

# Legislative Guide on Insolvency Law



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# UNCITRAL

## Legislative Guide on Insolvency Law



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## *Preface*

The *Legislative Guide on Insolvency Law* was prepared by the United Nations Commission on International Trade Law (UNCITRAL). The project arose from a proposal made to the Commission in 1999 that UNCITRAL should undertake further work on insolvency law, specifically corporate insolvency, to foster and encourage the adoption of effective national corporate insolvency regimes. An exploratory meeting to consider the feasibility of such a project was held in December 1999. On the basis of the recommendation of that meeting, the Commission gave Working Group V (Insolvency Law) a mandate to prepare a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features, including a discussion of the alternative approaches possible and the perceived benefits and detriments of such approaches.<sup>1</sup> To seek input from the international insolvency community on the key objectives and the scope of the core features of an insolvency regime to be included in the *Guide*, an international colloquium, organized in conjunction with INSOL International and the International Bar Association, was held in December 2000.

The first draft of the legislative guide on insolvency law was considered by Working Group V in July 2001 and work developed through seven one-week sessions, the final meeting taking place in late March 2004. In addition to representatives of the 36 member States of the Commission, representatives of many other States and a number of international organizations, both intergovernmental and non-governmental, participated actively in the preparatory work. The work was also undertaken in close collaboration with Working Group VI (Security Interests), to ensure coordination of the treatment of security interests in insolvency with the legislative guide on secured transactions being developed by UNCITRAL.

The final negotiations on the draft legislative guide on insolvency law were held during the thirty-seventh session of UNCITRAL in New York from 14 to 21 June 2004 and the text was adopted by consensus on 25 June 2004 (see annex II). Subsequently, the General Assembly adopted resolution 59/40 of 2 December 2004 (see annex II) in which it expressed its appreciation to UNCITRAL for completing and adopting the *Legislative Guide*.

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<sup>1</sup>*Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17 (A/55/17)*, paras. 400-409.



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# Introduction

## A. Organization and scope of the *Legislative Guide*

1. The purpose of the *Legislative Guide on Insolvency Law* is to assist the establishment of an efficient and effective legal framework to address the financial difficulty of debtors. It is intended to be used as a reference by national authorities and legislative bodies when preparing new laws and regulations or reviewing the adequacy of existing laws and regulations. The advice provided in the *Guide* aims at achieving a balance between the need to address the debtor's financial difficulty as quickly and efficiently as possible and the interests of the various parties directly concerned with that financial difficulty, principally creditors and other parties with a stake in the debtor's business, as well as with public policy concerns. The *Guide* discusses issues central to the design of an effective and efficient insolvency law, which, despite numerous differences in policy and legislative treatment, are recognized in many legal systems. It focuses on insolvency proceedings commenced under the insolvency law and conducted in accordance with that law, with an emphasis on reorganization, against a debtor, whether a legal or natural person, that is engaged in economic activity. Issues specific to the insolvency of individuals not so engaged, such as consumers, are not addressed.

2. The *Legislative Guide* also discusses the increasing use and importance of other tools for addressing insolvency, specifically restructuring negotiations entered into voluntarily between a debtor and its key creditors, which are not regulated by the insolvency law. In addition to addressing the requirements of domestic insolvency laws, the *Guide* includes the text and Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency (the "UNCITRAL Model Law") (annex III) to facilitate consideration of cross-border insolvency issues. It should be noted, however, that a model law generally would be used differently to a legislative guide. Specifically, a model law is a legislative text recommended to States for enactment as part of national law, with or without modification. As such, model laws generally propose a comprehensive set of legislative solutions to address a particular topic and the language employed supports direct incorporation of the provisions of the model law into a national law. The focus of a legislative guide, on the other hand, is upon providing guidance to legislators and other users and for that reason guides generally include a substantial commentary discussing and analysing relevant issues. It is not intended that the recommendations of a legislative guide be enacted as part of national law as such. Rather, they outline the core issues that it would be desirable to address in that law, with some recommendations providing specific guidance on how certain legislative provisions might be drafted.

3. The *Legislative Guide* does not provide a single set of model solutions to address the issues central to an effective and efficient insolvency law, but assists the reader to evaluate different approaches available and to choose the one most suitable in the national or local context. The first section of each chapter of the *Guide* contains a commentary identifying the key issues for consideration in formulating an insolvency law and discussing and analysing the various approaches adopted by insolvency laws. The second part of each chapter contains a set of recommended legislative principles that deals more specifically with the manner in which those key issues should be addressed in an insolvency law and includes both a statement of the purpose of including provisions on a particular topic in an insolvency law and an outline of the content recommended for inclusion in those provisions. These recommendations are intended to assist in the establishment of a legislative framework for insolvency that is both efficient and effective and reflects modern developments and trends in the area of insolvency. The recommendations adopt different levels of specificity, depending upon the issue in question. A number employ legislative language to detail the manner in which a particular issue should be addressed in an insolvency law, reflecting a high degree of consensus as to the particular approach to be adopted. Other recommendations identify key points to be addressed by an insolvency law with respect to a particular topic and offer possible alternative approaches, indicating the existence of different policy and procedural concerns that might need to be considered.

4. The user is advised to read the legislative recommendations together with the commentary, which provides detailed background information to enhance understanding of the legislative recommendations, as well as a discussion of issues not specifically included as recommendations. In view of the key importance of secured creditors to insolvency proceedings and the policy considerations associated with their treatment under an insolvency law, the user of this *Legislative Guide* is also encouraged to consider the work of Working Group VI (Security Interests) and, when completed, the UNCITRAL legislative guide on secured transactions.

5. The recommendations included in the *Guide* do not deal with other areas of law, although, as discussed throughout the *Guide*, those other laws have an impact on both the design of an insolvency law and the conduct of insolvency proceedings commenced under that law (e.g. part two, chap. I, paras. 80-91, concerning applicable law, and recommendation 35 (a) pertaining to property rights of the debtor). Moreover, the successful implementation of an insolvency regime requires various measures beyond the establishment of an appropriate legislative framework, especially an adequate institutional infrastructure, organizational capacity, technical professional expertise and appropriate human and financial resources. Although these matters are discussed in the commentary, they generally are not addressed in the legislative recommendations, except where they relate to the insolvency professional appointed to administer an insolvency estate.



## B. Glossary

### 1. Notes on terminology

6. The following terms are intended to provide orientation to the reader of the *Legislative Guide*. Many terms such as “secured creditor”, “security interest”, “liquidation” and “reorganization” may have fundamentally different meanings in different jurisdictions. An explanation of the use of the term in the *Guide* may assist in ensuring that the concepts discussed are clear and widely understood.

#### (a) References in the Legislative Guide to the “court”

7. The *Legislative 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 some other authority is preferred (see part one, chap. III, Institutional framework).

8. For purposes of simplicity, the *Guide* uses the word “court” in the same way as article 2, subparagraph (e), of the UNCITRAL Model Law on Cross-Border Insolvency to refer to a judicial or other authority competent to control or supervise insolvency proceedings. An authority which supports or has specified roles in insolvency proceedings, but which does not have adjudicative functions with respect to those proceedings, would not be regarded as within the meaning of the term “court” as that term is used in the *Guide*.

#### (b) Rules of interpretation

9. “Or” is not intended to be exclusive; use of the singular also includes the plural; “include” and “including” are not intended to indicate an exhaustive list; “may” indicates permission and “should” indicates instruction; and “such as” and “for example” are to be interpreted in the same manner as “include” or “including”.

10. “Creditors” should be interpreted as including both the creditors in the forum State and foreign creditors, unless otherwise specified.

11. References to “person” should be interpreted as including both natural and legal persons, unless otherwise specified.

### 2. Terms and definitions

12. The following paragraphs explain the meaning and use of certain expressions that appear frequently in the *Legislative Guide*:

(a) “Administrative claim or expense”: claims that include costs and expenses of the proceedings, such as remuneration of the insolvency representative and any professionals employed by the insolvency representative, expenses for the continued operation of the debtor, debts arising from the exercise of the insolvency representative’s functions and powers, costs arising from continuing contractual and legal obligations and costs of proceedings;

(b) “Assets of the debtor”: property, rights and interests of the debtor, including rights and interests in property, whether or not in the possession of the debtor, tangible or intangible, movable or immovable, including the debtor’s interests in encumbered assets or in third party-owned assets;

(c) “Avoidance provisions”: provisions of the insolvency law that permit transactions for the transfer of assets or the undertaking of obligations prior to insolvency proceedings to be cancelled or otherwise rendered ineffective and any assets transferred, or their value, to be recovered in the collective interest of creditors;

(d) “Burdensome assets”: assets that may have no value or an insignificant value to the insolvency estate or that are burdened in such a way that retention would require expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money;

(e) “Cash proceeds”: proceeds of the sale of encumbered assets to the extent that the proceeds are subject to a security interest;

(f) “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;<sup>1</sup>

(g) “Claim”: a right to payment from the estate of the debtor, whether arising from a debt, a contract or other type of legal obligation, whether liquidated or unliquidated, matured or unmatured, disputed or undisputed, secured or unsecured, fixed or contingent.

*Note:* Some jurisdictions recognize the ability or right, where permitted by applicable law, to recover assets from the debtor as a claim;

(h) “Commencement of proceedings”: the effective date of insolvency proceedings whether established by statute or a judicial decision;

(i) “Court”: a judicial or other authority competent to control or supervise insolvency proceedings;<sup>2</sup>

(j) “Creditor”: a natural or legal person that has a claim against the debtor that arose on or before the commencement of the insolvency proceedings;

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<sup>1</sup>European Council Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings, recital 13.

<sup>2</sup>Based on the UNCITRAL Model Law on Cross-Border Insolvency (United Nations publication, Sales No. E.99.V.3), art. 2, subpara. (e). The text of the Model Law and its Guide to Enactment are set forth in annex III.

(k) “Creditor committee”: representative body of creditors appointed in accordance with the insolvency law, having consultative and other powers as specified in the insolvency law;

(l) “Debtor in possession”: a debtor in reorganization proceedings, which retains full control over the business, with the consequence that the court does not appoint an insolvency representative;

(m) “Discharge”: the release of a debtor from claims that were, or could have been, addressed in the insolvency proceedings;

(n) “Disposal”: every means of transferring or parting with an asset or an interest in an asset, whether in whole or in part;

(o) “Encumbered asset”: an asset in respect of which a creditor has a security interest;

(p) “Equity holder”: the holder of issued stock or a similar interest that represents an ownership claim to a proportion of the capital of a corporation or other enterprise;

(q) “Establishment”: any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services;<sup>3</sup>

(r) “Financial contract”: 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;<sup>4</sup>

(s) “Insolvency”: when a debtor is generally unable to pay its debts as they mature or when its liabilities exceed the value of its assets;

(t) “Insolvency estate”: assets of the debtor that are subject to the insolvency proceedings;

(u) “Insolvency proceedings”: collective proceedings, subject to court supervision, either for reorganization or liquidation;

(v) “Insolvency representative”: a person or body, including one appointed on an interim basis, authorized in insolvency proceedings to administer the reorganization or the liquidation of the insolvency estate;

(w) “Liquidation”: proceedings to sell and dispose of assets for distribution to creditors in accordance with the insolvency law;

(x) “Lex fori concursus”: the law of the State in which the insolvency proceedings are commenced;

(y) “Lex rei situs”: the law of the State in which the asset is situated;

(z) “Netting”: the setting-off of monetary or non-monetary obligations under financial contracts;

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<sup>3</sup>UNCITRAL Model Law on Cross-Border Insolvency, art. 2, subpara. (f) (see annex III).

<sup>4</sup>United Nations Convention on the Assignment of Receivables in International Trade (United Nations publication, Sales No. E.04.V.14), art. 5, subpara. (k).

(aa) “Netting agreement”: a form of financial contract 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;<sup>5</sup>

(bb) “Ordinary course of business”: transactions consistent with both: (i) the operation of the debtor’s business prior to insolvency proceedings; and (ii) ordinary business terms;

(cc) “Pari passu”: the principle according to which similarly situated creditors are treated and satisfied proportionately to their claim out of the assets of the estate available for distribution to creditors of their rank;

(dd) “Party in interest”: any party whose rights, obligations or interests are affected by insolvency proceedings or particular matters in the insolvency proceedings, including the debtor, the insolvency representative, a creditor, an equity holder, a creditor committee, a government authority or any other person so affected. It is not intended that persons with remote or diffuse interests affected by the insolvency proceedings would be considered to be a party in interest;

(ee) “Post-commencement claim”: a claim arising after commencement of insolvency proceedings;

(ff) “Preference”: a transaction which results in a creditor obtaining an advantage or irregular payment;

(gg) “Priority”: the right of a claim to rank ahead of another claim where that right arises by operation of law;

(hh) “Priority claim”: a claim that will be paid before payment of general unsecured creditors;

(ii) “Protection of value”: measures directed at maintaining the economic value of encumbered assets and third party owned assets during the insolvency proceedings (in some jurisdictions referred to as “adequate protection”). Protection may be provided by way of cash payments, provision of security interests over alternative or additional assets or by other means as determined by a court to provide the necessary protection;

(jj) “Related person”: as to a debtor that is a legal entity, a related person would include: (i) a person who is or has been in a position of control of the debtor; and (ii) a parent, subsidiary, partner or affiliate of the debtor. As

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<sup>5</sup>United Nations Convention on the Assignment of Receivables in International Trade, art. 5, subpara. (l).

to a debtor that is a natural person, a related person would include persons who are related to the debtor by consanguinity or affinity;

(*kk*) “Reorganization”: the 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;

(*ll*) “Reorganization plan”: a plan by which the financial well-being and viability of the debtor’s business can be restored;

(*mm*) “Sale as a going concern”: the sale or transfer of a business in whole or substantial part, as opposed to the sale of separate assets of the business;

(*nn*) “Secured claim”: a claim assisted by a security interest taken as a guarantee for a debt enforceable in case of the debtor’s default;

(*oo*) “Secured creditor”: a creditor holding a secured claim;

(*pp*) “Security interest”: a right in an asset to secure payment or other performance of one or more obligations;

(*qq*) “Set-off”: where a claim for a sum of money owed to a person is applied in satisfaction or reduction against a claim by the other party for a sum of money owed by that first person;

(*rr*) “Stay of proceedings”: a measure that prevents the commencement, or suspends the continuation, of judicial, administrative or other individual actions concerning the debtor’s assets, rights, obligations or liabilities, including actions to make security interests effective against third parties or to enforce a 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;

(*ss*) “Suspect period”: the period of time by reference to which certain transactions may be subject to avoidance. The period is generally calculated retroactively from the date of the application for commencement of insolvency proceedings or from the date of commencement;

(*tt*) “Unsecured creditor”: a creditor without a security interest;

(*uu*) “Voluntary restructuring negotiations”: negotiations that are not regulated by the insolvency law and generally will involve negotiations between the debtor and some or all of its creditors aiming at a consensual modification of the claims of participating creditors.



## *Part one*

# **Designing the key objectives and structure of an effective and efficient insolvency law**

## **I. Key objectives of an effective and efficient insolvency law**

### **A. Introduction**

1. When a debtor is unable to pay its debts and other liabilities as they become due, most legal systems provide a legal mechanism to address the collective satisfaction of the outstanding claims from assets (whether tangible or intangible) of the debtor. A range of interests needs to be accommodated by that legal mechanism: those of the parties affected by the proceedings 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 creditors), 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 and required for its operation. Generally, the mechanism must strike a balance not only between the different interests of these stakeholders, but also between these interests and the relevant social, political and other policy considerations that have an impact on the economic and legal goals of insolvency proceedings. To the extent that it is excluded from the scope of such legal mechanisms, a debtor and its creditors will not be subject to the discipline of the mechanism, nor will they enjoy the protections provided by the mechanism.

