party may be restricted.

[5] However, when making a distribution, the insolvency representative may be required to take account of claims which have been provisionally admitted, or submitted but not yet admitted: see recommendation (171).

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Draft legislative guide on insolvency law

Note by the Secretariat

Contents

[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Add.3 and Add.4; Chapter III.A-F appear in documents A/CN.9/WG.V/WP.63/Adds.5-9; Chapter IV. A-D appear in Adds. 10-11, Chapter V appears in Add.12, Chapter VI. A appears in Add.13, Chapter VII.A-B appear in Add.15, and Chapter VI.D-E will appear in Add.16]

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* This document was submitted late because of the need to complete consultations and finalize consequent amendments.

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Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.

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Part Two (continued)

VI. Management of proceedings

B. Post-commencement finance

1. Need for post-commencement finance

412. [187] The continued operation of the debtor's business after the commencement of insolvency proceedings is critical for reorganization and, to a lesser extent, in liquidation where the business is to be sold as a going concern. To maintain its business activities, the debtor must have access to funds to enable it to continue to pay for crucial supplies of goods and services, including labour costs, insurance, rent, maintenance of contracts and other operating expenses, as well as costs associated with maintaining the value of assets. It may also be relevant in those cases of liquidation where funds are required to continue the business for a short period to facilitate sale of the assets. In some insolvency cases, the debtor may already have sufficient liquid assets to fund the ongoing business expenses in the form of cash or other assets that can be converted to cash (such as anticipated proceeds of receivables). Alternatively, those expenses can be funded out of the debtor's existing cash flow through operation of the stay and cessation of payments on pre-commencement liabilities. Where the debtor has no available funds to meet its immediate cash flow needs, it will have to seek financing from third parties. This financing may take the form of trade credit extended to the debtor by vendors of goods and services, or loans or other forms of finance extended by lenders.

413. To ensure the continuity of the business where this is the object of the proceedings, it is highly desirable that a determination on the need for new finance is made at an early stage, in some cases even in the period between the making of the application and commencement of proceedings. In many jurisdictions, however, the provision of finance in the period before commencement raises difficult questions relating to avoidance powers, and the liability of the lender and of the debtor. Some insolvency laws provide, for example, that where a lender advances funds to an insolvent debtor it may be responsible for any increase in the liabilities of other creditors that arise from what is simply a postponement of the commencement of liquidation. Beyond that initial period, particularly in reorganization proceedings, the availability of new finance will also be important in the period between commencement of the proceedings and consideration of the plan; obtaining finance in the period after approval of the plan generally should be addressed in the plan, especially in those jurisdictions which prohibit new borrowing unless the need for it is identified in the plan.

414. [187] An insolvency law can recognize the need for such post-commencement finance, provide authorization for it and create priority for repayment of the lender. The central issue is the scope of the power, and in particular, the inducements that can be offered to a potential creditor as a means of obtaining finance from that creditor. To the extent that the solution adopted impacts the rights of existing secured creditors or those holding an interest in assets that was established prior in time, it is desirable that provisions addressing post-commencement financing are balanced against the general need to uphold commercial bargains, protect the pre-existing rights and priorities of creditors and minimize any negative impact on the availability of credit, in particular secured finance, that may result from interfering with those pre-existing security rights and priorities. As a general rule, the economic value of the rights of pre-existing secured creditors should be protected so that they will not be unreasonably harmed. If necessary (and as already discussed in relation to protection of the insolvency estate: see Part two, chapter III.B.5), pre-existing secured creditors should receive additional protections to preserve the economic value of their security rights, such as periodic payments or security rights in additional assets in substitution for any assets that may be used by the debtor or encumbered in favour of new lending. In addition to issues of availability and security or priority for new lending, an insolvency law may need to consider the treatment of funds that may have been advanced before the reorganization fails and where the debtor subsequently is to be liquidated. Some insolvency laws provide that any security provided in respect of new lending can be set aside in a subsequent liquidation, while other laws provide that creditors obtaining priority for new funding will retain that priority in any subsequent liquidation.

2. Sources of post-commencement finance

415. [188] Post-commencement lending is likely to come from a limited number of sources. The first is pre-insolvency lenders or vendors of goods who have an ongoing relationship with the debtor and its business and may advance new funds or provide trade credit in order to enhance the likelihood of recovering their existing claims and perhaps gaining additional value through the higher rates charged for the new lending. A second type of lender has no pre-insolvency connection with the business of the debtor and is likely to be motivated only by the possibility of high returns. The inducement for both types of lender is the certainty that special treatment will be accorded to post-commencement lending and credit. For existing lenders there are the additional inducements of the ongoing relationship with the debtor and its business, the assurance that the terms of their pre-commencement lending will not be altered and under some laws, the possibility that, if they do not provide post-commencement finance, their priority may be displaced by the lender who does provide that finance.

3. Attracting post-commencement finance—providing security or priority

416. [189] A number of different approaches can be taken to attracting post-commencement finance and providing for repayment. [190] Many insolvency laws provide that the insolvency representative can obtain unsecured credit without approval by the court or by creditors, while other laws require approval by the court or creditors in certain circumstances. Where the lender requires security, it can be provided on unencumbered property, or as a junior or lower security interest on already encumbered property where the value of the encumbered asset is

significantly in excess of the amount of the secured obligation. In that case, no special protections will generally be required for the pre-existing secured creditor, unless circumstances change at a later time.

417. [189] Where these approaches are either insufficient or not available, for example because there are no unencumbered assets or there is no excess value in those assets already encumbered, insolvency laws adopt a variety of approaches to obtaining new finance. A number of insolvency laws do not specifically address the issue of new finance and do not provide for any priority to be given for its repayment. In those cases where there are no unencumbered assets that the debtor can offer as security or the lender is prepared to take the risk of lending without security, no new money will be available.

418. [189] Some insolvency laws provide that new lending will be afforded some level of priority over other creditors, in some cases including existing secured creditors. One level of priority is classed as an administrative priority (see Part two, chapter VI.C), which will rank ahead of ordinary unsecured creditors, but not ahead of a secured creditor with respect to its security. In some cases, this priority is afforded on the basis that the new lending is extended to the insolvency representative, rather than to the debtor, and becomes an expense of the insolvency estate. Some insolvency laws require such borrowing to be approved by the court or by creditors, while other laws provide that the insolvency representative may obtain the necessary finance without approval, although this may involve an element of personal liability for the insolvency representative. Such a requirement is likely to result in reluctance to seek new finance.

419. [189] Other insolvency laws provide for a “super” administrative priority, which ranks ahead of administrative creditors or a priority that ranks ahead of all creditors, including secured creditors (sometimes referred to as a “priming lien”). In countries where this latter type of priority is permitted, insolvency courts recognize the risk to the existing secured lenders and authorize these types of priority reluctantly and as a last resort. The granting of such a priority may be subject to certain conditions such as the provision of notice to affected secured creditors and the opportunity for them to be heard by the court; proof by the debtor that it is unable to obtain the necessary finance without the priority; and the provision of adequate protection for any diminution of the economic value of the security interests of the affected secured creditor. In some legal systems, all of these options for attracting post-commencement finance are available.