2. Most legal systems contain rules on various types of proceeding (which are referred to in this *Legislative 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 what might be described as “formal” and “informal” elements. Formal insolvency proceedings are those commenced under the insolvency law and governed by that law. They generally include both liquidation and reorganization proceedings. Informal insolvency processes are not regulated by the insolvency law and will generally involve voluntary

negotiations between the debtor and some or all of its creditors. Often these types of negotiations have been developed through the banking and commercial sectors and typically provide for some form of restructuring of the insolvent debtor. While not regulated by an insolvency law, these voluntary negotiations nevertheless depend for their effectiveness upon the existence of an insolvency law, which can provide indirect incentives or persuasive force to achieve reorganization.

## **B. Establishing the key objectives**

3. Although country approaches vary, there is broad agreement that effective and efficient insolvency regimes should aim to achieve the key objectives identified below in a balanced manner. 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 social values 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 laws other than the insolvency law are based. Where the insolvency law does seek to achieve a result that differs or fundamentally departs from that other 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. Provision of certainty in the market to promote economic stability and growth*

4. Insolvency laws and institutions are critical to enabling States to achieve the benefits and avoid the pitfalls of integration of national financial systems with the international financial system. Those laws and institutions should promote restructuring of viable business and efficient closure and transfer of assets of failed businesses, facilitate the provision of finance for start-up and reorganization of businesses and enable assessment of credit risk, both domestically and internationally. The following key objectives of an insolvency law should be implemented with a view to enhancing certainty in the market and promoting economic stability and growth.

### *2. Maximization of value of assets*

5. Participants in insolvency proceedings 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 of the risks allocated between the parties involved in insolvency proceedings. The manner in which avoidance provisions treat prior transactions, 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 that 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 proceedings and ensure the maximization of value.

### 3. *Striking a balance between liquidation and reorganization*

6. The first key objective of maximization of value is closely linked to the balance to be achieved in the insolvency law between liquidation and reorganization. An insolvency law needs to balance the advantages of near-term debt collection through liquidation (often the preference of secured creditors) against preserving the value of the debtor's business through reorganization (often the preference of unsecured creditors and the debtor). Achieving that balance may have implications for other social policy considerations, such as encouraging the development of an entrepreneurial class and protecting employment. Insolvency law should include 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 together, rather than breaking them up and disposing of them in fragments. To ensure that insolvency proceedings are not abused by either creditors or the debtor and that the procedure most appropriate to resolution of the debtor's financial difficulty is available, an insolvency law should also provide for conversion between the different types of proceedings in appropriate circumstances.

### 4. *Ensuring equitable treatment of similarly situated creditors*

7. The objective of equitable treatment is based on the notion that, in collective proceedings, creditors with similar legal rights should be treated fairly, receiving a distribution on their claim in accordance with their relative ranking and interests. This key objective recognizes that all creditors do not need to be treated identically, but in a manner that reflects the different bargains they have struck with the debtor. This is 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) and tax authorities. Even though the principle of equitable treatment may be modified by social policy on priorities and give way to the prerogatives pertaining to holders of claims or interests that arise, for example, by operation of law, it 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. An insolvency law 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.

#### *5. Provision for timely, efficient and impartial resolution of insolvency*

8. Insolvency should be addressed and resolved in an orderly, quick and efficient manner, with a view to avoiding undue disruption to the business 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 focused on the goal of liquidating non-viable and inefficient businesses and the survival of efficient, potentially viable businesses.

9. Quick and orderly resolution of a debtor's financial difficulties can be facilitated by an insolvency law that provides easy access to insolvency proceedings 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 proceedings (including both professionals and the institutions involved) and provides, as an end result, effective resolution of the debtor's financial obligations and liabilities.

#### *6. Preservation of the insolvency estate to allow equitable distribution to creditors*

10. An insolvency law should preserve the estate and 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 stay does not affect the rights of secured creditors.

7. *Ensuring a transparent and predictable insolvency law that contains incentives for gathering and dispensing information*

11. An insolvency law should be transparent and predictable. This will enable potential lenders and creditors to understand how insolvency proceedings operate 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 prior to insolvency. 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 and debt for equity swaps; and even family and matrimonial law).

12. An 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 and, where appropriate, sanctions for failure to do so. The availability of this information will enable those responsible for administering and supervising insolvency proceedings (courts or administrative agencies, the insolvency representative) and creditors to assess the financial situation of the debtor and determine the most appropriate solution.

8. *Recognition of existing creditor rights and establishment of clear rules for ranking of priority claims*

13. Recognition and enforcement in insolvency proceedings of the differing rights that creditors had with respect to the debtor and its assets before the commencement of insolvency proceedings will create certainty in the market and facilitate the provision of credit, in particular 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 predictability to lenders, and to ensure consistent application of the rules, confidence in the proceedings and that all participants are able to adopt appropriate measures to manage risk. To the greatest extent possible,<sup>1</sup> 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 therefore should be minimized.

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<sup>1</sup>The priority of claims under an insolvency law may be affected by a State's international treaty obligations (see the discussion on priorities in part two, chap. V, paras. 67-74).

## 9. *Establishment of a framework for cross-border insolvency*

14. To promote coordination between jurisdictions and facilitate the provision of assistance in the administration of insolvency proceedings 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 (see annex III).

### ***Recommendations 1-5 (paras. 4-14)***

1. In order to establish and develop an effective insolvency law, the following key objectives should be considered:

(a) Provide certainty in the market to promote economic stability and growth;

(b) Maximize value of assets;

(c) Strike a balance between liquidation and reorganization;

(d) Ensure equitable treatment of similarly situated creditors;

(e) Provide for timely, efficient and impartial resolution of insolvency;

(f) Preserve the insolvency estate to allow equitable distribution to creditors;

(g) Ensure a transparent and predictable insolvency law that contains incentives for gathering and dispensing information; and

(h) Recognize existing creditors rights and establish clear rules for ranking of priority claims.

2. The insolvency law should include provisions addressing both reorganization and liquidation of a debtor.

3. The insolvency law should recognize rights and claims arising under law other than the insolvency law, whether domestic or foreign, except to the extent of any express limitation set forth in the insolvency law.

4. The insolvency law should specify that where a security interest is effective and enforceable under law other than the insolvency law, it will be recognized in insolvency proceedings as effective and enforceable.

5. The insolvency law should include a modern, harmonized and fair framework to address effectively instances of cross-border insolvency. Enactment of the UNCITRAL Model Law on Cross-Border Insolvency is recommended.

## **C. Balancing the goals and key objectives of an insolvency law**

15. 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 broad goals of the law (rescuing businesses in financial difficulty, protecting employment, protecting the interests of creditors,

encouraging the development of an entrepreneurial class) and achieving the desired balance between the specific objectives identified above. Insolvency laws achieve that balance by reapportioning the risks of insolvency in a way that suits a State's economic, social and political goals. As such, an insolvency law can have widespread effects in the broader economy.

16. The achievement of that balance in the insolvency law and the integration of the law with the wider legal regime are vital to maintaining social order and stability. All parties need to be able to anticipate how their legal rights will be affected 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. These issues are discussed in detail throughout the *Legislative Guide*.

17. There is no universal solution to the design of an insolvency law because States vary significantly in their needs, as do their laws on other issues of key importance to insolvency, such as security interests,<sup>2</sup> property and contract rights, remedies and enforcement procedures. Although there may be no universal solution, most insolvency laws address the range of issues raised by the key objectives discussed above, albeit with different emphasis and focus. Some laws favour stronger recognition and enforcement of creditor rights and commercial bargains in insolvency and give creditors more control over the conduct of insolvency proceedings than the debtor (sometimes referred to as "creditor-friendly" regimes). Other laws lean towards giving the debtor more control over the proceedings (referred to as "debtor-friendly" regimes), while yet others seek to strike a balance in the middle. Some laws give more prominence to liquidation of the debtor in order to weed out inefficient and incompetent market players, while others favour reorganization. The focus on reorganization may serve a number of different aims, such as 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.<sup>3</sup> Some laws give particular emphasis to the protection of employees and the maintenance of employment in insolvency, while others provide that business can be downsized with minimum protections afforded to employees.

18. Nevertheless, adopting a reorganization-friendly approach should not result in establishing a safe haven for moribund enterprises: enterprises that are

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<sup>2</sup>Steps have been taken in recent years towards harmonizing the law on security interests, such as the United Nations Convention on the Assignment of Receivables in International Trade, the UNidroit Convention on International Interests in Mobile Equipment (Cape Town, 2001) and work by UNCITRAL to develop a legislative guide on secured transactions.

<sup>3</sup>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 the *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 between 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 not necessarily true.

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 law may provide a better solution than trying to address those interests under the insolvency regime. For example, where as a matter of policy it is decided that employee claims should rank lower than secured and priority creditors in insolvency, insurance arrangements can be used to protect employee entitlements (see below, part two, chap. V, paras. 72 and 73).

19. 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. Such practice can then be transposed into national insolvency regimes, taking into account the realities of the system and available human and material resources.

***Recommendation 6 (paras. 15-19)***

6. The recommendations in the *Legislative Guide* have been designed to address each of the key objectives and achieve an appropriate balance between them.

## **D. General features of an insolvency law**

### *I. Substantive issues*

20. Designing an effective and efficient insolvency law involves the consideration of a common set of issues relating to the substantive and procedural legal framework and the institutional framework required for its implementation. The substantive issues, which are discussed in detail in part two of the *Legislative Guide*, include:

(a) Identifying the debtors that may be subject to insolvency proceedings, including those debtors which 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 (referred to in the *Guide* 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) Identification of the assets of the debtor that will be subject to the insolvency proceedings and constitute the insolvency estate;

(e) Protection of the insolvency estate 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 will be protected during the insolvency proceedings;

(f) 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;

(g) The extent to which set-off or netting rights can be enforced or will be protected, notwithstanding the commencement of the insolvency proceedings;

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

(i) The extent to which the insolvency representative can avoid certain types of transaction that result in the interests of creditors being prejudiced;

(j) 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;

(k) Rights and obligations of the debtor;

(l) Duties and functions of the insolvency representative;

(m) Functions of the creditors and creditor committee;

(n) Costs and expenses relating to the insolvency proceedings;

(o) The treatment of claims and their ranking for the purposes of distributing the proceeds of liquidation;

(p) Distribution of the proceeds of liquidation;

(q) Discharge or dissolution of the debtor; and

(r) Conclusion of the proceedings.

## 2. *The structure of an insolvency law*

21. In addition to consideration of these substantive issues, an insolvency law will need to consider the structure of the procedure that leads to the choice of reorganization or liquidation proceedings. Approaches differ widely. Some insolvency laws provide for unitary, flexible insolvency proceedings with a single commencement requirement alternatively resulting in reorganization or liquidation, 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. The laws that treat reorganization and liquidation proceedings as distinct from one another do so on the basis of different social and commercial policy considerations. However, a significant number of issues are common to both reorganization and liquidation, 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.



22. The determination of whether the business of the insolvent debtor is viable should determine, at least in theory, which proceedings will be sought. As a matter of practice, however, at the time of commencement of either reorganization or liquidation, it is often impossible to make a final evaluation as to the financial viability of the business. Some of the disadvantages of an approach that requires a decision to be made between the different proceedings at the time of commencement are that it may create an undesirable degree of polarization between reorganization and liquidation 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 proceedings, such as commencing reorganization proceedings as a means of avoiding or delaying liquidation.

23. As to the question of choice between proceedings, some States 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 that enables the debtor to request conversion into reorganization proceedings where feasible. When the debtor applies for reorganization proceedings, whether on its 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 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 for protection of creditors may consist of setting forth the maximum period for which reorganization against the will of the creditors could be continued.

24. As a general principle, although usually presented as separate, liquidation and reorganization proceedings are normally carried out sequentially; that is, liquidation proceedings will only run their 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 proceedings 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 provisions of 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. While 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.



25. Difficulties of determining at the very outset whether the debtor should be liquidated rather than reorganized have led some States to revise their insolvency laws by replacing separate proceedings with “unitary” proceedings.<sup>4</sup> Under the “unitary” 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 reorganization and liquidation proceedings only occurs once the financial situation of the debtor has been assessed and a determination 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. Simple, unitary proceedings may also encourage early recourse to the proceedings by debtors facing financial difficulties, thus enhancing the chances of successful reorganization. A disadvantage of the approach, however, may be the delay that occurs between the decision to commence and the decision as to which proceedings should be followed, and the consequences for the debtor’s business and the value of its assets that may flow from that delay. However the insolvency law is arranged in terms of reorganization and liquidation, it should ensure that, once a debtor is in the system, it cannot exit without some final determination of its future.

### 3. *Relationship between insolvency law and other law*

26. 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 set-off and netting, laws that limit debt-for-equity conversions and laws that impose foreign exchange and foreign investment controls that could affect the content of a reorganization plan (see labour contracts, part two, chaps. II, para. 145, and V, paras. 72 and 73; set-off and netting, part two, chap. II, paras. 204-215; and content of a reorganization plan, part two, chap. IV, paras. 18-22). The relationship between insolvency law and other laws should be clear and, where possible, references to the other laws should be included in the insolvency law.

27. While the institutional framework is not discussed in any detail in the *Legislative Guide*, some of the issues are touched upon below. 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 between the various participants, in particular 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 enable the required decisions to be made.

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<sup>4</sup>Where a unitary system is chosen, some changes will need to be made to the various core elements of the insolvency law.

**Recommendation 7 (para. 20)**

7. In order to design an effective and efficient insolvency law, the following common features should be considered:

(a) Identifying the debtors that may be subject to insolvency proceedings, including those debtors which 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 the *Legislative 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) Identification of the assets of the debtor that will be subject to the insolvency proceedings and constitute the insolvency estate;

(e) Protection of the insolvency estate 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 will be protected during the insolvency proceedings;

(f) 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;

(g) The extent to which set-off or netting rights can be enforced or will be protected, notwithstanding the commencement of insolvency proceedings;

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

(i) The extent to which the insolvency representative can avoid certain types of transaction that result in the interests of creditors being prejudiced;

(j) 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;

(k) Rights and obligations of the debtor;

(l) Duties and functions of the insolvency representative;

(m) Functions of the creditors and creditor committee;

(n) Costs and expenses relating to the insolvency proceedings;

(o) The treatment of claims and their ranking for the purposes of distributing the proceeds of liquidation;

(p) Distribution of the proceeds of liquidation;

(q) Discharge or dissolution of the debtor; and

(r) Conclusion of the proceedings.

## **II. Mechanisms for resolving a debtor’s financial difficulties**

### **A. Introduction**

1. The following discussion focuses upon different mechanisms that have been developed for resolving a debtor’s financial difficulties and have proved to be useful tools for addressing those difficulties. These include proceedings conducted under the insolvency law, whether reorganization or liquidation; negotiations with creditors entered into by the debtor on a voluntary basis and conducted essentially outside the insolvency law; and administrative procedures that have been developed in a number of countries to address, specifically, systemic financial problems in the banking sector. The latter have been included simply for information and it is not suggested that they should be developed to address the insolvency of debtors engaged in economic activity. Similarly, the facilitating agency used to supervise these particular administrative procedures should not be confused with the authorities that might be developed to supervise insolvency proceedings conducted under the insolvency law in respect of economic debtors that are contemplated by the use of the term “court” in the *Legislative Guide*.

### **B. Voluntary restructuring negotiations**

2. Voluntary restructuring negotiations were developed some years ago by the banking sector, as an alternative to formal reorganization proceedings under the insolvency law. Led and influenced by internationally active banks and financiers, this type of negotiation has gradually spread to a considerable number of jurisdictions, although use of them varies—in some jurisdictions they are, reportedly, rarely used, while in others most reorganization is reported to be conducted by way of such negotiations. 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 this type of negotiation as likely to be successful, irrespective of the formal absence of features of proceedings conducted under the insolvency law, such as a stay of creditor actions.

3. The use of voluntary restructuring negotiations 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 negotiations are aimed at securing contractual arrangements both between the lenders themselves and the lenders and the debtor for the restructuring of the debtor, with or without rearrangement of the financing. This can provide a means of introducing flexibility into an insolvency regime by reducing the burden on judicial

infrastructure, facilitating an earlier proactive response from creditors than would normally be possible under formal insolvency proceedings and avoiding the stigma that often attaches to insolvency. While not based or reliant upon the provisions of the insolvency law, use of this type of negotiation depends very largely for its success upon the existence and availability of an effective and efficient insolvency law and supporting institutional framework<sup>1</sup> to provide sanctions that can assist to make the voluntary negotiations successful. Unless the debtor and its bank and financial creditors take the opportunity to join together and voluntarily enter into these negotiations, the debtor or the creditors can invoke the insolvency law, with some potential for detriment to both the debtor and its creditors in terms of delay, cost and outcome.

4. Many legal systems contemplate that a debtor can enter into agreements or arrangements designed to restructure it or its debt with some of all of its creditors that may be governed not by the insolvency law but 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 that do not allow such agreements or arrangements to occur outside of the court system or the insolvency law. Some laws would regard the steps associated with such voluntary restructuring negotiations as sufficient for the courts to make a declaration of insolvency. Similarly, there are a number of jurisdictions that, 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 voluntary negotiations to circumstances where the formal conditions for commencement of proceedings have not been met. Notwithstanding these limitations, it is suggested that banks and other creditors in these jurisdictions often use various techniques to achieve some form of reorganization of debtors outside the insolvency law.

### *1. Necessary preconditions*

5. Voluntary restructuring negotiations depend for their 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 or imminent 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 debtor and the financiers and also between the financiers themselves, to resolve the financial difficulties of the 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;

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<sup>1</sup>See the discussion of institutional framework in chap. III below.

(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.

## 2. Main processes

6. To be effective, voluntary restructuring negotiations require a number of different steps to be followed and a range of skills to be employed. The main elements in the process are discussed below.

### (a) *Commencing the negotiations*

7. Voluntary negotiations essentially involve bringing together the debtor and creditors, or at least the main creditors, one or more of whom must initiate the negotiations (as there can be no reliance upon a law or a facilitator for initiation, imposition or assistance of the negotiations). 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 collective negotiations. 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 such negotiations. A debtor who remains reluctant to participate may find itself subject to individual debt or 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 that 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 is therefore crucial.

### (b) *Coordinating participants: appointing a lead creditor and steering committee*

8. The voluntary negotiations would need to involve all key constituencies; generally the lenders' group and sometimes key creditor constituencies that may be affected by a voluntary restructuring agreement are critical to the negotiations. To better coordinate negotiations, a principal creditor is often appointed to provide leadership, organization, management and administration. This creditor typically reports to a committee that is representative of all creditors (a steering committee) and can provide assistance and act as a sounding board for proposals regarding the debtor.

(c) *Agreeing to a “standstill”*

9. To allow business operations to continue and to ensure that sufficient time is available to obtain and evaluate information about the debtor and 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.

(d) *Engaging advisors*

10. Few, if any, attempts are made at voluntary restructuring without the involvement of independent experts and advisors from various disciplines (e.g. legal, accounting, finance and business regulation or marketing). While it may be suggested that such 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 these negotiations.

(e) *Ensuring adequate cash flow and liquidity*

11. A debtor that becomes a candidate for voluntary restructuring negotiations 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 negotiations fail. While this issue can be addressed under the insolvency law by providing some form of priority or security for such ongoing lending (see part two, chap. II, paras. 100-104), the insolvency law will not generally extend to an agreement reached by way of voluntary negotiations.

12. Those creditors who participate in voluntary negotiations can nevertheless agree among themselves that if one or more of them extends further credit the others will subordinate 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 restructuring negotiations are successful. Where the negotiations fail, however, and the debtor is liquidated, the creditor who has provided the fresh credit may be left with an unsecured claim (unless a security interest was provided) and receive only partial repayment along with other unsecured creditors.<sup>2</sup>

(f) *Access to information on the debtor*

13. Access to complete, accurate information on the debtor is essential to enable proper evaluation to be made of its financial position and proposals to

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<sup>2</sup>See part two, chap. V, paras. 55-61, on subordination of claims.

be made to relevant creditors. Information concerning the assets, liabilities and business of the debtor will need to be made available to all relevant creditors but that information, unless already publicly available, may need to be treated as confidential.

(g) *Dealing with creditors*

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

15. In many cases, however, it will not be possible (or indeed necessary) to involve every creditor in the negotiations, 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. While creditors who fall into these categories may often be left out of the negotiations, 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 that can compel such creditors to accept the decision of a majority of their number.

16. In a voluntary restructuring agreement, trade and small creditors often 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 restructuring plan and then use the plan as the basis of a formal court supervised reorganization proceedings in which other creditors participate (sometimes referred to as a "pre-packaged" plan and in this *Guide* as "expedited reorganization proceedings"—see part two, chap. IV, paras. 76-94). This plan can then bind the other creditors. Without an effective formal insolvency regime, this result could not be achieved in those circumstances.

### 3. *Rules and guidelines for voluntary restructuring*

17. To assist the conduct of voluntary restructuring negotiations, 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", which can be summarized as an informal framework introduced with the support of the Bank of England for dealing with temporary support operations mounted by banks and other lenders to a company or group in financial difficulties, pending a possible restructuring. The approach urges commercial banks to take a supportive attitude toward their debtors that are in financial



difficulties. Decisions about the debtor's longer-term future should be made only on the basis of comprehensive information, which is shared between 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 approaches, and in some cases guidelines, have been developed by the central banks of other countries.

18. An international organization that has undertaken work in this area is INSOL International, which has published a *Statement of Principles for a Global Approach to Multi-Creditor Workouts*. The *Principles* are designed to expedite voluntary restructuring negotiations 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.

### C. Insolvency proceedings

19. Two main types of proceedings are common to the majority of insolvency laws: reorganization and liquidation.

20. The traditional division or distinction between these two types of proceeding 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 or realization of the assets) being used in order to obtain as much value as possible from the insolvency estate. To achieve such a sale or realization, the insolvency law may need to include an element of flexibility not generally available in laws that define liquidation as a sale of assets as soon as possible and allow the business to be continued only for that purpose. Some laws, for example, actually provide the power for the insolvency representative to effect a more advantageous sale or realization of the debtor's assets than would be affected in liquidation. Similarly, reorganization may require the sale of significant parts of the debtor's business or contemplate an eventual liquidation or sale of the business to a new company and the dissolution of the existing debtor.

21. For these reasons, it is desirable that an insolvency law provide more than a choice between a single, narrowly defined type of reorganization and strictly traditional liquidation. 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 were liquidated.

22. In discussing the core provisions of an effective and efficient insolvency regime, the *Legislative Guide* focuses upon reorganization proceedings on the one hand and liquidation proceedings on the other. However, the adoption of this approach is not intended to indicate a preference for particular types of proceeding or a preference for the manner in which the different proceedings should be integrated into an insolvency law. Rather, the *Guide* seeks to compare and contrast the core elements of the different types of proceeding and to promote an approach that focuses upon maximizing the result for the parties involved in an insolvency rather than upon strictly defined types of proceeding. This may be achieved by designing an insolvency law that incorporates the traditional formal elements in a way that promotes maximum flexibility.

### 1. Reorganization proceedings

23. As a procedure designed to save a debtor or, failing that, a business, reorganization may take one of several forms and may be more varied as to its concept, acceptance and application around the world than liquidation. For the sake of simplicity, the term “reorganization” is used in the *Guide* in a broad sense to refer to the type of proceeding 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).

24. Not all debtors that falter or experience serious financial difficulty in a competitive marketplace should necessarily be liquidated; a debtor with a reasonable prospect of survival (such as one that 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 proceedings 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 debt 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.

25. 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 interests of equity holders 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 were to be liquidated.

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

27. Reorganization may take a number of different forms. It 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. It 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 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.

28. Although reorganization may not be as widely included in insolvency laws 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 proceedings (whether on its own application 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 that 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 or confirmation of an accepted plan;  
and
- (g) Implementation of the plan.

29. 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 voluntary negotiations, are relied upon to achieve the objectives of reorganization varies between countries. In any event, it is generally recognized that the existence of liquidation under the insolvency law can facilitate the reorganization of a debtor by providing an incentive to both creditors and debtors to reach an appropriate agreement through a reorganization plan.

30. 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 or small number of banks and institutional creditors are involved, it is likely that the debtor can negotiate a voluntary restructuring agreement with those creditors and resolve its difficulties without involving trade creditors and without the need to commence proceedings under the insolvency law. Where the financial situation is more complex and requires the involvement of a large number of different types of creditor, a greater degree of formality may be needed to find a solution that addresses the disparate interests and objectives of those creditors, since voluntary restructuring agreements generally require unanimity of the parties participating to be effective. In such situations, commencement of reorganization proceedings under the insolvency law may assist in achieving the desired goal where those proceedings enable a plan approved by the requisite majority of creditors to be imposed upon a dissenting minority of creditors. Thus, in some cases, proceedings under the insolvency law work well precisely because they are regulated by that law, imposing the discipline of the law on the participants, while at the same time providing certain protections. In other cases, voluntary negotiations succeed because they are not regulated and avoid the delays and costs often associated with such regulation.

31. Since, as noted above, reaching agreement through voluntary restructuring negotiations is often impeded by the ability of creditors to take individual enforcement action and by the need for unanimous consent to alter the terms of some existing classes of debt, some States have adopted different types of mechanism, including “pre-insolvency” or “pre-packaged” procedures, to address those situations. The expedited reorganization proceedings discussed in the *Guide* to address those situations follow the procedure of reorganization, but on an expedited basis, combining voluntary restructuring negotiations, where a plan is negotiated and agreed by the majority of affected creditors, with reorganization proceedings commenced under the insolvency law to obtain court confirmation of the plan in order to bind dissenting creditors. Such proceedings are designed to minimize the cost and delay associated with formal reorganization proceedings, while at the same time providing a means by which a restructuring plan negotiated voluntarily by a debtor with some or all of its creditors nevertheless can be approved in the absence of

unanimous support of those creditors. They also allow the approval of the restructuring plan obtained in the voluntary negotiations to be used to achieve a reorganization that will bind creditors, at the same time providing the protections of the insolvency law to affected creditors. These types of procedure are discussed in more detail in part two, chapter IV, paragraphs 76-94.

32. A different approach 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 existing debts (except salaries) or dispose of any assets other than in the ordinary 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.

## 2. Liquidation

33. The type of proceeding referred to as “liquidation” is regulated by the insolvency law and generally provides 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 or realization of the assets proportionately to creditors. Although generally requiring the sale or realization of assets to occur in a piecemeal manner as quickly as possible, some insolvency laws permit liquidation to involve sale of the business in productive units or as a going concern; under other laws that is only permissible in reorganization. Liquidation usually results in the dissolution or disappearance of a debtor that is a commercial legal entity and discharge of a natural person debtor.

34. Around the world, liquidation proceedings tend to be very similar 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 creditors;
- (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, if the business of the debtor cannot be sold as a going concern, and termination of the powers of owners and management and the employment of employees;

- (e) Sale or realization of the debtor's assets, either piecemeal or as a going concern;
- (f) Adjudication of the claims of creditors;
- (g) Distribution of available funds to creditors (under some form of priority); and
- (h) Dissolution of the debtor, where it is a corporation or some other form of legal person, or discharge, in the case of a natural person.

35. There are a number of legal and economic justifications for liquidation. Broadly speaking, it can be argued that a commercial business that is unable to compete in a market economy should be removed from the marketplace. 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 proceedings 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. Orderly and effective liquidation proceedings address the inter-creditor problem by setting in motion a collective proceeding that seeks to avoid those actions which, while 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.

36. 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 they make their lending decisions and can 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 law should function as a means of enforcing the rights of individual creditors, although there is a clear and important relationship between enforcement and insolvency mechanisms. The efficiency and effectiveness of procedures for the individual enforcement of creditors' rights will mean that creditors are not forced to use insolvency proceedings for that purpose, especially since insolvency proceedings generally require a level of proof, cost and procedural complexity that makes it unsuitable for use in that way. Nevertheless, effective insolvency proceedings 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 pay a particular creditor.

## D. Administrative processes

37. In recent years a number of crisis-affected jurisdictions have developed semi-official “structured” forms of insolvency processes, inspired largely by government or central banks, to deal with systemic financial problems within the banking sector. These processes have been developed on a similar pattern. Firstly, each has a facilitating agency to encourage and, in part, coordinate and administer the process to provide the incentive and motivation necessary for its development. Secondly, 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 that are indebted to one or more of the banks and 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 reorganization under this process is required to agree to the application of these rules. Thirdly, time limits are provided for various parts of the process and, in some cases, agreements in principle can be referred to the relevant court for reorganization proceedings to commence under the insolvency law. In addition, one jurisdiction established a special agency that has extremely wide powers under its governing legislation to acquire non-performing loans from the banking and finance sector and then to impose extrajudicial processes upon a defaulting corporate debtor, including a forced or imposed reorganization.

38. 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 the *Legislative Guide*.

### III. Institutional framework

1. An insolvency law is a part of an overall commercial legal system and is heavily reliant for its proper application not only on a well-developed commercial legal system, but also on a well-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 regime exists. If that institutional capacity does not already exist, it is highly desirable that reform of the insolvency law be 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 and effective and in which the public has confidence. Although a detailed discussion of the means by which such institutional capacity can be developed or enhanced is beyond the scope of the *Legislative Guide*, a number of general observations can be made.<sup>1</sup>

2. In most jurisdictions, insolvency proceedings are 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.

3. In designing the insolvency law it may be appropriate to consider the extent to which courts will be required to supervise the proceedings and whether or not their role can be limited with respect to different parts of the proceedings or balanced by the role of other participants, such as the creditors

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<sup>1</sup>A number of international organizations are undertaking work on institutional capacity-building. It is beyond the scope of the *Legislative Guide* to provide an exhaustive survey of the institutions involved, but some examples are: INSOL International, which is involved in providing training and technical assistance for insolvency practitioners, judges, regulators and lenders through conferences, ad hoc training and technical research; the Asian Development Bank, which provides assistance to Governments to enhance the performance of public institutions, especially courts, regulatory institutions and ministries of justice, through the establishment of legal training institutions, web-based access to training and legal research materials; the World Bank, which recognizes the importance of strong institutions to sustainable development, supports client countries in their efforts to strengthen institutional capacity through a wide range of lending, assessment, technical assistance and knowledge products; and the International Monetary Fund, which provides expert training, workshops and seminars for the authorities of member countries to help strengthen their legal infrastructure and institutional performance of the judiciary, where such issues are macroeconomically relevant. More information can be obtained from the institutions in question.