420. It may be desirable in considering the issue of authorization to link it to the damage that may occur or the benefit that is likely to be provided as a result of the provision of new finance. Although many insolvency laws require authorization by the court, and court involvement may assist in promoting transparency and provide additional assurance to lenders, in many instances the insolvency representative may be in a better position to assess the need for new finance. In any event, the court generally will not have expertise or information additional to that provided by the insolvency representative on which to base its decision. Alternative approaches may include establishing a threshold above which approval of the court is required or requiring court approval only where affected creditors object to what is proposed by the insolvency representative.

Recommendations

Purpose of legislative provisions

The purpose of provisions on post-commencement finance and credit is to:

(a) Permit finance and credit to be obtained for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the assets of the debtor;

(b) Provide appropriate protection for the providers of post-commencement finance and credit;

(c) Provide appropriate protection for those parties whose rights may be affected by the provision of post-commencement finance and credit.

Content of legislative provisions

(161) [(110)] The insolvency law should permit the insolvency representative to obtain post-commencement finance and credit where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the assets of the debtor. The insolvency law may provide that authorization by the court or creditors is required.

~~[(111)] The insolvency law should permit the insolvency representative to obtain post-commencement credit where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the assets of the debtor.~~

Security for post-commencement finance

(162) [(112)] The insolvency law should enable security to be provided for repayment of post-commencement finance, including security on unencumbered assets [including after-acquired assets] and a junior or lower priority security on already encumbered assets of the debtor.

(163) [(113)] The insolvency law should provide that a security over the assets of the debtor to secure post-commencement finance does not have priority ahead of any existing security over the same assets unless the insolvency representative notifies the existing security holder and obtains their agreement or follows the procedure in recommendation [(114)].

(164) [(114)] The insolvency law should provide that where the holder of the existing security does not agree, the court may authorize the [granting] [creation] of that security provided specified conditions are satisfied, including:

~~(a) That the existing secured creditor has sufficient security in the assets that it will not [be harmed] [suffer unreasonable harm] by a priority given to the post-commencement finance;~~

(a) The existing [secured creditor] [security holder] was given notice and the opportunity to be heard by the court;

(b) The debtor can prove that it cannot obtain the finance in any other way; and

(c) The interests of the existing [secured creditor] [security holder] will be adequately protected, including through a sufficient excess in the value of the secured asset so that the existing secured creditor will not suffer unreasonable harm by a priority given to the post-commencement finance.

Priority for post-commencement finance

(165) [(115)] The insolvency law should establish the priority that may be provided for post-commencement finance, ensuring at least the payment of the post-commencement finance provider ahead of payment of ordinary unsecured creditors ~~(an administrative priority)~~ [including those unsecured creditors with administrative priority]. Where reorganization proceedings are converted to liquidation, any priority provided to post-commencement finance in the reorganization should continue to be recognized in the liquidation.

C. Priorities and distribution [of proceeds of liquidation]

1. Priorities

421. [253] Distribution of the proceeds of the estate will generally be made according to the ranking of creditor's claims by class. To the extent that different creditors have struck different commercial bargains with the debtor, the ranking of creditors may be justified by the desirability of the insolvency system recognizing and respecting those commercial bargains and promoting the equal treatment of similarly situated creditors. Establishing a clear and predictable ranking system for distribution can help to ensure that creditors are certain of their rights at the time of entering into commercial arrangements with the debtor and, in the case of secured credit, facilitate its provision. [215] In addition to relying upon these categories based upon commercial and legal relationships between the debtor and its creditors, distribution policies also very often reflect choices that recognize important public interests (such as the protection of employment), the desirability of ensuring the orderly and effective conduct of the insolvency proceedings (providing priority for the remuneration of insolvency professionals and the expenses of the insolvency administration), and promoting the continuation of the business and its reorganization (by providing a priority for post-commencement finance).

422. Insolvency laws adopt a wide variety of different approaches to the ranking of creditors, both in terms of priorities between different classes and in terms of the treatment of creditors within a particular class, for example those creditors broadly defined as unsecured.

(a) Secured creditors

423. [218] Many insolvency laws recognize the rights of secured creditors to have a first priority for satisfaction of their claims, either from the proceeds of sale of the specific assets secured or from general funds. The method of distribution to secured creditors depends on the method used to protect the secured creditor during the proceedings. If the security interest was protected by preserving the value of the secured asset, the secured creditor generally will have a priority claim on the proceeds of the sale of that asset to the extent of the value of its secured claim (provided this does not exceed the value of the asset). Alternatively, if the security interests of the secured creditor were protected by fixing the value of the secured portion of the claim at the time of the commencement of the proceedings, the creditor generally will have a priority claim to the general proceeds of the estate with respect to that value. Where the secured creditor's claim is in excess of the value of the secured asset, or the value of the secured claim as determined at commencement (where that approach is followed), the unsecured portion of the claim will generally be treated as an ordinary unsecured claim for purposes of distribution.

424. [219] In insolvency laws that do not afford secured creditors a first priority, payment of secured creditors may be ranked after costs of administration and other claims which are afforded the protection of priority, such as unpaid wage claims, tax claims, environmental claims and personal injury claims. Another approach is reflected in those laws which provide that the amount that can be recovered (in priority) by secured creditors from the assets securing their claim is limited to a certain percentage of that claim. The carved-out portion of the claim is generally used to serve the claims of other creditors, whether lower ranking priority creditors or ordinary unsecured creditors, or to pay the remuneration and expenses of the insolvency representative and costs in connection with the preservation and administration of the estate where the value of assets of the estate is insufficient to meet these costs. One of the rationales of this approach is that the secured creditor should share, in some equitable manner, some of the losses of other creditors in liquidation and, in reorganization, some of the costs. It is desirable, however, that these types of exceptions to the rule of first priority of secured creditors are limited to provide certainty with respect to the recovery of secured credit, thus encouraging the provision of secured credit and lowering the associated costs.

425. [219] Where the secured claim is satisfied directly from the net realization proceeds of the asset concerned, the secured creditor, unlike unsecured creditors, generally will not contribute (either directly or indirectly) to the general costs of the insolvency proceeding, unless there are provisions such as noted above. However, the secured creditor still may be required in those cases to contribute to other costs directly related to its interests, such as the administrative expenses related to the maintenance of the secured asset. If the insolvency representative has expended resources in maintaining the value of the secured asset, it may be reasonable to recover those expenses as administrative expenses from the amount that would otherwise be paid in priority to the secured creditor from the proceeds of the sale of the asset. A further exception to the first priority rule may also relate to priorities provided in respect of post-commencement finance, where the effect on the interests of secured creditors of any priority granted should be clear at the time the finance is

obtained, particularly since it may have been approved by the secured creditors (see Part two, chapter VI.B).

(b) Administrative claims

426. [220] The administrative expenses of the insolvency proceeding often have priority over unsecured claims, and generally are accorded that priority to ensure proper payment for the parties acting on behalf of the insolvency estate. These expenses would generally include remuneration of the insolvency representative and any professionals employed by the insolvency representative; debts arising from the proper exercise of the insolvency representative's (or in some cases the debtor's) functions and powers (see Part two, chapter IV.A and B); costs arising from continuing contract obligations (e.g. labour and lease agreements); costs of the proceedings (e.g. court fees) and, under some insolvency laws, the remuneration of any professionals employed by a committee of creditors.

(c) Priority or privileged claims

427. [223] Insolvency laws often attribute priority rights to certain (mainly unsecured) claims which in consequence will be paid in priority to other, unsecured and non-privileged (or less privileged) claims. These priority rights, which are often based upon social, and sometimes political, considerations, militate against the principle of *pari passu* distribution and generally operate to the detriment of ordinary unsecured debts by reducing the value of the assets available for distribution to ordinary unsecured creditors. The provision of priority rights has the potential to foster unproductive debate on the assessment of which classes of creditors should be afforded priority and the justifications for doing so. The provision of these rights in an insolvency law also has an impact on the cost of credit, which will increase as the amount of funds available for distribution to other creditors decreases.

428. [226] Some priorities are based on social concerns that may more readily be addressed by non-insolvency law such as social welfare legislation than by designing an insolvency law to achieve social objectives which are only indirectly related to questions of debt and insolvency. Providing a priority in the insolvency law may at best afford an incomplete and inadequate remedy for the social problem, while at the same time rendering the insolvency process less effective. Where priorities are to be included in an insolvency law or priorities exist in other laws which will affect the operation of the insolvency law, it is desirable that these priorities be clearly stated or referred to in the insolvency law (and if necessary ranked with other claims). This will ensure that the insolvency regime is at least certain, transparent and predictable as to its impact on creditors and will enable lenders to more accurately assess the risks associated with lending.

429. [225] In some recent insolvency laws there has been a significant reduction in the number of these types of priority rights, reflecting a change in the public acceptability of such treatment. A few countries, for example, have recently removed the priority traditionally provided to tax claims. In other countries, however, there is a tendency to increase the categories of debt that enjoy priority. Maintaining a number of different priority positions for many types of claims has the potential to complicate the basic goals of the insolvency process and to make the achievement of an efficient and effective process difficult. It may create inequities

and, in reorganization, complicates preparation of the plan. In addition, it should be remembered that adjusting the order of distribution to create these priorities will not increase the total amount of funds available for creditors. It will only result in a benefit to one group of creditors at the expense of another group. The larger the number of categories of priority creditors, the greater the scope for other groups to claim that they also deserve priority treatment. The greater the number of creditors receiving priority treatment, the less beneficial that treatment becomes.

430. Some of the factors that may be relevant in determining whether compelling reasons exist to grant privileged status to any particular type of debt may include the need to give effect to international obligations; the need to strike a balance between private rights and public interests and the alternative means available to address those public interests; the desirability of creating incentives for creditors to manage credit efficiently and to fix the price of credit as low as possible; the impact of creating certain preferences on transaction and compliance costs; and the desirability of drawing fine distinctions between creditors that result in one class of creditor having to bear a greater burden of unpaid debt.

431. [224] Many different approaches are taken to the types of claims that will be afforded priority and what that priority will be. The types of priorities afforded by countries vary, but two categories are particularly prevalent. The first is a priority for employee salaries and benefits (social security and pension claims), and a second is for tax claims. Consideration of the priority of tax claims may be of particular concern in transnational cases. One approach might be to disallow priority for all foreign tax claims. An alternative might be to recognize some type of priority for such tax claims, perhaps limited in scope, either where there is reciprocity with respect to the recognition of such claims or where insolvency proceedings in respect of a single debtor are being jointly administered in more than one state. Article 13 of the UNCITRAL Model Law on Cross-Border Insolvency recognizes the importance of the non-discrimination principle with respect to the ranking of foreign claims, but also provides that countries which do not recognize foreign tax and social security claims can continue to discriminate against them.[1]

(i) Employee claims

432. In a majority of countries, workers' claims (including claims for wages, leave or holiday pay, allowances for other paid absence, and severance pay) constitute a class of priority claims, which in a number of cases ranks above tax and social security claims. [224] This approach is generally consistent with the special protection that is afforded to employees in other areas of insolvency law (see Part two, chapter III.D.6), as well as with the approach of some international conventions.[2] In some insolvency laws, the importance of maintaining continuity of employment in priority to other objectives of the insolvency process, such as maximization of value of the estate for the benefit of all creditors, is evidenced by a focus on sale of the business as a going concern (with the transfer of existing

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[1] UNCITRAL Model Law on Cross-Border Insolvency article 13(2) and footnote 2.

[2] For example, the ILO Protection of Workers' Claims (Employer's Insolvency) Convention, 1992 (No. 173). Article 8(1) provides that "national laws or regulations shall give workers' claims a higher rank of privilege than most other privileged claims, and in particular those of the State and social security system". The Convention entered into force in 1995.

employment obligations), as opposed to liquidation or reorganization where these obligations may be altered or terminated.

433. In some countries, employee claims are afforded priority but will rank equally with taxes and social security claims in a single class of priority claims and may be satisfied proportionately in the event of insufficient funds. In other countries, no priority is provided for employee claims and they are ranked as ordinary unsecured claims, although in some cases payment of certain obligations accrued over specified periods of time (for example, for wages and remuneration arising within three months before commencement of insolvency proceedings) may be guaranteed by the State through a wage guarantee fund. The fund guaranteeing the payment of such claims may itself have a claim against the estate and may or may not have the same priority vis-à-vis the insolvency estate as the employee claims, depending upon policy considerations such as the use of public monies (as opposed to the assets of the insolvent debtor) for funding the provision of wage compensation. [230] Usual practice would be for the fund to enjoy the same rights as the employee, at least in respect of a certain specified amount which may be denoted in terms of an amount of wages or a number of weeks of pay.

(ii) Tax claims

434. [224] Priority is often accorded to government tax claims on the basis of protecting public revenue. According a priority to such claims has been justified on a number of other grounds. These grounds include that it can be beneficial to the reorganization process because tax authorities will be encouraged to delay the collection of taxes from a troubled business entity on the basis that eventually they will be afforded a priority for payment under insolvency, and that because the government is a non-commercial and unwilling creditor, it may be precluded from some commercial debt recovery options. Providing a priority to such claims, however, can be counterproductive because failure to collect taxes can compromise the uniform enforcement of tax laws and may constitute a form of state subsidy which undermines the discipline that an effective insolvency regime is designed to support. It may also encourage tax authorities to be complacent about monitoring debtors and collecting debts in a commercial manner that would assist to prevent insolvency and the depletion of assets.

(d) Ordinary unsecured creditors

435. [227] Once all secured and priority creditors have had their claims satisfied the balance of the insolvency estate generally would be distributed pro rata to ordinary unsecured creditors. There may be subdivisions within the class, with some claims being treated as subordinate or with a priority as noted above. Some claims that generally are subordinated are discussed below.