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 issue likely to be encountered in insolvency.

4. To reduce the functions to be performed by the court under an insolvency law, but at the same time provide the necessary checks and balances, an insolvency law can assign specific functions to other participants, such as the insolvency representative and creditors, or to some other authority, such as an insolvency or corporate regulator. An insolvency law may provide that the insolvency representative, for example, is authorized to make decisions on a number of issues, such as verification and admission of claims, the need for post-commencement funding, surrender of encumbered 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 concerning one of these matters. The use of this approach depends upon the availability of a body of suitably qualified professionals to serve as insolvency representatives. 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 the decisions 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.

5. The court's capacity to handle the sometimes 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.

6. 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 may also lead to rigidity if there are too many of these types of element. A discretionary approach allows the court to weigh facts and circumstances, taking into account precedent, community interests and the interests of persons affected by the decision and market conditions. Nevertheless, that approach 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 and rely upon creditors having sufficient commercial acumen to make an informed decision on approval of the plan. 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 also be included, in particular where economic or commercial issues are involved. This approach is consistent with a general objective of ensuring the transparency and predictability of insolvency proceedings.

7. 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 proceedings. 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 proceedings proceed quickly, the inclusion of such provisions in the law will not achieve the goal of establishing 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, minimizing the delays that can result in diminution in value of the debtor's assets and impair the prospects of 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.

8. Implementing an insolvency system depends not only on the court, but also on the professionals involved in insolvency proceedings, 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 appropriate to assess which insolvency functions are truly public in nature and therefore 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 insolvency proceedings, such as the function of insolvency representative.



## *Part two*

# **Core provisions for an effective and efficient insolvency law**

1. Part two of the *Legislative Guide* focuses on the content of the insolvency law and the core elements that are regarded as necessary for insolvency proceedings conducted under the law to be effective and efficient. As far as possible, the order in which the *Guide* addresses the core elements corresponds to the sequence of insolvency proceedings.

2. Chapter I analyses application and commencement criteria. Chapter II considers the effects of commencement of insolvency proceedings on the debtor and its assets, including constitution of an insolvency estate, protection and preservation of the estate, use and disposal of assets, post-commencement finance, treatment of contracts, exercise of avoidance provisions, rights of set-off and financial contracts and netting. Chapter III examines the role of the debtor and the insolvency representative in insolvency proceedings and their various duties and functions, as well as mechanisms to facilitate creditor participation. While issues relevant to reorganization are considered throughout the *Guide*, chapter IV examines, in particular, issues relating to the proposal and approval of a reorganization plan and expedited reorganization proceedings. Chapter V addresses different types of creditor claim and their treatment, as well as establishment of priorities for distribution. Chapter VI deals with issues relating to the conclusion of insolvency proceedings, including discharge and closure. Cross-border insolvency issues are addressed in the UNCITRAL Model Law on Cross-Border Insolvency and its Guide to Enactment (see annex III).

## I. Application and commencement

### A. Eligibility and jurisdiction

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

1. An important threshold issue in designing an insolvency law focused on debtors engaged in economic activities<sup>1</sup> (whether or not they are conducted for profit) is determining and clearly defining which debtors will be subject to the law. To the extent that any debtor is excluded from the law, it will not enjoy the protections offered by the law, nor will it be subject to the discipline of the law. This argues in favour of an all-inclusive approach to the design of an insolvency law, with limited exceptions. The design of eligibility provisions for an insolvency law raises two basic questions. Firstly, whether the law should distinguish between debtors who are natural persons and debtors that are some form of limited liability enterprise or corporation or other legal person, each of which will raise not only different policy considerations, but also considerations concerning social and other attitudes. Secondly, the types of debtor, if any, that should be excluded from the application of the law.

2. States 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 States distinguish between natural person debtors and juridical or legal person debtors and provide different insolvency laws for each. A further approach distinguishes between legal and natural persons on the basis of their engagement in economic (or consumer) activities. Some of these laws address the insolvency of “merchants”, which are defined by reference to engagement in economic activities as an ordinary occupation, or companies incorporated in accordance with commercial laws and other entities that regularly undertake economic activities. Some laws also include different procedures based on levels of indebtedness and a number of States have developed special insolvency regimes for different sectors of the economy, in particular the agricultural sector.

#### (a) *Natural persons engaged in economic activities*

3. Policies applicable to individual or personal debt and insolvency often evidence cultural attitudes that are not as relevant to debtors engaged in economic activity. These may include, for example, attitudes toward the incurring of personal debt; the availability of relief for unmanageable debt; the social

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<sup>1</sup>The term “economic activities” should be given a broad interpretation so as to cover matters arising from all relationships involving economic activity, whether contractual or not. These relationships would include, but are not limited to, the following transactions: any trade transaction for the supply or exchange of goods or services; distribution agreement; commercial representation or agency; factoring; leasing; construction of works; consulting; engineering; licensing; investment; financing; banking; insurance; exploitation agreement or concession; joint venture and other forms of industrial or business cooperation; and carriage of goods or passengers by air, sea, rail or road.

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 (release of the debtor from liability for part or all of certain debts after the closure of the proceedings—see chap. VI, paras. 1-13). 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 economic and entrepreneurial activity; and the need to encourage the provision of credit and protect creditors.

4. The interests of natural persons involved in economic activity (including, for example, partnerships of individuals and sole traders) differ from those of consumer debtors, at least in some aspects of their indebtedness, but it is often difficult to separate an individual's personal indebtedness from their business indebtedness for the purposes of determining how they should be treated in insolvency. Different tests may be developed to facilitate that determination, by focusing, for example, upon the nature of the activity being undertaken, the level of debt and the connection between the debt and the economic activity. Indicators of involvement in economic activity may include whether the business is registered as a trading or other business operation; whether it is a certain type of legal person under the commercial law; the nature of its regular activities; and information concerning turnover and assets and liabilities.

5. Many States include natural person debtors involved in economic activity within the scope of their commercial insolvency laws. The experience of other States suggests that although business activities conducted by natural persons form part of economic activity, those cases often are best dealt with under the regime for insolvency of natural persons because ultimately the proprietor of a personal business will conduct his or her activities through a structure that does not enjoy any limits on liability, leaving them personally liable, without limitation, for the debts of the business. These cases also raise difficult issues of discharge, including the length of time required to expire before the debtor can be discharged and the obligations that can be discharged or exempted from discharge. Debts that cannot be discharged often involve personal matters such as settlements in divorce proceedings or child support obligations.

6. An additional consideration is that the inclusion of natural persons in the commercial insolvency regime may have the potential, in some States, to act as a disincentive to use of the commercial regime because of the social attitude towards personal insolvency, irrespective of its nature. It is desirable that these concerns be considered in designing a law to address business-related insolvency, taking into account the manner in which economic activity is generally conducted in a particular State and the existence and effectiveness of insolvency laws dealing with natural persons. In many States, for example, economic activity is conducted almost exclusively by individuals and to exclude them from the insolvency law would significantly limit its operation and effectiveness. In others, insolvency of natural persons engaged in economic activity is specifically addressed by the personal insolvency law and they are excluded from the commercial insolvency regime.

7. The *Legislative Guide* focuses upon the conduct of economic activities by both legal and natural persons, irrespective of the legal structure through which those activities are conducted and whether or not they are conducted for profit.<sup>2</sup> It identifies those issues where additional or different provisions will be required if natural person debtors are included in the insolvency law.

(b) *State-owned enterprises*

8. An insolvency law can apply to all types of debtor engaged in economic activities, both private and state-owned, especially those state-owned enterprises which compete in the market place as distinct economic or business operations and otherwise have the same commercial and economic interests as privately-owned businesses. The discussion here is not intended to include States, subnational governments, municipalities and other similar types of organization or public authority, unless they are state-owned enterprises operating as commercial enterprises.

9. 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 States 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 commercial 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 that has the potential to minimize conflicts of interest.

10. The need for exceptions to a general policy of inclusion of such enterprises in a general insolvency law may arise where the Government has adopted a policy of extending an explicit guarantee in respect of the liabilities of such enterprises, where the treatment of state enterprises is part of a change in macroeconomic policy, such as a large-scale privatization programme or where state-owned enterprises are involved in sensitive sectors of the economy, such as provision of key services or utilities (e.g. electricity and water). 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) *Debtors requiring special treatment*

11. Although it may be desirable to extend the protections and discipline of an insolvency law to as wide a range of debtors 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.

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<sup>2</sup>It would include, for example, economic activity conducted for charitable purposes.

Exceptions for these types of debtor are widely reflected in insolvency laws and are generally justified on the basis of the detailed regulatory legal regimes to which these businesses are often subjected outside the insolvency context. To address the insolvency of such debtors, regulatory regimes can include provisions particular to the type of business being regulated or special rules can be included in the general insolvency law. The special considerations arising from the insolvency of such debtors and consumer insolvency are not specifically addressed in the *Legislative Guide*.

## 2. Jurisdiction

12. In addition to possessing the necessary business or economic 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 economic activities in the State through a legal structure registered or incorporated in the State. However, where there is a question of the debtor's connection with the State, insolvency laws adopt different tests, including whether the debtor has its centre of main interests in the State, whether the debtor has an establishment in the State or whether it has assets in the State.

### (a) Centre of main interests

13. Although some insolvency laws use tests such as principal place of business, UNCITRAL has adopted, in the Model Law on Cross-Border Insolvency, the test of "centre of main interests" of the debtor to determine the proper location for commencement of what is termed the "main proceedings" for that debtor. That test is also used in European Council (EC) Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings. The UNCITRAL Model Law does not define the term; the EC Regulation (recital 13) 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, paragraph 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 that has the centre of its main interests in a State should be subject to that State's insolvency law.

14. Notwithstanding the adoption of the "centre of main interests" test, a debtor that 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 resultant possibility of separate insolvency proceedings in those States. In such cases, it will be appropriate to have in place legislation based on the UNCITRAL Model Law to address questions of coordination and cooperation. In terms of the application of different tests, the Model Law

focuses on the primacy of centre of main interests and main proceedings, but recognizes that other tests, such as presence of assets, can be used to commence local “non-main” proceedings to deal with local assets once the foreign main proceedings have been recognized.<sup>3</sup>

*(b) Establishment*

15. 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 as “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. In many countries, managers of an establishment that is unable to pay its debts will have personal liability to creditors unless they commence insolvency proceedings. Eligibility to commence proceedings on the basis of an establishment is therefore of relevance to a domestic insolvency regime and the treatment of that debtor’s assets in a particular State.

16. The EC Regulation similarly provides that insolvency proceedings may be opened in a jurisdiction where a debtor has an establishment (termed “secondary proceedings”). 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*

17. Some laws provide that insolvency proceedings may be commenced by or against a debtor that has or has had assets within a jurisdiction without requiring the debtor to have an establishment or centre of main interests in the jurisdiction. The UNCITRAL Model Law does not provide for the recognition of foreign proceedings commenced on the basis of presence of assets, although it does provide for local proceedings based on presence of assets to be commenced in a State recognizing foreign main proceedings in order to deal with those local assets.<sup>4</sup>

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<sup>3</sup>UNCITRAL Model Law, article 28 (see annex III).

<sup>4</sup>UNCITRAL Model Law, article 28, and Guide to Enactment, paras. 184-187 (see annex III).



18. 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, in particular where proceedings commenced in the centre of main interests are liquidation proceedings or where the assets in question are limited. Although one State 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), this option is not widely available. Where proceedings are commenced against a multinational debtor on the basis of presence of assets, there generally will be a need to coordinate 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 the possibility of multiple proceedings and questions of coordination and cooperation between proceedings that are addressed by the UNCITRAL Model Law.

*(d) Competent courts*

19. An additional issue of jurisdiction is the question of which court is competent to commence insolvency proceedings and to resolve matters arising in the course of those proceedings. The competence for commencement and all later issues arising in the conduct of insolvency proceedings may lie with the same court of a State or different courts will have competence for different issues. To increase the transparency and ease of use of the insolvency law for the benefit of debtors, creditors and third parties (especially where they are from a foreign country), it should be made clear in the law which courts have jurisdiction for which functions. Although provisions specifying which courts have jurisdiction over insolvency proceedings may not always be included in the insolvency law, a reference to the provisions of the law other than the insolvency law that specifies court jurisdiction might usefully be included in the insolvency law.

### ***Recommendations 8-13***

#### **Purpose of legislative provisions**

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

- (a) The types of debtor that are subject to the insolvency law;
- (b) The types of debtor that may be excluded from the insolvency law;
- (c) The debtors that have sufficient connection to a State to be subject to the insolvency law; and
- (d) The courts that have jurisdiction over the commencement and conduct of insolvency proceedings.

### ***Recommendations 8-13 (continued)***

#### **Contents of legislative provisions**

##### *Eligibility (paras. 1-11)*

8. The insolvency law should govern insolvency proceedings against all debtors that engage in economic activities, whether natural or legal persons, including state-owned enterprises,<sup>5</sup> and whether or not those economic activities are conducted for profit.

9. Exclusions from the application of the insolvency law should be limited and clearly identified in the insolvency law.<sup>6</sup>

##### *Jurisdiction ( paras. 12-18)*

10. The insolvency law should specify which debtors have sufficient connection to the State to be subject to its insolvency law. Different approaches may be taken to identifying appropriate connecting factors, but the grounds upon which a debtor can be subject to the insolvency law should include:<sup>7</sup>

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

11. The insolvency law should establish 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 that person has their habitual residence.

12. The insolvency law should define "establishment" to mean "any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services".<sup>8</sup>

##### *Competent courts (para. 19)*

13. The insolvency law should clearly indicate (or include a reference to the relevant law that establishes) the court that has jurisdiction over the commencement and conduct of insolvency proceedings, including matters arising in the course of those proceedings.

<sup>5</sup>It is not intended that the *Guide* should apply to the insolvency of States, subnational governments, municipalities and other similar types of organization, except to the extent that they are a "state-owned enterprise".

<sup>6</sup>Highly regulated organizations such as banks and insurance companies may require specialized treatment that can appropriately be provided in a separate insolvency regime or through special provisions in the general insolvency law. Some state-owned enterprises, such as those involved in sensitive sectors of the economy, might also be excluded.

<sup>7</sup>This recommendation is intended to indicate minimum and non-exclusive grounds for commencing insolvency proceedings. Other grounds, such as presence of assets, are used in some jurisdictions, but are not recommended: see above, paras. 17 and 18, and the Guide to Enactment of the UNCITRAL Model Law (see annex III), paras. 184-187.

<sup>8</sup>UNCITRAL Model Law, art. 2, para. (f), (see annex III).

## B. Commencement of proceedings

### 1. Introduction

20. The standard to be met for commencement of insolvency proceedings is central to the design of an insolvency law. As the basis upon which insolvency proceedings can be commenced, this standard is instrumental to identifying the debtors that can be brought within the protective and disciplinary mechanisms of the insolvency law and determining who may make an application for commencement, whether the debtor, creditors or other parties.