(e) Owners and shareholders

436. [232] Owners and shareholders may have claims arising from loans extended to the debtor and claims arising from their equity or ownership interest in the debtor. Many insolvency laws distinguish between these different claims. With respect to claims arising from equity interests, many insolvency laws adopt the general rule that the owners and shareholders of the business are not entitled to a distribution of the proceeds of assets until all other claims which are senior in priority have been

fully repaid (including claims of interest accruing after commencement). As such, shareholders and owners will rarely receive any distribution in respect of their equity interest in the debtor. Where a distribution is made, it would generally be made in accordance with the ranking of shares specified in the company law and the corporate charter. Debt claims, such as those relating to loans, however, are not always subordinated.

(f) Related persons

437. [233] A category of creditors that may require special consideration is those persons related to the debtor, whether in a familial or business capacity (discussed above, see Part two, chapter III.E.3(e) and chapter VI.A). Under some insolvency laws, these claims are always subordinated, and under other laws they are subordinated only on the basis of inequitable conduct or fraudulent or quasi-fraudulent conduct. Where they are subordinated, the claims may rank after ordinary unsecured claims. Other approaches for treatment of these claims do not relate to ranking, but to restrictions on voting rights or to the amount of the claim that will be admitted in the proceedings.

(g) Fines, penalties and post-commencement interest

438. [227] Some countries treat claims such as gratuities, fines and penalties (whether administrative, criminal or some other type) as ordinary unsecured claims, and subordinate them to other unsecured claims. In some insolvency laws these types of claims are treated as excluded claims.

439. Different approaches are taken to the accrual and payment of interest on claims. Some insolvency laws provide that interest on claims ceases to accrue on all unsecured debts once liquidation proceedings have commenced, but that payment in reorganization will depend upon what is agreed in the plan. In other cases where provision is made for interest to accrue after commencement of proceedings, payment may be subordinated and it will be paid only after all other unsecured claims have been paid.

2. Distribution

440. [254] Where there are a number of different categories of claims with different priorities, each level of priority generally will be paid in full before the next level is paid. Once a level of priority is reached where there are insufficient funds to pay all the creditors in full, the creditors of that priority share pro rata. In some laws which do not establish different levels of priority, all the creditors share pro rata if there are insufficient funds to pay them in full.

441. [255] It may be desirable to provide in reorganization proceedings that priority claims must be paid in full as a predicate to confirmation of a plan unless the affected priority creditors agree otherwise [*reasons*?] A plan of reorganization may propose distribution priorities that are different to those provided by the insolvency law in a liquidation, provided that creditors voting on the plan approve such a modification.

Recommendations

Purpose of legislative provisions

The purpose of provisions on distribution is to:

(a) Establish the order in which claims should be paid from the estate of the debtor following realization of the assets in liquidation or upon confirmation of the reorganization plan;

(b) Ensure that creditors of the same class are treated equally and are paid proportionately out of the assets of the estate;

[(c) Specify limited circumstances in which priority in distribution is permitted.]

Content of legislative provisions

(166) [(116)] The insolvency law should establish the order in which claims, other than secured claims, are to be paid from the estate of the debtor following sale of the assets in liquidation.

(167) [(117)] The insolvency law should minimize the priorities accorded to categories of unsecured claims. Where priorities are granted by operation of law other than the insolvency law, they should be clearly set forth in the insolvency law.

(168) [(118)] Secured claims should be paid from the proceeds of the realization of the security, subject to claims that are superior in priority to the secured claim, if any.[3]

(169) [(119)] With respect to the payment of classes of claims other than secured claims, the insolvency law should provide that the amount available for distribution to creditors be paid in the following order:

(a) Administrative costs and expenses, including those in connection with the appointment, performance of the powers and functions and remuneration of the insolvency representative and the creditor committee;

(b) Pre-commencement claims with priority;

(c) Ordinary pre-commencement claims;

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[3] NOTE TO THE WORKING GROUP: The European Bank for Reconstruction and Development has suggested that the Guide consider the proposition that a secured creditor should share some of the burden of a financial failure, at least with respect to involuntary creditors, such as tort claimants and employees and in particular where the secured creditor holds an “enterprise mortgage” over every asset of the debtor entity. To this end, the following drafting for the protection of employees rights is proposed to be added at the end of this recommendation: “… provided, however, that if a secured creditor holds a lien or mortgage over substantially all the assets of the debtor, the proceeds from the realization of the security should be paid first to satisfy all accrued and unpaid employee wage claims (if not otherwise guaranteed by a State agency) and then to satisfy all personal injury claims (not covered by insurance) and then to the secured creditor in accordance with the first clause of this recommendation.”

(d) Deferred or subordinated pre-commencement claims;

(e) The debtor (i.e. equity interests or owners of the debtor).

(170) [(120)] With respect to the payment of claims of the same class, the insolvency law should provide, as a general principle, that claims in each class are ranked equally as between themselves unless the holders of the affected claims agree otherwise. All the claims in a particular class should be paid in full before the next class is paid. If there is insufficient funds to pay them in full they should be paid in proportion.

(171) [(121)] The insolvency law should provide that distributions be made promptly and that they may be paid as far as possible on an interim or regular basis. In making a distribution an insolvency representative is required to make provision for provisionally admitted claims, and submitted claims that are not yet admitted.

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Draft legislative guide on insolvency law

Note by the Secretariat

Contents

[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Add.3 and Add.4; Chapter III.A-F appear in documents A/CN.9/WG.V/WP.63/Adds.5-9; Chapter IV. A-D appear in Adds. 10-11, Chapter V appears in Add. 12, Chapter VI. A-C appear in Adds. 13-14, and Chapter VI. D-E will appear in Add.16]

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* This document was submitted late because of the need to complete consultations and finalise consequent amendments.

Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.
Recommendation numbers in [..] refer to relevant recommendations in A/CN.9/WG.V/WP.61 and A/CN.9/WG.V/WP.61/Add.1, the previous version of the recommendations. Additions to the recommendations are indicated in this document by underlined text.

Part Two (continued)

VII. Resolution of proceedings

A. Discharge

1. Discharge of the debtor in liquidation[1]

442. [256] Following distribution in the liquidation of the estate of an individual debtor, it is likely that a number of creditors will not have been paid in full. An insolvency law will need to consider whether these creditors will still have an outstanding claim against that individual debtor or, alternatively, whether the debtor will be released or "discharged" from those residual claims.

443. [257] When the debtor is a limited liability company, the question of discharge following liquidation does not arise; either the law provides for the disappearance of the legal entity or, alternatively, that it will continue to exist as a shell with no assets. The shareholders will not be liable for the residual claims and the issue of their discharge does not arise. If the debtor's business takes a different form, such as an individual (sole proprietorship), a group of individuals (a partnership), or an entity whose owners have unlimited liability, the question arises as to whether these individuals will still be personally liable for unsatisfied claims following liquidation.

444. There is an increasing awareness in some circles of the need to recognize business failure as a natural feature of the economy and to accept that both weak and good businesses can fail, albeit for different reasons, without necessarily involving irresponsible, reckless or dishonest behaviour on the part of the management of the business. A person who has failed in one business may have learned from that experience and some studies suggest that they are often very successful in later business ventures. For these reasons, a number of countries have taken the view that their insolvency regime needs to focus not only on addressing the administration of failure, but also upon facilitating a fresh start for insolvent debtors by clearing their financial situation and taking other steps to reduce the stigma associated with business failure, rather than upon punishment of the debtor. In addition to adapting the insolvency law to remove unnecessary conditions and restrictions on discharge, there is a need to encourage banks and the wider community to take a different view of business failure, and to provide assistance and support to those involved in business failure. At the same time, the insolvency regime needs to protect the public and the commercial community from those debtors whose conduct of their financial affairs has been irresponsible, reckless or dishonest.

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[1] These paragraphs relate to discharge of a debtor who is an individual or natural person.

445. [258] Insolvency laws adopt different approaches to the question of discharge. In some, the debtor remains liable for unsatisfied claims, subject to any applicable limitation periods (which in some cases might be quite long, for example, 10 years) and may also be subject to a number of conditions and restrictions relating to professional, commercial and personal activities. This type of rule emphasizes the value of a debtor-creditor relationship: the continued responsibility of the debtor following liquidation is intended to both moderate a debtor's financial behaviour and encourage a creditor to provide financing. At the same time, it may work to inhibit opportunity, innovation and entrepreneurial activity because the sanctions for failure are severe.

446. [258] Other insolvency laws provide for a complete discharge of an honest, non-fraudulent debtor immediately following liquidation. This approach emphasizes the benefit of the "fresh start" that discharge brings and is often designed to encourage the development of an entrepreneurial class. It is also a recognition that over-indebtedness is a current economic reality and should be addressed in an insolvency law. A third approach attempts to strike a compromise: discharge is granted after a period following distribution, during which the debtor is expected to make a good faith effort to satisfy its obligations.

447. [259] In some circumstances, it may be appropriate to limit the availability of discharge. These may include those cases where, for example, the debtor has acted fraudulently; engaged in criminal activity; violated employment or environmental laws; failed to keep appropriate records; failed to participate in the insolvency proceedings in good faith or to co-operate with the insolvency representative; failed to provide or has concealed information; continued trading at a time when it knew it was insolvent; incurred debts with no reasonable expectation of being able to pay them; and concealed or destroyed assets or records after the application for commencement.

448. [259] Different approaches are taken to the conditions that will apply to discharge in these types of circumstances. In some countries, the period before a discharge is given may be quite long or conditions and restrictions will apply to the discharge, or a combination of both. In some of the countries where a discharge is given, certain debts may be excluded from the discharge, such as those arising from maintenance agreements (payments to a divorced spouse or to support children of the debtor); fraud; court fines; and taxes. Conditions may also be imposed upon the debtor, both during the proceedings or as a condition for a discharge, either by way of recommendation by the insolvency representative or by the court. These conditions may include restrictions on the ability of the debtor to obtain new credit, to leave the country, to carry on business for a certain period of time or a ban, where relevant, on practising its profession for a period of time. They may also include a discharge that is provided on the condition that the debtor does not subsequently acquire a substantial new fortune from which previous debts may be paid. The length of the application of these provisions will vary, depending upon the situation of the debtor. Other limitations relate to the number of times a debtor can be discharged. In some jurisdictions, a discharge is a once in a lifetime opportunity; in others there is a minimum waiting period, for example, 10 years, before a debtor will qualify for a new discharge, or even be able to enter insolvency proceedings which may lead to a new discharge. A further approach restricts discharge where, for example, the debtor has been given a discharge within a certain period of time before commencement of the current proceedings and where the payments made in those proceedings were less than a fixed percentage.

449. Some insolvency laws also provide for a discharge to be suspended where the debtor fails to comply with an obligation, or revoked in certain circumstances such as

where it was obtained by fraud, where the debtor fraudulently withheld information concerning property that should be property of the estate, or failed to comply with orders of the court.

450. [260] One issue that may need to be taken into account in considering discharge of individuals engaged in a business undertaking is the intersection of business indebtedness with consumer indebtedness. Recognizing that different approaches are taken to the insolvency of natural persons (in some countries a natural person cannot be declared bankrupt at all, in others there is a requirement for the individual to have acted in the capacity of a "merchant") and that many countries do not have a developed consumer insolvency system, a number of countries do have insolvency laws that seek to distinguish between those who are simply consumer debtors and those whose liabilities arise from small businesses. Since consumer credit often is used to finance small business either as start-up capital or for operating funds, it may not always be possible to separate the debts into clear categories. For that reason, where a legal system recognizes individual consumer and business debt, it may not be feasible to have rules on the business debts of individuals that differ from the rules applicable to consumer debts.

2. Discharge of debts and claims in reorganization

451. [298] To ensure that the reorganized debtor has the best chance of succeeding, an insolvency law can provide for a discharge or alteration of debts and claims that have been discharged or otherwise altered under the plan. This approach supports the goal of commercial certainty by giving binding effect to the forgiveness, cancellation or alteration of debts in accordance with the approved plan. The principle is particularly important to ensure that the plan provisions will be complied with by creditors that rejected the plan and by creditors that did not participate in the process. It also gives certainty to other lenders and investors that they will not be involved in unanticipated liquidation or have to compete with hidden or undisclosed claims. Thus the discharge establishes unequivocally that the plan fully addresses the legal rights of creditors.

Recommendations

Purpose of legislative provisions

The purpose of provisions on discharge is to:

(a) enable an individual debtor to be finally discharged from liabilities for pre-commencement debts, thus providing the debtor with a fresh start;

(b) establish the circumstances under which discharge will be granted and the terms of that discharge.

Content of legislative provisions

Liquidation

(172) [(122)] Where the insolvency law allows the insolvency of individuals engaged in business activity, the issue of discharge of the debtor from liability for pre-

commencement debts following [liquidation of the assets of the estate] [termination of the liquidation proceedings] should be addressed. Different approaches may be taken:

(a) the debtor may be discharged completely and immediately where the debtor [is honest] [and] has not acted fraudulently] [acts in good faith];
(b) the discharge may not apply until after the expiration of a specified period of time following [distribution] [commencement], during which period the debtor is expected to make a good faith attempt to satisfy its obligations;
(c) certain debts may be excluded from the discharge, such as those that were not disclosed by the debtor;[2]
(d) the discharge may be subject to certain conditions, such as restricting access to new credit or preventing the carrying on of business for a certain period of time.

Reorganization

(173) (138) Once the plan has been fully implemented, the debtor should be discharged from all debts that have been provided for in the plan.

B. Conclusion of proceedings

452. Insolvency laws adopt different approaches to the manner in which a proceeding is to be concluded or closed, the pre-requisites for closure and the procedures to be followed.

1. Liquidation

453. A number of insolvency laws adopt an approach that generally requires, following realisation of assets and distribution, that the insolvency representative call a meeting of creditors and present a final accounting. Provided that creditors agree to the accounting, all that is then required under some laws (where the debtor is a corporate entity) is that the final accounts and a report of the final meeting be filed with the administrative body responsible for registration of corporate entities and the debtor entity will be dissolved, while other laws require a formal application to the court for an order for dissolution. Some variations on this general approach include slightly different procedures for voluntary and involuntary proceedings.