21. As a general principle it is desirable that the commencement standard be transparent and certain, facilitating access to insolvency proceedings conveniently, cost-effectively and quickly to encourage financially distressed or insolvent businesses to voluntarily commence proceedings. It is also desirable that access be flexible in terms of the types of insolvency proceedings available (reorganization and liquidation), and the ease with which the proceedings most relevant to a particular debtor can be accessed, and that conversion between the different types of proceeding can be achieved. Restrictive access can deter both debtors and creditors from commencing proceedings, while the effects of delay can be harmful to the value of assets and the successful completion of insolvency proceedings, in particular in cases of reorganization. Ease of access needs to be balanced with proper and adequate safeguards to prevent improper use of proceedings. Examples of improper use may include application by a debtor that is not in financial difficulty in order to take advantage of the protections provided by the insolvency law, such as the automatic stay, or to avoid or delay payment to creditors and application by creditors who are competitors of the debtor, where the purpose of the application is to take advantage of insolvency proceedings to disrupt the debtor's business and thus gain a competitive edge.<sup>9</sup>

22. Laws differ on the specific standard that must be satisfied before insolvency proceedings can commence. A number of laws include alternative standards and distinguish between the standard applicable to commencement of liquidation and reorganization proceedings, as well as between applications by a debtor and a creditor or creditors.

### 2. Commencement standards

#### (a) *Liquidity, cash flow or general cessation of payments test*

23. A standard that is used extensively for commencement of insolvency proceedings is what is variously known as the liquidity, cash flow or general cessation of payments tests. This requires that the debtor has generally ceased making payments and will not have sufficient cash flow to service its existing

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<sup>9</sup>This is discussed further in the context of denial of the application to commence and discontinuation of proceedings, see below paras. 61-63 and 79.

obligations as they fall due in the ordinary course of business. Indicators of a debtor's general cessation of payments may include its failure to pay rent, taxes, salaries, employee benefits, trade accounts payable and other essential business costs. As such, this test puts the defining factors within the reach of creditors. Reliance on this test is designed to activate insolvency 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 of proceedings to take place only when the debtor can demonstrate balance sheet insolvency (when the debtor's balance sheet shows that the value of its liabilities exceed its assets—as discussed below), may serve only to delay the inevitable and diminish recoveries.

24. One issue associated with the general cessation of payments test that needs to be considered is that the inability of the debtor to pay its debts as they become due may point only to a temporary cash flow or liquidity problem in a business that is otherwise viable. In today's competitive markets, competition may compel market participants to accept ever-lower profits or even losses on a temporary basis in order to become competitive and maintain or gain market share. While it will be a question of fact in each case, it is desirable that an insolvency law provide guidance for the court to determine whether or not the commencement standard has been met in order to avoid a premature finding of insolvency.

*(b) Balance sheet test*

25. An alternative standard to general cessation of payments is the balance sheet test, which is based on excess of liabilities over assets as an indication of financial distress. Since it relies on information under the control of the debtor, a practical limitation of the balance sheet test is that it is rarely possible for other parties to ascertain the true state of the debtor's financial affairs until after its difficulties have become a settled and often irreversible fact and thus it may not easily form the basis for a creditor application. In addition, it may give a misleading indication of the debtor's financial situation because it focuses upon what is essentially an accounting question of how assets should be valued (e.g. a liquidation value as opposed to a going concern value). It also raises questions of whether a debtor's balance sheet is reliable and gives a true indication of the debtor's ability to pay, in particular where accounting standards and valuation techniques give rise to results that do not reflect the fair market value<sup>10</sup> of a debtor's assets or where markets are not sufficiently developed or stable to enable that value to be established. This may be

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<sup>10</sup>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 it is based on assumptions made about 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 enterprise's earnings potential. In markets where assets cannot easily be sold, either because the market is saturated or because a market for the assets in question does not exist, value is difficult to measure.

particularly true in the case of service businesses that under this test may technically be insolvent because of a lack of assets, even when the business is essentially viable. Alternatively, a business may have a positive balance sheet without the cash flow necessary to sustain its operations.

26. 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<sup>11</sup> to reach a determination of the fair market value of the business. This will be especially difficult where those records are not properly maintained or readily available. For these reasons, the balance sheet test often leads to proceedings being commenced after the possibilities of reorganization have disappeared and can have a negative effect on the debtor's ability to deal collectively with its creditors when it maintains an operating business, thus circumventing the objective of maximization of value. It will thus not be sufficiently reliable to constitute the sole basis of a definition of insolvency and it may be desirable to use it in conjunction with the cessation of payments test. When used in that manner, the balance sheet test can assist in defining insolvency by focusing on whether the assets, however valued, will be sufficient to satisfy the debtor's liabilities, including those obligations which are not yet mature.

*(c) Designing the commencement standard*

27. Insolvency laws use the general cessation of payments test and the balance sheet test in different combinations to establish a commencement standard. Some laws adopt a simple form of the general cessation of payments test, requiring that the debtor be unable to meet its obligations as they fall due. Other laws adopt that test but 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. The more elements are added to the commencement standard, the more difficult it will be to satisfy, especially where the elements included are subjective. This may lead to applications for commencement of insolvency proceedings being contested, causing delay, uncertainty and expense. By contrast, tests that are relatively simple and straightforward may have a tendency to include more cases, but this may be balanced by the increased ease of application that results from such tests.

28. Another approach combines the cessation of payments test with the balance sheet test. One example requires that, in addition to having ceased

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<sup>11</sup>The book value of an asset is the amount for which the asset is shown for accounting purposes. It is usually derived from the original acquisition value, which is adjusted for a combination of depreciation, amortization and revaluation to any lower current market price or, occasionally, revaluation upwards in accordance with accounting principles. Although international financial reporting standards have been produced by the International Accounting Standards Board, it is important to note that there are no universally agreed accounting guidelines that dictate the basis on which assets should be valued for accounting purposes. Furthermore, the book value of assets for management account purposes may not be the same as the values for which the same assets are included in year-end audited financial statements. The result is that the book values of assets may bear little or no relationship to the amounts for which they could be realized to satisfy creditors.

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. An approach that combines the two tests may support commencement where there is a lack of information as to the existence of a general default and provide a more complete picture of the debtor's present and prospective financial situation. The balance sheet test may facilitate, for example, consideration of immature debt that would not otherwise be considered under the cessation of payments test, but which will be very relevant, for example, to the likely success of reorganization.

29. An insolvency law may adopt a single standard for insolvency, in which case the cessation of payments test provides an efficient trigger for access to insolvency proceedings; the balance sheet test, as noted above, suffers from a number of disadvantages and should not be used as the single test. An insolvency law may also adopt a standard that contains both the cessation of payments test and the balance sheet test. Where this approach is followed, proceedings can be commenced if either of the tests can be satisfied.

*(i) Imminent insolvency (prospective illiquidity)*

30. Some laws that adopt only a 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 of time 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 that 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 be unable to pay the associated damages.

*(ii) Types of proceeding that may be commenced*

31. A second dimension of the commencement standard is the type of proceeding that can be commenced (see generally part one, chap. II). In some laws the commencement standard provides the basis for commencement of either reorganization or liquidation proceedings. Where a liquidation application is made by a creditor, 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, reorganization proceedings must be commenced, but can be converted to liquidation when it is demonstrated that the debtor cannot be reorganized. Under a further approach, the effect of the application is neutral and the choice between reorganization and liquidation will only be made after a period of assessment of the debtor's financial situation.

### 3. Liquidation

#### (a) *Persons permitted to apply*

32. Insolvency laws generally permit an application for liquidation proceedings to be made by the debtor, one or more creditors or 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.

#### (b) *Debtor application*

33. Many insolvency laws adopt a general cessation of payments test for debtor applications for liquidation. Since, as a matter of practice, an application by a debtor to commence liquidation proceedings will generally be a last resort in situations of severe financial difficulty, some laws allow a debtor to make an application either on the basis that it has ceased to repay its debts as they become due or, alternatively, on the basis of a simple declaration of its financial condition, such as that it is unable or does not intend to pay its debts (in the case of a legal person the declaration 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. In such cases, whatever burden of proof is placed on the debtor, the insolvency law should distinguish between, and provide for, on the one hand, situations where acceptance of the debtor's financial declaration can be assumed provided no objections are raised by creditors and, on the other, situations where the debtor should be questioned as to its financial circumstances because there is some doubt regarding its financial situation or because creditors have raised objections to the commencement of proceedings.

34. To some extent, these issues can be addressed by the procedure for commencement of proceedings. Where the court is required to make the commencement decision, for example, it will have the opportunity to review the application and creditors can raise objections at that hearing. Where the application functions to automatically commence proceedings, creditors and other parties in interest will still have the opportunity to raise objections, albeit after the commencement of proceedings (see below, paras. 55-58, on the decision to commence; paras. 61-63, on denial of an application; and para. 79, on dismissal of proceedings). In both cases, attempts to misuse the application procedure can be reviewed.

#### (i) *Establishing an obligation for the debtor to apply*

35. A matter related to debtor applications is the question of whether or not the debtor should have an obligation to apply 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 that require the debtor to apply within a specified 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 is no 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 that 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 following the imposition of an obligation of this kind.

36. Establishing such an obligation may also raise difficult practical questions of how and when it should apply, in particular 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 a voluntary restructuring agreement, which may be a more appropriate alternative in particular cases.<sup>12</sup> In addition, an obligation to apply 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 generally chap. II, paras. 25-73) may be a more effective means of encouraging debtors to initiate proceedings at an early stage than the imposition of sanctions for failure to meet the obligation to apply.

(c) *Creditor application*

37. Many insolvency laws also adopt a cessation of payments requirement for creditor applications for liquidation of a debtor, often with the additional requirement that a significant portion of the debt be undisputed and free of offset. In a few laws, the debt must be based upon a court judgement. Where a test of general cessation of payments is adopted for creditor applications, problems of proof may arise. While individual 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, such as by way of a presumption, that establishes the insolvency of a debtor, without placing an unreasonably heavy burden of proof on creditors. A presumption that the debtor is generally unable to pay its debts might be established, for example, where the debtor fails to pay one or more of its mature debts and the unpaid debt is

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<sup>12</sup>This issue is discussed further in the context of expedited reorganization proceedings and the relevant commencement criteria, see part two, chap. IV, paras. 76-90.



undisputed, that is, not subject to a legitimate dispute or offset. Where the insolvency law provides such a presumption, there is a corresponding need for the insolvency law to provide the debtor with an opportunity to rebut the presumption and specify the grounds upon which it could be rebutted. These grounds might include the debtor showing that it was able to pay its debts; that the debt was subject to a legitimate dispute; or any other negation of the elements by which a creditor established the presumption. Notifying a debtor of an application for commencement of insolvency proceedings by a creditor will allow the debtor the opportunity to dispute the creditor's claims regarding its financial position (see also below, paras. 64-68, on provision of notice).

38. To refine the test 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 period of time, in those cases where a formal demand is required, ranging from eight days to 24 weeks. 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. Where time periods are to be included in the law, it may be desirable, in order to satisfy the key objectives of quick access to insolvency proceedings and preservation of value, for relatively short periods to be specified.

39. 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 commencement test is based on mature debt, those creditors might never be eligible to apply for commencement of proceedings, although it may be clear that the debtor will be unable to meet the relevant obligation when the date of maturity of the debt approaches. One solution might be for an insolvency law to provide that the failure to pay an instalment of long-term debt could form the basis of a creditor application. However, developing a test that would allow an application in those circumstances may raise difficult issues of proof, in particular as to how the failure to make a single payment relates to the debtor's overall financial status. If an insolvency law were to permit applications to be made by creditors not holding mature debt, those issues of proof would need to be balanced against the objective of convenient, cost-effective and quick access to insolvency proceedings. These issues could be addressed by using a standard that contains both the cessation of payments and balance sheet tests.

40. In addition to the requirements for cessation of payments, maturity of the debt and that the claim be undisputed, some insolvency laws include other requirements, for example that the application must 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 or percentage of creditors and a composite value of claims).

41. These requirements are often based upon the desire to minimize possible improper use by a single creditor who may seek to use insolvency proceedings as a substitute for a debt enforcement mechanism, in particular where the debt in question is small, or by a small number of creditors whose debt is only a fraction of the debtor's total indebtedness. The arguments in favour of such an approach may need to be balanced, however, against the objective of facilitating quick and easy access to insolvency proceedings. The concerns with improper use 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 that requires the debtor to provide information to the court that will enable the court to determine whether non-payment of a debt is the result of a dispute with a particular creditor or is, in fact, evidence of a lack of liquid assets. Concerns with improper use can also be addressed by focusing on discouraging improper use, rather than upon constructing a complex commencement standard to the potential detriment of all eligible debtors, and providing for certain consequences, such as denial of the application and damages for harm done to the debtor. These damages may relate not only to the costs and expenses incurred by the debtor, but also to disruption to the debtor's business.

*(d) Application by a government authority*

42. Where the Government is a creditor, it should have the same right as any other creditor to initiate liquidation proceedings. That right is generally given to a specific government department or agency (normally the public prosecutor's office or the equivalent) or other supervisory authority and the same commencement standard as applies in the case of applications by other creditors should generally apply.

43. Some countries provide an additional more broadly based power for government or other supervisory authorities to use the insolvency regime to shut down a business in circumstances where the authority is not necessarily a creditor but closure of the business is considered to be in the public interest. In that case, a demonstration of illiquidity is not always necessary, enabling the Government to terminate the operations of businesses that have been engaged in certain activities, generally of a fraudulent or criminal nature or involving serious breach of regulatory obligations or a combination of these. Given the potential for such a power to be misused in circumstances unrelated to insolvency and for public interest grounds to be very broadly defined, it is highly desirable that such powers be available only in very limited circumstances and only as a last resort in the absence of appropriate remedies under other laws. These limited circumstances may include the use of insolvency powers in conjunction with enforcement of laws, such as laws relating to money-laundering or regulation of securities, where a demonstration of insolvency may not be required. They may also include circumstances involving actual indications of insolvency where, for example, the authority is acting in the interests of a large number of small creditors, none of whom has a large

enough debt to justify applying for proceedings, but who are nevertheless being harmed by the activities of the debtor.

44. Certain protections may also be required where the insolvency regime is to be used in these ways. For example, a preliminary investigation of the affairs of the debtor may be required; and preliminary measures, such as application of a stay and appointment of an interim insolvency representative, may be granted to prevent the possibility of impropriety pending the court's determination as to what further action should be taken with respect to the business. The additional powers discussed above would generally only be available to commence liquidation proceedings, although there may be exceptional circumstances where liquidation could be converted to reorganization, subject to certain conditions. These conditions might include that the business activity is lawful and that management of the debtor's business is taken over by an insolvency representative or governmental agency.

#### 4. *Reorganization*

##### (a) *Parties who may apply*

45. To a greater extent than with applications to commence liquidation proceedings, insolvency laws take different approaches to the parties that may apply to commence reorganization proceedings. While some laws allow applications by both debtor and creditors, a number of laws only permit debtor applications.

##### (b) *Debtor application*

46. 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 to enable the business to continue to the benefit of the debtor and creditors alike. A commencement standard that is consistent with that objective may be one that is more flexible than the commencement standard for liquidation and does not require the debtor to wait until it has ceased making payments generally before making an application, but allows an application in financial circumstances that, 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 standard: 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 which adopt a unitary approach (see part one, chap. I, paras. 21-25), 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's business.