2. Reorganization

454. [299] In general, insolvency laws adopt one of two or three approaches to the conclusion of reorganization proceedings. Reorganization proceedings may be treated as concluded where the reorganization plan is not approved (whether by creditors or the court) (see Part two, chapter V.A.6); where the liabilities have been discharged in accordance with the plan and the plan has otherwise been fully implemented (with or without the need for a formal court order, although some laws make provision for the insolvency representative to

[2] Where the insolvency law provides that certain claims will not be affected by the insolvency proceedings, those claims will be excluded from the discharge, but do not need to be specifically referred to in this section: see recommendations on treatment of creditor claims: see Part two, chapter VI.A.

be discharged from its duties by a formal order of the court); and where the court orders the proceedings to be terminated because of a failure of implementation (because the plan cannot be implemented or because there is a continuing deterioration in the debtor's financial condition). Proceedings may also be terminated in accordance with the terms of the plan or some other contractual agreement with creditors. Where the proceedings are terminated without implementation of the reorganization plan, the insolvency law may provide, and the court may also make an order, for the proceedings to be converted to liquidation, in order to avoid the debtor being left in an insolvent state with its financial situation unresolved. A number of insolvency laws adopt a different approach, providing that the reorganization proceedings will conclude once creditors have approved the plan. In this situation, the enforcement of rights and obligations provided for in the plan will be under non-insolvency law.

Recommendations

Purpose of legislative provisions

The purpose of provisions on conclusion is to:

(a) ensure that the insolvency law includes a procedure for ending the proceedings once the goal of those proceedings has been achieved or addressing the situation where the goal of those proceedings cannot be achieved;
(b) provide for the dissolution of the debtor, where relevant.

Content of legislative provisions

Liquidation

(174) [(123)] After an insolvency estate is fully administered [and the insolvency representative discharged] provision should be made for the insolvency proceedings to be closed.

~~(124) [*reopening*]~~

Reorganization

(175) (139) The insolvency law should make provision for reorganization proceedings to be concluded when the reorganization plan is fully implemented. The court may order the proceedings to be terminated where implementation of the plan fails, where the plan cannot be implemented or because there is a continuing deterioration in the debtor's financial condition. [Where the proceedings are terminated without implementation of the plan, the insolvency law should make provision for conversion of the proceedings to liquidation.] ~~After an insolvency estate is fully administered [and the insolvency representative discharged] the court should close the proceedings.~~

~~(140) [*reopening*]~~

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Contents

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*This document was submitted late because of the need to complete both consultations on the document and the twenty-seventh session of the Working Group (9-13 December 2002).

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Part Two (continued)

IV. Participants and institutions

A. The debtor

6. Rights of review and appeal

[*This section would be inserted after para. 230 of A/CN.9/WG.V/WP.63/Add.11*]

Note to the Working Group: in view of the section that follows in respect of creditors, does the debtor have any rights to seek review of decisions made by the insolvency representative or creditors? Can the debtor seek to have the insolvency representative removed and replaced? Can the debtor appeal against decisions made by the court with respect to aspects of the insolvency process? If so, should the Guide address those matters?

Under one law, for example, the debtor has a residual interest in the estate and can qualify as an aggrieved person who may seek review by the court of actions or decisions of the insolvency representative (leave of the court is required for actions against the trustee for malicious prosecution or defamation), and may also seek removal of the insolvency representative.

C. Creditors

3. Rights of review and appeal

[*The following paragraphs may be inserted after para. 295, A/CN.9/WG.V/WP.63/Add.11*]

(a) Introduction

1. Creditors, collectively, hold the primary economic interest in an insolvent estate. This interest is generally protected by an insolvency representative, who administers the estate with a view to preserving and protecting its assets and value, ultimately for the benefit of creditors.

2. To ensure creditors have confidence in the protection of their interests, it is desirable that an insolvency law provide for the active involvement of creditors in the insolvency proceedings. As is evident from the discussion in chapter IV, the level of that involvement and the roles assigned respectively to creditors, the insolvency representative and the courts in the decision-making process vary considerably between jurisdictions. Most regimes, however, provide creditors, as the primary beneficiaries of the estate, with some ability to scrutinize both the administration of the estate and the conduct of the insolvency representative in performing its duties. Where decisions relating to administration of the estate are to be made by the courts, those decisions generally may be appealed to a higher court, although some insolvency laws do exempt certain decisions from appeal (e.g. the decision appointing the supervising judge or commencing the proceedings).

3. It should be noted, however, that in considering the extent of the powers to be given to creditors to object to acts or decisions of the insolvency representative

some level of disagreement is almost impossible to avoid, particularly as the insolvency representative will be required to act for the benefit of all creditors and to take action that individual creditors may not support or agree with. In the normal course of events, however, such dissatisfaction would not give the court cause to replace the insolvency representative or give the creditor grounds for an action against the insolvency representative.

(b) Review of acts and omissions of the insolvency representative

4. Where the insolvency law does provide creditors with the power to object to acts or decisions of the insolvency representative and where the insolvency representative does not agree with or accept such an objection, the course of action available to creditors and the applicable procedural and evidential requirements generally depend largely on the role assigned to creditors in a particular insolvency regime.

5. Where the regime provides for the actions or decisions of the insolvency representative to be supervised or approved by the general body of creditors or the creditor committee, a high level of creditor protection may ensue. Where that supervision or approval adds steps to the administration of the insolvency estate, however, it has the potential to affect the cost and efficiency of the administrative process. For these reasons an insolvency regime will need to balance the extent to which supervision or approval by creditors is required (including defining both the acts and decision that require approval and the procedure for obtaining that approval) against the independence of the insolvency representative and the desirability of speed and cost effectiveness in the conduct of the insolvency proceedings. Regimes vary in the balance reached between these possibly competing factors. Further relevant factors that may need to be taken into account include the extent to which the court plays a role in supervising the proceedings and the insolvency representative, and the manner in which the insolvency regime balances that role against the participation of creditors.

(c) Grounds for review

6. The grounds upon which creditors may question either the decisions or administration of an insolvency representative and the decisions that may be subject to such questioning should be expressly stated in an insolvency law. The grounds for creditor action under existing laws can be divided into two main categories.

7. In the first category are those laws under which creditors are given certain rights where the insolvency representative can be shown to have committed some wrong. That wrong may include actual wrongdoing, such as the misappropriation of funds or assets or obtaining creditors' approval by improper means; procedural errors, such as a failure to seek a necessary approval of creditors or a creditors committee, or to undertake another act required by law; or negligence by the insolvency representative in the performance of its duties. Some jurisdictions limit a creditor's right to challenge the insolvency representative to some, if not all, of these situations.

8. In the second category are those laws which provide, normally in addition to the grounds related to specific wrongdoing, that creditors can test (normally in the courts) any decision, act or omission of the insolvency representative which they

individually or collectively object to or disapprove of. The basis of a successful action will normally be grounds similar to those already mentioned above, but may also include proof that the decision, act or omission was contrary to the interests of creditors. To prevent unreasonable disruption of the administration of an estate, an insolvency law may adopt appropriate limitations such as adjusting the standard of proof to be met in order for the court to uphold the creditors' appeal or protecting certain aspects of an administration against appeal, e.g. excluding actions concerning commencement of insolvency proceedings.

(d) Review procedures

9. Procedural approaches to a creditor's objection to the administration of an estate are largely determined by the rules governing the duties of the insolvency representative and the active role, if any, of creditors in the administration. For example, in those laws which require the insolvency representative to gain the approval of creditors, or their representatives, before undertaking certain acts, direct involvement of creditors in the decision-making process will normally preclude the need for a review procedure with respect to those acts, apart from those situations where the insolvency representative has misled creditors.

10. Where acts of the insolvency representative are not subject to the prior approval of creditors, there may be a need for a formal review procedure.

11. That review procedure may take different forms. Some laws grant creditors, collectively, a review role in the case of a dispute between the insolvency representative and a creditor. Examples of laws which adopt this approach focus on giving creditors the power to require the insolvency representative to call a meeting of all creditors or the creditors committee to attempt to resolve the issue raised.

12. Most insolvency laws, however, require creditors to raise their objection through a court action. Some insolvency laws allow individual creditors to bring an action, while others require the objecting creditor or creditors to represent a certain number of creditors or percentage of the debt to have legal standing to proceed with the action, or even require the action to be brought by the creditors committee or the general body of creditors. Such requirements may depend upon the grounds of the objection raised.

13. Most laws provide the courts, in reviewing an insolvency administration and enforcing the substantive rights of creditors, a number of powers. At one level, a court may direct an insolvency representative to take, or refrain from taking, a particular action related to the creditor's objection. The court may also have powers to confirm, reverse or modify decisions of the insolvency representative or to remove the insolvency representative whether at the direct request of the objecting creditor or on the motion of the court (see Part two, chapter IV.B.9). Many insolvency laws provide that the insolvency representative is personally liable for damages intentionally or negligently caused to creditors through the performance of the insolvency representative's duties (see Part two, chapter IV.B.7). Some insolvency laws also provide that in those circumstances the court may impose a monetary penalty on the insolvency representative.

(e) Reorganization

14. In reorganization, the creditors may have, in addition to those discussed above which relate to the insolvency representative, remedies relating specifically to approval of the plan and its implementation. These are discussed in Part two, chapter V, A.8, 10, 13 and 14.

VI. Management of proceedings

D. Treatment of corporate groups in insolvency

[*The following paragraphs may be inserted after the recommendations following para. 441, A/CN.9/WG.V/WP.63/Add.14*]

1. Introduction

15. It is common practice for commercial ventures to operate through groups of companies and for each company in the group to have a separate legal personality. Where a company in a group structure becomes insolvent, treatment of that company as a separate legal personality raises a number of issues which are generally complex and may often be difficult to address. In certain situations, such as where the business activity of a company has been directed or controlled by a related company, the treatment of the group companies as separate legal personalities may operate unfairly. That treatment, for example, may prevent access to the funds of one company for the payment of the debts or liabilities of a related debtor company (except where the debtor company is a shareholder or creditor of the related company), notwithstanding the close relationship between the companies and the fact that the related company may have taken part in the management of the debtor or acted like a director of the debtor and caused it to incur debts and liabilities. Furthermore, where the debtor company belongs to a group of companies, it may be difficult to untangle the specific circumstances of any particular case to determine which group company particular creditors dealt with or to establish the financial dealings between group companies.

16. Two issues of specific concern in insolvency proceedings involving one of a group of companies are:

(a) Whether any other company in the group will be responsible for the external debts of the insolvent company (being all debts owed by the insolvent company except for those owed to related group companies, i.e. "intra-group debts"); and

(b) Treatment of intra-group debts (claims against the debtor company by related group companies).

17. Insolvency laws provide different responses to these issues. Some laws adopt a prescriptive approach which strictly limits the circumstances in which group companies can be treated as other than separate legal personalities, in other words, the circumstances in which a related company can be responsible for the debts of an insolvent group member. Other laws adopt a more expansive approach and give courts broad discretion to evaluate the circumstances of a particular case on the basis of specific guidelines. The range of possible results in the latter case is

broader than under those laws adopting a prescriptive approach. In either case, however, it is common for insolvency laws to address these issues of intra-group liability based upon the relationship between the insolvent and related group companies in terms of both shareholding and management control. One possible advantage of addressing these issues in an insolvency law is to provide an incentive for corporate groups to continuously monitor the activities of companies within the group, and take early action in the case of financial distress of a member of that group. Treating companies as other than separate legal entities however, may undermine the capacity of business, investors and creditors to quarantine, and make choices about, risk (which may be particularly important where the group includes a company with special requirements for risk management, such as a financial institution); it may introduce significant uncertainty that affects the cost of credit, particularly when the decision about responsibility for group debts is made by a court after the event of insolvency; and it may involve accounting complexities concerning the manner in which liabilities are treated within the group.

2. Group responsibility for external debts

18. Insolvency regimes look to a number of different circumstances or factors in the assessment of whether a related or group company should bear responsibility for the external debts of an insolvent member of the group.

19. It is common to many jurisdictions for the related company to bear responsibility for the debt where it has given a guarantee in respect of its subsidiaries. Similarly, many regimes infer responsibility to compensate for any loss or damage in cases of fraud in intra-group transactions. Further solutions may be prescribed by other areas of law. In some circumstances, for example, the law may treat the insolvent company as an agent of the related company, which would permit third parties to enforce their rights directly against the related company as a principal.

20. Where the insolvency law grants the courts a wide discretion to determine the liability of one or more group companies for the debts of other group companies, subject to certain guidelines, those guidelines may include the following considerations: the extent to which management, the business and the finances of the companies are intermingled; the conduct of the related company towards the creditors of the insolvent company; the expectation of those creditors that they were dealing with one economic entity rather than two or more group companies; and, the extent to which the insolvency is attributable to the actions of the related group company. Based on these considerations, a court may decide on the degree to which a corporate group has operated as a single enterprise and, in some jurisdictions, may order that the assets and liabilities of the companies be consolidated or pooled,[1] particularly where that order would assist in a reorganization of the corporate group, or that a related company contribute financially to the insolvent estate, provided that contribution would not affect the solvency of the contributing company. Contribution payments would generally be made to the insolvency representative administering the insolvent estate for the benefit of the estate as a whole.

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[1] A decision that a corporate group has operated as one economic entity will give rise to application of other provisions of the insolvency law, for example, the duty of directors to prevent insolvent trading. Some laws also allow, in limited circumstances, companies to voluntarily pool assets and liabilities.

21. One further and important consideration in insolvency laws that allow such measures is the effect of those measures on creditors. These regimes, in seeking to ensure fairness to creditors as a whole, must reconcile the interests of two (or more) sets of creditors who have dealt with two (or more) separate corporate entities. These collective interests will conflict if the total assets of the combined companies are insufficient to meet all claims. In such a case, creditors of a group company with a significant asset base would have their assets diminished by the claims of creditors of another group company with a low asset base. One approach to this issue is to consider whether the savings to creditors collectively would outweigh the incidental detriment to individual creditors. In the situation where both companies are insolvent, some laws take into account whether the withholding of a consolidation decision, ensuring separate insolvency proceedings, would increase the cost and length of proceedings and deplete funds which would otherwise be available for creditors, as well as allowing the shareholders of some corporate group companies to receive a return at the expense of creditors in other group companies.[2]

22. The common principle of all regimes with laws of this type is that, for a consolidation order to be granted, the court must be satisfied that creditors would suffer a greater prejudice in the absence of consolidation than the insolvent companies and objecting creditors would from its imposition. In the interests of fairness, some jurisdictions allow for partial consolidation by exempting the claims of specific creditors and satisfying these claims from particular assets (excluded from the consolidation order) of one of the insolvent companies. The difficulties imposed by this reconciliation exercise have resulted in such orders being infrequently made in those countries where they are available.