47. It might be suggested that a relaxation of the commencement standard could invite abuse of insolvency proceedings. For example, a debtor that is not

in financial difficulty might 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. These situations should be distinguished from those situations in which debtors should be encouraged to apply because, for example, the payment of mature debts caused financial hardship that could lead to insolvency in the future (see above, para. 30, on imminent insolvency), even if the debtor was not actually insolvent at the time the application was made. In other words, there is a financial basis for the application. Whether such improper use could arise is a question of how the elements of the reorganization procedure are designed, including the commencement standard, requirements for preparation of the reorganization plan, debtor control of the business after commencement and sanctions for improper use of the proceedings. As noted above, it may be desirable that the insolvency law focuses upon discouraging improper use rather than making commencement more difficult to the potential detriment of all eligible applicants. Improper use by the debtor could be addressed by providing, for example, that the relevant court has the power to deny 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.

*(c) Creditor application*

48. 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. As noted above, a number of laws include provision only for debtor applications. Given that one of the objectives of reorganization proceedings is to enhance the value of assets and thereby increase the return to creditors on their claims through the continued operation and reorganization of the debtor's business, it is highly desirable that the ability to apply not be given exclusively to the debtor. A further reason for allowing creditor applications is that there will be cases where the debtor will not or cannot apply for commencement because, for example, management has resigned. The ability of creditors to apply for reorganization is also central to the question of whether creditors can propose a reorganization plan (see chap. IV, paras. 8-14) and may significantly influence their support for any plan proposed. 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 reasoning is followed, it seems reasonable to permit creditors to apply for commencement of reorganization proceedings.

49. Insolvency laws that permit creditors to apply for reorganization of a debtor take different approaches to the commencement standard. One approach is those insolvency laws which use the same test, including prospective illiquidity, as applies in the case of a debtor application for reorganization. A different approach regards use of the same test, especially the inclusion of prospective illiquidity, as difficult to justify. This is not only because of the difficulties associated with creditors being able to prove that a standard of

prospective illiquidity has been met by the debtor, but rather 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.

50. To address these issues with respect to creditor commencement of reorganization proceedings, some laws adopt commencement standards that require creditors to demonstrate certain factors in addition to the debtor's insolvency. For example, they must show 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 reorganization is likely to exceed the return in liquidation. One clear disadvantage of such an approach is that it requires creditors to have made, or be able to make, a thorough assessment of the debtor's business before making an application. To make that assessment, however, creditors must be able to obtain information from the debtor that is relevant to that assessment and reliable enough to facilitate the assessment. To assist in such situations, an insolvency law can provide, for example, that on an application by creditors, an assessment of the debtor's financial situation will be undertaken by an independent authority. Such a procedure may help to ensure that proceedings are only commenced in appropriate cases. Care may be needed to ensure, however, that the additional requirements do not serve to complicate the application procedure, discouraging creditors from proposing reorganization and promoting liquidation as an easier alternative or delaying commencement of the proceedings with consequences for maximization of value of the assets and the likelihood of successful reorganization. Care should also be taken to ensure that the insolvency context is not used by a competitor of the debtor to obtain commercially sensitive or confidential information or to disrupt the debtor's business by imposing unjustifiable requirements with regard to assessment of its financial position.

51. Some insolvency laws adopt a variation of the cessation of payments test and require the application to be made by a specified number of creditors or by creditors holding a specified 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.<sup>13</sup> These requirements might be said to suffer from the same disadvantages as noted above in respect of requirements that creditors must show sufficient means are available to achieve a successful reorganization.

52. 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. In insolvency laws that apply a stay automatically on commencement of the proceedings, for example, the ability of the business to continue trading and be successfully reorganized can be assessed after commencement (and, where the law permits, the proceedings can be converted to

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<sup>13</sup>Such a payment may also provide remuneration for the insolvency representative (see part two, chap. III, para. 58, and also the discussion on fees for insolvency proceedings below, paras. 76-78).

liquidation if reorganization is determined to be inappropriate). 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.

53. For the reasons discussed in the paragraphs above, it may be appropriate to apply the same commencement standard to applications by creditors for both liquidation and reorganization of a debtor (i.e. a general cessation of payments test). Such a standard would appear to be consistent with both the two-track approach and the unitary approach (see part one, chap. I, para. 25), where the use of a different commencement standard is a function not so much of the type of proceeding being initiated, but rather of whether the applicant is the debtor or a creditor. The exception to the approach of having the same commencement standard 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 standard for liquidation would not be a general cessation of payments, but rather a determination that reorganization cannot succeed.

## 5. *Procedural issues*

### (a) *Making an application for commencement*

54. The insolvency law should specify the procedural requirements for making an application. 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 proceedings to be initiated by the debtor lodging a declaration with the corporate regulatory authority. The issue of procedural requirements raises the question of the involvement of the court in insolvency proceedings more generally, which is discussed in part one (see above, chap. III, paras. 1-8, on institutional framework). Law other than the insolvency law may also affect the way in which insolvency proceedings are commenced, such as constitutional law (which may be relevant, for example, to the role of courts and administrative agencies and to issues of competence), procedural law (including court rules) or company law.

### (b) *The decision to commence insolvency proceedings*

55. A preliminary procedural issue relates to the manner in which the proceedings commence once the application has been made. In many States the normal practice is for a court of competent jurisdiction to determine, on the basis of the application, whether the requisite conditions for commencement have been met. In some States, that determination can also be made by the appropriate administrative agency or tribunal, where that agency plays a central supervisory role in the insolvency proceedings. 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 approve an application and for proceedings to commence.



56. Entry conditions that are designed to facilitate early and easy access to insolvency proceedings not only will facilitate the consideration of the application by the court or other body by reducing complexity and, where appropriate, 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. Such entry conditions are also less likely to place a burden on systems, which may lack institutional capacity or the expertise to undertake complex investigations requiring considerable commercial and business expertise. The issue of the costs and fees associated with accessing insolvency proceedings may be of particular importance in the case of small- and medium-size businesses. A further factor to be noted with respect to the commencement procedure is a recent trend in several insolvency laws of recognizing that the debtor has a fundamental right to be heard by the court or body that would determine an application for commencement of proceedings, whether the application was made by the debtor or by creditors.

57. In addressing requirements for commencement, some insolvency laws draw a distinction between an application by a debtor and an application by a creditor. In some laws, an 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 insolvency law is being abused by the debtor. In contrast, in the case of an application by a creditor under these laws, a court is required to consider whether the commencement criteria have been met before deciding to commence the proceedings. A primary reason is to avoid abuse by creditors or other parties in interest. The debtor would have various courses of action open to it, including consenting to the application, disputing the applicant's claim as to its financial position and requesting the commencement of different proceedings (e.g. where the application is for liquidation, requesting commencement of reorganization). The debtor may also have jurisdictional or procedural defences to a creditor application. In some other laws, irrespective of whether the application is made by a debtor or creditors, the court is required to determine not only whether the entry conditions have been met, but also whether the type of proceeding applied for is appropriate to the particular circumstances of the debtor.

58. If the assessment to be made is complex there is a potential not only for delay between application and commencement, but also 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 the court is required to assess various issues before proceedings can be commenced, 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 application of the stay (see generally chap. II, paras. 25-73), priority for repayment of debts incurred (see chap. V, para. 66) and the debtor's authority to dispose of assets between application and commencement (see chap. II, paras. 16 and 70-73), as well as

the treatment of unauthorized transactions occurring during the assessment period (see chap. II, para. 147).

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

59. 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 and the efficient conduct of the proceedings without delay. This will be particularly important in the case of reorganization to avoid further diminution of the value of assets and to improve the chances of a successful reorganization. Some insolvency laws prescribe set time periods after the application within which the decision to commence must be made. These laws often distinguish between applications by debtors and by creditors, with applications by debtors tending to be determined more quickly. Any additional period for creditor applications is designed to allow prompt notice to be given to the debtor and provide the debtor with an opportunity to respond to the application.

60. 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 those objectives may need to be balanced against possible disadvantages. For example, a fixed time period may be insufficiently flexible to take account of the circumstances of the particular case. More generally, such time periods may be set without regard to the resources available to the body responsible for supervising insolvency proceedings 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 appropriate consequences where there is no compliance. The time period between application and the decision to commence proceedings should also reflect the type of proceeding applied for, the application procedure and the consequences of commencement in any particular regime. For example, the extent to which notification of parties in interest 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 an application to commence proceedings*

61. The preceding paragraphs refer to a number of instances where it will be desirable, in those cases where the court is required to make the commencement decision, for the court to have the power to deny the application for commencement, either because of questions of improper use of the insolvency law or for technical reasons relating to satisfaction of the commencement standard. The cases referred to include examples of both debtor and creditor applications. Principal among the grounds for denial of the application for technical reasons might be those cases where the debtor is found not to satisfy



the commencement standard; where the debt is subject to a legitimate dispute or off-set in an amount equal to or greater than the amount of the debt; where the proceedings will serve no purpose because, for example, secured debt exceeds the value of assets; and where the debtor has insufficient assets to pay for the insolvency administration and the law makes no other provision for funding the administration of such estates.

62. Examples of improper use might include those cases where the debtor uses an application for insolvency as a means of prevaricating and unjustifiably depriving creditors of prompt payment of debts or of obtaining relief from onerous obligations, such as labour contracts. In the case of a creditor application, it might include those cases where a creditor uses insolvency as an inappropriate substitute for debt enforcement procedures (which may not be well developed); to attempt to force a viable business out of the market place; or to attempt to obtain preferential payments by coercing the debtor (where such preferential payments have been made and the debtor is insolvent, investigation would be a key function of insolvency proceedings).

63. As noted above, where there is evidence of improper use of the insolvency proceedings by either the debtor or creditors, the insolvency law may provide, in addition to denial of the application, that sanctions can be imposed on the party improperly using the proceedings or that that party should pay costs and possibly damages to the other party for any harm caused. Remedies may also be available under non-insolvency law. Where an application is denied, any provisional measures of relief ordered by the court after the time of the application for commencement should terminate (see chap. II, para. 53).

*(e) Notice of application and commencement*

64. Giving notice of an application for commencement and of the commencement of insolvency proceedings is central to several key objectives of an insolvency regime. It ensures the transparency of the proceedings and that all affected parties—the creditors and parties in interest in the case of a debtor application, and the debtor and other creditors and parties in interest the case of a creditor application—are equally well informed.

*(i) Debtor applications: notice to creditors*

65. In the event of a debtor application, creditors and other parties in interest have a direct interest in receiving notice of the proceedings and an opportunity to dispute the presumptions of eligibility (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. Creditors will have an interest in being notified of the application in order to be able to make an informed decision concerning continuing provision of goods and services to the debtor to avoid the accumulation of further debt. A delay between application and commencement could have serious consequences for creditors who continue to trade with the debtor, unaware of its

financial difficulties. The interests of creditors in knowing that the application has been made may need to be balanced, in certain circumstances, against the possibility that, if notice of the application is provided, the business position of the debtor may be unnecessarily affected where the application is ultimately rejected or creditors may be encouraged to take last-minute action to enforce their claims. These concerns may be addressed by providing generally that creditors and other parties in interest will be notified only of commencement of the proceedings and adopting a commencement procedure that avoids unnecessary delay between application and commencement.

66. A further consideration is whether to expressly address foreign creditors in any notification requirements included in an insolvency law, 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. The factors to be balanced in determining that issue are discussed below in the context of the manner of giving notice.

*(ii) Creditor application: notice to the debtor*

67. In the event of a creditor application for commencement of insolvency proceedings, it is increasingly recognized that the debtor should have a fundamental right to immediate notice of the application and an opportunity to be heard and to dispute the applicant's claims as to its financial position (see chap. III, paras. 20 and 21). Where the debtor has disappeared or is avoiding receiving personal notice, requirements for public notification might suffice or notice could be served at the last known address of the debtor. Nevertheless, there may be exceptional circumstances where provision could be made, with the consent of the court, for personal notice to the debtor to be dispensed with on the basis that it may thwart the purpose of a particular application. These circumstances may include cases 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. The counter-argument is that, where the debtor is not notified, it could unknowingly continue to act to the detriment of the value of its assets and thus its creditors. This concern may be better addressed in terms of provisional measures such as the imposition of a stay than by dispensing with notice of the application. However, where the law does permit the court to dispense with notice of the application, the debtor should nevertheless receive notice of commencement of proceedings as soon as possible. Creditors other than those applying for commencement of proceedings may have a direct interest in being notified of the commencement of those proceedings.

*(iii) Notice of commencement to parties other than creditors*

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

*(iv) Manner of giving notice*

69. In addition to the question of the time at which notice is to be given, an insolvency law may need to address, in order to ensure the effectiveness of the notice, the manner in which notice is given and the information to be included. The manner of giving the notice could address both the party required to give the notice (e.g. the court or the party making the application for commencement) and how the information can be made available, with the key consideration being delivery or publication in a form that is generally likely to come to the notice of parties in interest. For example, while known creditors<sup>14</sup> may be notified individually (the effectiveness of this method will depend upon the state of the debtor's records), the need to inform unknown creditors has led legislators to adopt broad requirements, such as publication in an official government publication or a commercial or widely circulated newspaper. That newspaper may be regional, national or local (by reference to the location of the debtor's business), depending upon the circumstances of the case and what will prove to be most cost-effective. It may not always be necessary, for example, to require publication at considerable expense in a national newspaper when the debtor's business is based and conducted locally.

70. To avoid the notification procedure becoming unwieldy and requiring in each case an investigation into what will prove to be the most effective means of giving notice, the obligation should refer to standard forms, with some flexibility for local conditions. Other options for achieving effective notification may include various forms of electronic communication and use of relevant public registries.

*(v) Content of the notice*

71. The information required in the notice may include the effect of the commencement of proceedings (especially as to the application of the stay—see chap. II, sect. B); 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 chap. V, paras. 2-5—and any special provisions applicable to foreign creditors); consequences of failure to make a claim or to make a claim in the prescribed manner; and information concerning verification of claims and meetings of creditors.

*6. Debtors with insufficient assets*

72. Many debtors that would satisfy the criteria for commencement of insolvency proceedings are never formally liquidated, either because creditors are reluctant to initiate proceedings where it appears that the debtor has no, or

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<sup>14</sup>This will be facilitated by reference to the list of creditors to be provided by the debtor in cooperation with the insolvency representative (see chap. III, paras. 23-27 and 49-51; also art. 14, UNCITRAL Model Law (see annex III)).

insufficient, assets to fund the administration of insolvency proceedings or because debtors in such a position will rarely take steps to commence proceedings. Some insolvency laws provide that where an application for commencement is made in these circumstances, it will be denied on the basis of an assessment of insufficiency of assets by the court, while others provide a mechanism for appointment and remuneration of an insolvency representative (see chap. III, paras. 44-47). Some other laws provide for a surcharge on creditors to pay for the administration of estates (see paras. 76-78, on fees, below).

73. There are a number of reasons, in particular of a public interest nature, for devising a mechanism to enable the administration of a debtor with apparently few or no assets under a formal proceeding. Where an insolvency law does not provide for exploratory investigations of insolvent companies with few or no assets, 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.

74. A mechanism for administration will assist in overcoming any perception that such abuse is tolerated and may provide a return for creditors where antecedent transactions can be avoided, as well as a means of investigating the conduct of the management of such debtors. It may also encourage entrepreneurial activity and responsible economic risk-taking through the provision of a discharge and fresh start for entrepreneurs and others engaging in economic activities—the punitive and deterrent aspects of insolvency laws will be less appropriate where the debtor is honest. For example, where an application to commence insolvency proceedings might otherwise be denied, some insolvency laws provide an exception for individuals with insufficient assets to fund the administration of proceedings, enabling the affairs of that debtor to be investigated to determine if there are assets that can be recovered and whether the debtor should receive a discharge.