23. It should be noted that insolvency laws providing for consolidation do not affect the rights of secured creditors, other than possibly the holders of intra-group securities (where the secured creditor is a group company).

3. Intra-group debts

24. Intra-group debts may be dealt with in a number of ways. As discussed above (see Part two, chapter III.E), intra-group transactions may be subject to avoidance actions. Under some insolvency laws that provide for consolidation, intra-group obligations are terminated by the consolidation order. Other approaches involve classifying intra-group transactions differently from similar transactions conducted between unrelated parties (e.g. a debt may be treated as an equity contribution rather than as an intra-group loan) with the consequence that the intra-group obligation will rank lower in priority than the same obligation between unrelated parties.

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[2] Some laws require creditors, as well as assets and liabilities, of each relevant group company to be separately identified before any distribution can be made.

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Draft legislative guide on insolvency law

Note by the Secretariat

[The Glossary to the Guide appears in A/CN.9/WG.V/WP.63/Add.1; Part One of the Guide appears in A/CN.9/WG.V/WP.63/Add.2; Part Two of the Guide appears in documents A/CN.9/WG.V/WP.63/Adds.3-16]

Applicable law governing in insolvency proceedings

Recommendations

Purpose of legislative provisions

The purpose of provisions on the applicable law governing in insolvency proceedings is to:

(a) promote cross-border financing, commerce and trade;
(b) facilitate commercial transactions by providing a clear and transparent basis for predicting the rules of law that will apply to the legal relationships with the debtor;
(c) provide courts with clear and predictable rules for the enforcement of choice of law provisions in contracts with a debtor; and
(d) in the absence of a choice of law provision in a contact with the debtor, to provide courts with clear and predictable rules for determining the rules of law applicable to legal relationships with the debtor.

* This document was submitted late because of the need to complete the twenty-seventh session of the Working Group (9-13 December 2002) and finalize revision of the document.

Contents of legislative provisions

Administration of insolvency proceedings

- Law of the forum

(1) The general insolvency law [of the State] should [apply] [be the law that applies] to all aspects of the commencement, conduct, administration and termination of insolvency proceedings, [in particular] [including]:

(a) eligibility and commencement criteria;
(b) creation and scope of the insolvency estate;
(c) treatment of property of the estate, including the scope of, exceptions to, and relief from application of a stay;
(d) powers of the debtor, insolvency representative, creditors and creditors' committee;
(e) costs and expenses;
(f) proposal, acceptance, confirmation and enforcement of a plan of reorganization;
(g) treatment of legal acts detrimental to creditors;
(h) conditions under which setoff can occur after commencement of insolvency proceedings;
(i) effect of the commencement of the proceedings upon contracts and leases under which both the debtor and its counterparty have not yet fully performed their respective obligations, including the enforceability of automatic termination and anti-assignment provisions in those contracts and leases;
(j) claims and their treatment; and
(k) resolution and conclusion of the proceedings.

- Law other than the law of the forum

[Note: The Working Group may wish to consider whether recommendations of a general nature should be included here to indicate those cases where the law of another jurisdiction should apply, for example that insolvency proceedings should not affect the validity of a security interest which should be governed by the law applicable to the security interest (which could include a cross-reference to the secured transactions guide); employment contracts and relationships, which should be dealt with in accordance with the law governing those contracts.]

(2) As an exception to recommendation (1), the [general insolvency] law [of a State] may provide that the law of another State applies to [the avoidability of a transaction or setoff that occurred or an obligation that was incurred before the commencement of those proceedings] [whether or not a transaction or setoff that occurred or an obligation that was incurred before the commencement of those proceedings is avoidable].

[Note: This recommendation does not state the circumstances in which the law of another State would be recognized with respect to avoidability. The Working Group may wish to consider the circumstances in which such recognition would be accorded or specify the connecting factor between the law of the other State and the transaction in question.]

(3) [As a further exception to recommendation (1),] the general insolvency law should provide that the [acceleration,] [closeout,] setoff or netting of financial obligations and transactions pursuant to the rules of a payment or settlement system or a financial market, should not be subject to avoidance [except to the extent that recommendation (70)(a) would apply] [or unwinding]. The general insolvency law [of the State] should recognize the [acceleration,] [closeout,] setoff or netting pursuant to similar rules of a payment or settlement system or a financial market in another State.

[Note: The Working Group may wish to consider whether a recommendation of this nature should be included in this section of the Guide or in chapter III.E or F. In this regard see document A/CN.9/WG.V/WP.63/Add.9 and the reference to possible additional recommendations.]

Validity of contractual choice of law provisions

(4) The general insolvency law should recognize contractual provisions in which the debtor and its counterparty expressly agree that the law applicable to their legal relationship under the contract will be the law of a specified jurisdiction without regard to the nexus between the transaction or the parties at issue and the chosen applicable law, except where:

(a) consumer or employment transactions are involved;
(b) such a provision is viewed as manifestly contrary to a public policy of the jurisdiction whose law would apply in the absence of such a provision; or
(c) those provisions pertain to the priority, creation, perfection or enforceability of a security interest as against third parties.

Determining the applicable law

(5) The general insolvency law should clearly indicate when the rules of the insolvency law would be [subordinate to] [affected by] other laws of the jurisdiction. The insolvency law should recognize and respect rights, claims and other entitlements valid under non-insolvency law except to the extent it may be necessary to modify or postpone those rights, claims and entitlements in order achieve the specific goals of the insolvency process.

[Note: The Working Group may wish to consider whether a recommendation to this effect should be included in the Guide, bearing in mind that it reflects several key objectives as well as principles generally agreed and already mentioned in several chapters of the commentary. If such a recommendation is to be included, the Working Group may wish to consider whether it should be located in this section or elsewhere in the guide.]

(6) Where the general insolvency law or other applicable law [of the State] does not provide the governing legal rule, the insolvency court [before which insolvency proceedings have been commenced] should apply non-insolvency law. Where the law of more than one State is relevant to the application of the non-insolvency law, the insolvency court will need to apply a conflict of laws rule of the forum to determine which State's non-insolvency law should apply. The conflict of laws rules should be clear and predictable and should follow modern conflict of laws rules embodied in international treaties and legislative guides sponsored by international bodies.

[Note: The Working Group may wish to consider, depending upon its decision with

respect to recommendation (4), whether examples of the approaches adopted by modern conflicts of laws rules could be included in recommendation (6), for example, respect for the choice of the parties of the law applicable without undue restriction or without requiring a nexus between the transaction or the parties and the chosen applicable law. Such examples could be helpful in clarifying what is intended by the third sentence of the recommendation.]