75. 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 utilizing an existing office; establishing a fund out of which the costs may be met; or appointing a listed insolvency professional on the basis of a roster or rotation system. The latter systems are generally designed to ensure a fair and ordered distribution of all insolvency cases, whether with insufficient assets 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-subsidized by their clients generally (since, where they are a professional, their remunerative rates can be adjusted to take into account unremunerative work—this approach could not be taken where the insolvency representative is a government official). 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, for example, debtors having available less than a prescribed value of

unencumbered assets (not including those assets which natural person debtors are allowed to retain—see chap. II, paras. 18-21) and no regular source of revenue that would otherwise enable the liquidation to proceed.

### 7. *Fees for insolvency proceedings*

76. 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 proceedings. It is thus important, when designing an insolvency law, to avoid the situation where the proceedings are subject to cost burdens that will deter creditors, discourage commencement and frustrate the basic objectives of the proceedings. This is of particular importance in the case of insolvency of small and medium-size businesses. It may also be important where, for example, the debtor has a large debt that comprises a number of smaller creditors whose individual debts might not support the costs of the application procedure or where the estate has few assets.

77. 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 might be to set a fee that can be used to help defray the costs of the proceedings. Where the resultant fee is high, however, it could operate as a deterrent and run counter to the objective of convenient, cost-effective and quick access to insolvency proceedings. A very low fee, on the other hand, might not be sufficient to deter frivolous applications and it is therefore desirable that a balance between these objectives be reached.

78. Some insolvency laws require 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 to pay 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 law generally provides for the application to be denied (which may result in the debtor's financial situation remaining unresolved) or for it to be treated in accordance with provisions on estates with few or no assets (see above). A further approach establishes the fees that may be levied as a fixed percentage of the value of the assets of the estate. In large cases, this may result in significant fees being paid out of the estate, discouraging both creditor and debtor applications.

### 8. *Dismissal of insolvency proceedings after commencement*

79. In addition to circumstances where the application to commence proceedings might be denied as discussed above (paras. 61-63), there will also be instances where, after proceedings have already commenced, an insolvency

law should permit them to be dismissed. A dismissal procedure will be relevant to an insolvency law irrespective of whether an application by the debtor functions to automatically commence proceedings or the decision to commence is made by the court. In either situation, information relevant to dismissal may become available at some later stage of the proceedings or circumstances may change. The grounds for dismissal would be essentially the same as those for denial, that is, that there is improper use of the insolvency law, either by the debtor or creditors, or that the debtor did not satisfy the commencement criteria at the time of commencement.

### ***Recommendations 14-29***

#### **Purpose of legislative provisions**

The purpose of provisions on commencement of insolvency proceedings is:

- (a) To facilitate access for debtors and creditors to the remedies provided by the law;
- (b) To establish commencement criteria that are transparent and certain;
- (c) To enable applications for insolvency proceedings to be made and dealt with in a speedy, efficient and cost-effective manner;
- (d) To establish safeguards to protect both debtors and creditors from improper use of the application procedure; and
- (e) To establish requirements for effective notification of commencement of proceedings.

#### **Contents of legislative provisions**

##### *Commencement standard*

##### *Persons permitted to apply (paras. 32-53)*

14. The insolvency law should specify the persons permitted to make an application for commencement of insolvency proceedings, which should include the debtor and any of its creditors.<sup>15</sup>

##### *Debtor application (paras. 33-36 for liquidation and 45-47 for reorganization)*

15. The insolvency law should specify that insolvency proceedings can be commenced on the application of a debtor if the debtor can show either that:

- (a) It is or will be generally unable to pay its debts as they mature; or
- (b) Its liabilities exceed the value of its assets.<sup>16</sup>

<sup>15</sup>This would include a government authority that is a creditor of the debtor.

<sup>16</sup>The intention of this recommendation and the recommendation on creditor applications is to allow legislators flexibility in developing commencement standards, based on a single or dual test approach. Where the insolvency law adopts a single test, it should be based on the debtor's inability to pay debts as they mature (cessation of payments test) and not on the balance sheet test. Where the insolvency law contains both tests (cessation of payments and balance sheet tests), proceedings can be commenced if one of the tests can be satisfied.

*Creditor application (paras. 37-41 for liquidation and 48-53 for reorganization)*

16. The insolvency law should specify that insolvency proceedings can be commenced on the application of a creditor if it can be shown that either:

- (a) The debtor is generally unable to pay its debts as they mature; or
- (b) The debtor's liabilities exceed the value of its assets.

*Presumption that the debtor is unable to pay (para. 37)*

17. The insolvency law may establish a presumption that, if the debtor fails to pay one or more of its mature debts, and the whole of the debt is not subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt claimed, the debtor is generally unable to pay its debts.<sup>17</sup>

*Commencement on debtor application (para. 65)*

18. The insolvency law should specify that where the application for commencement is made by the debtor:

- (a) The application for commencement will automatically commence the insolvency proceedings; or
- (b) The court will promptly determine its jurisdiction and whether the debtor is eligible and the commencement standard has been met and, if so, commence insolvency proceedings.

*Commencement on creditor application (paras. 57 and 67)*

19. The law generally should specify that, where a creditor makes the application for commencement:

- (a) Notice of the application promptly is given to the debtor;<sup>18</sup>
- (b) The debtor be given the opportunity to respond to the application, by contesting the application, consenting to the application or, where the application seeks liquidation, requesting the commencement of reorganization proceedings; and
- (c) The court will promptly determine its jurisdiction and whether the debtor is eligible and the commencement standard has been met and, if so, commence insolvency proceedings.<sup>19</sup>

<sup>17</sup>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. 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 offset; 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.

<sup>18</sup>Where the debtor's whereabouts is unknown and it cannot be contacted, the general law may provide relevant rules concerning the giving of notice in such circumstances.

<sup>19</sup>A determination that the commencement standard has been met may involve consideration of whether the debt is subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt. The existence of such a set-off may be a ground for dismissal of the application (see above, paras. 61-63).



### ***Recommendations 14-29 (continued)***

#### *Denial of an application to commence proceedings (paras. 61-63)*

20. The insolvency law should specify that, where the decision to commence proceedings is to be made by the court, the court may deny the application to commence and, where appropriate, impose costs or sanctions against the applicant, if it determines that:

- (a) It does not have jurisdiction or the debtor is ineligible or does not meet the commencement standard; or
- (b) The application is an improper use of the law.

21. Where the application was made by a creditor, the insolvency law should specify that the debtor promptly be given notice of the decision to deny.

#### *Notice of commencement of proceedings (paras. 64-71)*

22. The insolvency law should establish procedures for giving notice of the commencement of insolvency proceedings.

#### *General notice (paras. 69 and 70)*

23. The insolvency law should specify that the means of giving notice of the commencement of insolvency proceedings must be appropriate<sup>20</sup> to ensure that the information is likely to come to the attention of parties in interest.<sup>21</sup> The insolvency law should specify the party responsible for giving that notice.

#### *Notice to creditors (paras. 65 and 66)*

24. The insolvency law should specify that notice of the commencement of proceedings is to be given to creditors individually, unless the court considers that, under the circumstances, some other form of notice would be more appropriate.<sup>22</sup>

#### *Content of the notice (para. 71)*

25. The insolvency law should specify that the notice of commencement of insolvency proceedings is to include:

- (a) Information concerning submission of claims, including the time and place for submission;
- (b) The procedure and form requirements for the submission of claims;

<sup>20</sup>The question of what is appropriate in a particular case will also involve considerations of cost-effectiveness and the insolvency law should not require, for example, expensive publication in a national newspaper, when publication in a local paper will suffice.

<sup>21</sup>General notice would generally be provided by way of making the information available in a publication such as an official government gazette, a widely circulated national, regional or local newspaper, through electronic means or through relevant public registries.

<sup>22</sup>The obligation to prepare the list of creditors to be given notice is dealt with under obligations of the insolvency representative and the debtor (see chap. III, paras. 22-27 and 49-51).



(c) The consequences of failure to submit a claim in accordance with paragraphs (a) and (b) above; and

(d) Information concerning verification of claims, application of the stay and its effects and meetings of creditors.

*Debtors with insufficient assets (paras. 72-75)*

26. The insolvency law should specify the treatment of debtors whose assets and sources of revenue are insufficient to meet the costs of administering the insolvency proceedings. Different approaches may be taken, including:

(a) Denial of the application, except where the debtor is an individual who would be entitled to a discharge; or

(b) Commencement of the proceedings, where different mechanisms for appointment and remuneration of the insolvency representative may be available.<sup>23</sup>

*Dismissal of insolvency proceedings after commencement (para. 79)*

27. The insolvency law should permit the court to dismiss proceedings if, after commencement, the court determines, for example, that:

(a) The proceedings constitute an improper use of the insolvency law; or

(b) The debtor was ineligible or did not meet the commencement standard at the time of commencement.

28. The insolvency law should specify that, where proceedings are dismissed, the court may impose costs or sanctions, where appropriate, against the applicant for commencement of the proceedings.

29. The insolvency law should require notice of a decision to dismiss proceedings to be given.

## **C. Applicable law in insolvency proceedings\***

### *1. Introduction*

80. Where insolvency proceedings involve parties or assets located in different States, complex questions may arise as to the law that will apply to questions of validity and effectiveness of rights in those assets or of other claims; and to the treatment of those assets and of the rights and claims of those foreign parties in the insolvency proceedings. In the case of such insolvency proceedings, the forum State will usually apply its private international law

<sup>23</sup>On mechanisms for appointment, see chap. III, paras. 44-47; on remuneration, chap. III, paras. 53-59.

\*The present section was developed in close cooperation with the Hague Conference on Private International Law.

rules (or conflict of laws rules) to determine which law is applicable to the validity and effectiveness of a right or claim and to their treatment in the insolvency proceedings. The UNCITRAL Model Law on Cross-Border Insolvency (see annex III) does not include harmonized conflict of laws rules for adoption by enacting States, thus leaving these matters to established rules and practices. While insolvency proceedings may typically be governed by the law of the State in which those proceedings are commenced (the *lex fori concursus*), many States have adopted exceptions to the application of that law, which vary both in number and scope. The diversity in the number and scope of such exceptions may create uncertainty and unpredictability for parties involved in cross-border insolvency proceedings. By specifically addressing, in a transparent and predictable manner, issues of applicable law an insolvency law can assist in providing certainty with respect to the effects of insolvency proceedings on the rights and claims of parties affected by those proceedings.

## 2. *Law applicable to the validity and effectiveness of rights and claims*

81. In a purely domestic setting, insolvency law does not “create” rights (personal or proprietary) or claims, but should respect the rights and claims that have been acquired against the debtor according to other applicable laws, that is civil, commercial or public law. Insolvency law concerns itself with determining the relative position of each of those rights and claims once insolvency proceedings have commenced and, where appropriate, with establishing the restrictions and modifications to which they will be subject in insolvency proceedings in order to fulfil the collective aims of those proceedings. These limits and restrictions are “insolvency effects” because they arise from the commencement of insolvency proceedings against a debtor.

82. In the context of cross-border insolvency, it is essential to distinguish between the creation of rights and claims under the law designated as applicable law (whether domestic or foreign substantive law) in accordance with the conflict of laws rules of the forum and the insolvency effects on those rights and claims. Since, as noted, the insolvency law does not establish rights or claims, the issue of whether a given right or claim has been created, and the content of that right or claim, belongs to the realm of general conflict of laws rules. It is typical under general conflict of laws rules, for example, that the law governing the contract will determine if a contractual claim exists against the insolvent debtor and the amount of that claim; that the *lex rei sitae* will determine if a security interest in immovable assets has been created in favour of a specific creditor, and so on. In this sphere, each State will apply its own conflict of laws rules, including any international conventions in force. In the case of an insolvency proceeding, the forum State will usually apply its conflict of laws rules to determine which law governs the validity and effectiveness of a right or claim before considering the treatment of the right or claim in the insolvency proceedings. It is important to stress that the determination of validity and effectiveness is not an insolvency question, but a matter of other applicable law.

### 3. *Law applicable in insolvency proceedings: lex fori concursus*

83. Once a right or claim is determined to be valid and effective under the law designated as applicable by the conflict of laws rules of the forum, a second issue is the effect of insolvency proceedings on the right or claim—that is, whether it will be recognized and admitted in the insolvency proceedings and, if so, its relative position. This is an insolvency matter. From the conflict of laws point of view, the problem in this second phase lies in determining the law applicable to these insolvency effects. It is quite typical that the law of the State in which insolvency proceedings are commenced, the *lex fori concursus*, will govern the commencement, conduct, administration and conclusion of those proceedings. This would generally include, for example, determining the debtors that may be subject to the insolvency law; the parties that may apply for commencement of insolvency proceedings and the eligibility tests to be met; the effects of commencement, including the scope of application of a stay; the organization of the administration of the estate; the powers and functions of the participants; rules on admissibility of claims; priority and ranking of claims; and rules on distribution. Accordingly, this law generally will govern the insolvency effects over rights and claims validly acquired under foreign law, for example, whether the right or claim, given its nature and conditions, is admissible in the insolvency of the debtor and how it will be ranked.

84. Problems may arise when the law governing the ranking of a claim and the applicable law other than the insolvency law governing the claim are different. The categories of privileges and priorities that exist and the ranking of claims is always established by the *lex fori concursus*. Normally, when establishing these categories and ranking, the insolvency law of a State takes into account the existence of these claims under the domestic law of the State. However, the claim of a creditor may be constituted in accordance with a foreign law. In that case, it is necessary to determine which claims created under foreign law qualify as equivalent to domestic law claims conferring certain privileges or priorities. In other words, it is necessary to examine whether the kind of claim created under foreign law is “equivalent” to the kind of claim upon which the *lex fori concursus* confers a special status in insolvency proceedings. The test to apply is whether or not both claims, given their essential content and their function, correspond to each other to the extent that they can be considered as “functionally interchangeable”. If the answer is in the affirmative, the claims should be considered equivalent and receive the same treatment in insolvency proceedings. In the event that equivalence cannot be established, the claim would generally be treated as an ordinary claim.

### 4. *Law applicable in insolvency proceedings: exceptions to the lex fori concursus*

85. To determine the insolvency effects on valid and effective rights and claims, some laws adopt exceptions to the application of the *lex fori concursus*. The purpose of the exception is not to change the law applicable to the

question of validity and enforceability (which continues to be governed by the general conflict of laws rules of the forum), but to change the law applicable to the insolvency effects. Instead of applying the *lex fori concursus*, the insolvency effects may be governed, for example, by the same law applicable to the question of validity and effectiveness. For instance, the insolvency effects over a right to set-off may be determined not by the *lex fori concursus*, but by the law applicable to the right to set-off. Other examples of exceptions to the application of the law of the forum that have been adopted by different insolvency laws address the law applicable to payment systems, labour contracts, avoidance provisions and proprietary rights.

(a) *Payment and settlement systems and regulated financial markets*

86. Exceptions to the application of the *lex fori concursus* respond, in general, to certain social policy considerations. Some laws focus, for example, on supporting commercial certainty and reducing risk for the parties engaged in commercial transactions. The parties to a transaction shape their relationships against the background of a specific legal environment, which includes consideration of the degree to which their rights will be protected in the event of the insolvency of the debtor, the most typical risk faced by any creditor. The application of the law under which the right or claim in question was created may be, in general, less costly for the creditor to learn, more predictable in terms of insolvency effects and more difficult for the debtor to manipulate ex post than the application of the law of the debtor's centre of main interests or domicile. On that basis, it may be argued that it would be reasonable, under certain circumstances, to permit and protect reliance by the parties on the law under which the right or claim was created. A key example relates to payment or settlement systems and regulated financial markets, which many insolvency laws recognize as requiring an exception to the application of the *lex fori concursus*. By applying the law that is applicable to the system or the regulated market, alteration of the mechanisms for payment and settlement in the event of insolvency of a participant can be avoided, thus protecting general certainty and confidence in the system or market and avoiding systemic risk.

(b) *Labour contracts*

87. Some laws adopt exceptions to preserve certain rights or interests specially protected by the law of a State from the uncertainties or inconsistencies that may result from the application of the insolvency effects of a foreign *lex fori concursus*. For example, with respect to labour contracts, special (often mandatory) protections may be afforded in terms of a financial safety net for workers or restrictions on the rejection or modification of those contracts in insolvency. The rationale of such provisions lies in protecting the reasonable expectations of employees with respect to their contract of employment, recognizing that workers may have a relatively weaker bargaining position than their employer, and in ensuring non-discrimination among workers working in the same State, whether they are employed by a local or by a foreign employer. In some States, such protections will apply only to individual employment contracts, while in others these provisions also will apply to collective bargaining agreements.

(c) *Security interests*

88. Some insolvency laws also adopt the approach of providing an exception to the application of the *lex fori concursus* with respect to security interests. This solution means that the law governing a right *in rem* would determine not only its creation and general validity, but also its effectiveness in the case of insolvency proceedings. In other words, the position of the real security interest in insolvency proceedings commenced abroad will not be established by the *lex fori concursus*, but by the insolvency rules of the law applicable to the security interest. Application of the *lex fori concursus* otherwise may affect the legal framework for secured lending, introducing a factor of instability that may increase the domestic cost of finance. If foreign proceedings intrude upon local security interests, the value of those security interests may be seriously impaired. Similarly, a transfer of the debtor's centre of main interests to a different State can bring about a radical change in the position of the secured party. Rights of set-off may also be subject, as noted above, to law other than the law of the forum, for reasons related to the parties' expectations, especially if they engage in regular dealings with each other.

(d) *Avoidance provisions*

89. The rationale of supporting certainty and diminishing risk may also apply to the application of avoidance provisions. Many insolvency laws provide that the law governing the avoidance of transactions should be the *lex fori concursus*, even where, under the general conflict of laws rules of the forum, the transactions to be avoided would be governed by foreign law. Other laws look to the law governing the transaction to also govern avoidance actions relating to the transaction. The policy underlying these exceptions to the application of the *lex fori concursus* protects the counterparty and its reliance on the law governing the transaction. Such an approach may provide counterparties with some degree of certainty and predictability that their transaction with the debtor will not subsequently be subject to attack in insolvency proceedings and assist in reducing the cost of credit and commercial transactions because of the diminished risk of avoidance (which may be essential in the case of transactions taking place in a payment or settlement system).

90. Some of the laws that look to the law governing the transaction for avoidance actions adopt an approach that combines both the *lex fori concursus* and the law governing the transaction in one of several ways. One approach provides that a transaction will not be subject to avoidance in insolvency unless it is avoidable both under the law of the State in which the insolvency proceedings commenced and the law governing the transaction. A second approach provides that a transaction can be avoided if avoidance can be achieved under either the law of the forum or the law governing the transaction. One law, for example, provides that the law of the forum will apply to avoidance, but recognizes the application of a different law where that different law is stricter than the law of the forum and would lead to avoidance of a wider range of transactions.

### 5. *Achieving a balance between the desirability of exceptions and the goals of insolvency*

91. It is critical that policy considerations that form the basis of an exception to the application of the *lex fori concursus* be weighed against other considerations that are central to insolvency proceedings, in particular the goal of maximizing the value of the insolvency estate for the benefit of all creditors, rather than specific individual creditors, and treating all similarly situated creditors equally. The law of the forum will be designed to support the specific goals of insolvency in that State and will provide certainty for the insolvency representative in performing many of its functions with respect to the insolvency proceedings, including avoidance of transactions, treatment of contracts, treatment of claims and so on. Its application in insolvency proceedings may avoid potentially costly and extensive litigation to determine issues of applicable law for purposes of insolvency effects and the validity and effectiveness of rights or claims given the insolvency effects under the law of the forum. Thus, in many circumstances the application of the *lex fori concursus* for insolvency effects may reduce costs and delays and therefore maximize the value of the insolvency estate for the benefit of all creditors. Furthermore, the application of an exception to the *lex fori concursus* for insolvency effects may result in disparate treatment of the insolvency effects on similarly situated creditors merely because different applicable law governs their rights and claims. It may be argued, for example, that the rules of set-off of the forum should be applied to claims on the basis that, in insolvency, rights of set-off are closely related to the proof and quantification of claims and policies governing the equal treatment of creditors. Since these are questions regulated by the law of the forum, the rights of set-off should be similarly regulated.

#### ***Recommendations 30-34***

##### **Purpose of legislative provisions**

The purpose of provisions on the applicable law in insolvency proceedings is:

(a) To facilitate commerce by recognizing, in insolvency proceedings, the rights and claims that arise before commencement of insolvency proceedings and the law that will apply to the validity and effectiveness of those rights and claims; and

(b) To establish the law applicable in insolvency proceedings and exceptions, if any, to the application of that law.

##### **Contents of legislative provisions**

*Law applicable to validity and effectiveness of rights and claims*  
(paras. 81 and 82)

30. The law applicable to the validity and effectiveness of rights and claims existing at the time of the commencement of insolvency proceedings

should be determined by the private international law rules of the State in which insolvency proceedings are commenced.

*Law applicable in insolvency proceedings: lex fori concursus*  
(paras. 83 and 84)

31. The insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) should apply to all aspects of the commencement, conduct, administration and conclusion of those insolvency proceedings and their effects. These may include, for example:

(a) Identification of the debtors that may be subject to insolvency proceedings;

(b) Determination of when insolvency proceedings can be commenced and the type of proceeding that can be commenced, the party that can apply for commencement and whether the commencement criteria should differ depending upon the party applying for commencement;

(c) Constitution and scope of the insolvency estate;

(d) Protection and preservation of the insolvency estate;

(e) Use or disposal of assets;

(f) Proposal, approval, confirmation and implementation of a plan of reorganization;

(g) Avoidance of certain transactions that could be prejudicial to certain parties;

(h) Treatment of contracts;

(i) Set-off;

(j) Treatment of secured creditors;

(k) Rights and obligations of the debtor;

(l) Duties and functions of the insolvency representative;

(m) Functions of the creditors and creditor committee;

(n) Treatment of claims;

(o) Ranking of claims;

(p) Costs and expenses relating to the insolvency proceedings;

(q) Distribution of proceeds;

(r) Conclusion of the proceedings; and

(s) Discharge.

*Exceptions to the application of the law of the insolvency proceedings*  
(paras. 85-90, specifically paras. 86 and 87)

32. Notwithstanding recommendation 31, the effects of insolvency proceedings on the rights and obligations of the participants in a payment or settlement system or in a regulated financial market should be governed solely by the law applicable to that system or market.

***Recommendations 30-34 (continued)***

33. Notwithstanding recommendation 31, the effects of insolvency proceedings on rejection, continuation and modification of labour contracts may be governed by the law applicable to the contract.

34. Any exceptions additional to recommendations 32 and 33 should be limited in number and be clearly set forth or noted in the insolvency law.



## II. Treatment of assets on commencement of insolvency proceedings

### A. Assets constituting the insolvency estate

#### 1. Introduction

1. Fundamental to insolvency proceedings is the need to identify, collect, preserve and dispose of the debtor's assets. Many insolvency systems place these assets under a special regime sometimes referred to as the insolvency estate, over which the insolvency representative will have specified powers, subject to certain exceptions.

2. The present *Legislative Guide* uses the term "estate" in its functional sense to refer to assets of 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 States, the insolvency law provides that legal title over the assets is transferred to the designated official (generally the insolvency representative). In others, the debtor continues to be the legal owner of the assets, but its powers to administer and dispose of those assets are limited. Either the insolvency representative will have complete control of the assets or the debtor will only be able to deal with assets in the ordinary course of business and use or disposal of assets outside the ordinary course of business, including by the creation of security interests, will require the consent of the insolvency representative or, in some cases, the court or creditors.

3. 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 as discussed in the *Guide* and indicate how they will be affected by those proceedings, including clarifying the relative powers of the various participants. Identification of assets and their treatment will determine the scope and conduct of the proceedings and, in particular in reorganization, will have a significant bearing on the likely success of those proceedings. The inclusion in an insolvency law of clear and comprehensive provisions on these issues will ensure transparency and predictability for both creditors and the debtor.

#### 2. Assets included in the insolvency estate

##### (a) General definition of the insolvency estate

4. The estate may be expected to include all assets of the debtor, including rights and interests in assets, wherever located, whether in the forum or a

foreign State, whether or not in the possession of the debtor at the time of commencement, and including all tangible (whether movable or immovable) and intangible assets. It would include the debtor's rights and interests in encumbered assets and in third-party-owned assets (where the continued use of those assets by the estate may be subject to other provisions of the insolvency law—see chap. II, paras. 90 and 91). Generally, assets acquired by either the debtor or the insolvency representative after commencement of the insolvency proceedings (subject to specific exclusions that would apply in the case of natural person debtors—see below) and assets recovered through avoidance or other actions would also be included. Some assets may be freely sold or exchanged in the course of the proceedings, while others may be subject to limitations that arise from contract or other law (e.g. a non-assignable government licence or a customer list that is subject to privacy restrictions) or involve mediating problems that can arise with respect to other rights in those assets. Notwithstanding such limitations, it is desirable that these assets be included in the estate.

5. 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 national law, but may include intellectual property, securities and financial instruments, insurance policies, contract rights (including those relating to assets owned by third parties) and rights of action arising from a tort.<sup>1</sup> The inclusion of some intangible assets in the estate may give rise to conflicts with other laws, such as those restricting transferability or laws relating to privacy protection. 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 insolvency proceedings or which come into existence during the proceedings, as well as the debtor's interest in assets owned jointly with another person, including the debtor's spouse.

6. Notwithstanding the desirability of a broad definition of the estate, the inclusion of a number of types of asset can be controversial. Some assets can be included in the estate without difficulty, such as assets belonging to the debtor and that are unencumbered, assets that are not disputed by a third party and assets recovered by the insolvency representative, whether through claims against a third party or through avoidance actions. Other assets can be excluded from the estate without difficulty, such as assets belonging to a third party in which the debtor has no interest and assets belonging, with full ownership rights, to the debtor's spouse. Assets such as encumbered assets, joint assets, assets located abroad, some intangible assets and third-party-owned assets in which the debtor has an interest could raise difficult questions. These are discussed in the following sections.

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<sup>1</sup>Where the debtor is a natural person, some jurisdictions exclude torts of a personal nature such as defamation, injury to credit or reputation or personal bodily injury, 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, but may not be entitled to sue for any loss of earnings associated with those causes of action.

(b) *Encumbered assets*

7. One question of some importance is whether the insolvency law includes encumbered assets as part of the insolvency estate. Insolvency laws adopt different approaches to the treatment of such assets. Many laws provide that encumbered assets are included in the insolvency estate, with the commencement of proceedings giving rise to different effects, such as limiting the enforcement of security interests by application of a stay. Including encumbered assets in the estate and thus limiting the exercise of rights by secured creditors on commencement of proceedings may assist not only in ensuring equal treatment of creditors, but may be crucial to the proceedings where the encumbered 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. There will be advantages, in particular in reorganization and where the business is to be sold as a going concern in liquidation, in having all assets of the debtor available to the insolvency estate from the time of commencement.

8. Where encumbered assets are included in the insolvency estate, a number of insolvency laws provide certain protections, such as those relating to maintaining the value of the encumbered asset or the secured portion of a creditor's claim and to specified situations where the encumbered asset may be separated from the estate. An insolvency law should make it clear that such an inclusion will not deprive secured creditors of their rights in the encumbered assets, even if it does operate to limit the exercise of those rights (e.g. postponement by operation of the stay) and should specifically ensure the protection of the rights of secured creditors in encumbered assets.

9. Other insolvency laws provide that encumbered assets are unaffected by insolvency proceedings and secured creditors may proceed to enforce their legal and contractual rights. Recognizing that there will be cases where encumbered assets may be crucial to the proceedings, there are examples of laws that provide that even where those assets are unaffected by the insolvency, the court may be requested to prevent such enforcement where the asset is necessary for the business to continue operating. Exclusion of encumbered assets may have the advantage of generally enhancing the availability of credit because secured creditors would be reassured that their rights would not be adversely affected by the commencement of insolvency proceedings. It is increasingly accepted, however, that this general advantage to an economy is outweighed by the advantages to be derived from including encumbered assets in the insolvency estate and restricting the exercise of secured creditors' rights as noted above.

(c) *Third-party-owned assets*

10. Some jurisdictions permit assets in which a creditor retains legal title or ownership (e.g. a retention of title or a lease arrangement) to be separated from the insolvency estate on the basis that the insolvency law should respect the

creditor's legal title in the asset. In some jurisdictions the separation of the asset may be subject to the provisions of the insolvency law relating to treatment of contracts. The estate will generally include, however, as indicated above in the general definition of the estate, any rights that the debtor might have in respect of those third-party-owned assets. There will be cases where the third-party-owned assets may be crucial, like encumbered assets, to the continued operation of the business, whether in reorganization or sale as a going concern in liquidation. In those cases, it will be advantageous for the insolvency law to include a mechanism that will permit third-party-owned assets to remain at the disposal of the insolvency proceedings, subject to protecting the interests of the third-party owner and to the right of the third party to dispute that treatment.

11. If the economic terms of the transaction demonstrate that it is a device to finance the acquisition of an asset, although structured, for example, as a lease, some laws treat the arrangement as a secured lending arrangement and the lessor will be subjected to the same treatment in insolvency 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. The insolvency law may regard the debtor's rights as part of the insolvency estate and permit the asset to be used by the insolvency representative subject to certain conditions as described below (paras. 90 and 91).

12. Where the interest in assets that is claimed by the debtor is disputed by a third party, it will be desirable for the insolvency law to enable those assets to be protected on an interim basis to ensure their preservation, pending decision by the court as to ownership. Where the decision is ultimately made that the assets do not form part of the estate, the law may also address issues of damage to the third party arising from the debtor's retention. The issue of damages may also be relevant where a third party withholds assets that are found to form part of the estate.

*(d) Foreign assets*

13. Whether the debtor's assets outside the country where the proceedings are taking place will become part of the estate raises issues of cross-border insolvency. This may be of particular importance in reorganization, where the exclusion of foreign assets could significantly affect the success of the proceedings. Some insolvency laws take the approach that there should be a single insolvency proceeding, 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). This approach includes the idea that the State adopting it will accept the same claim made under the insolvency law of another State. Other insolvency laws are based upon an approach that limits the applicability of the insolvency law to the geographical area governed by the State enacting the legislation (the territorial approach). This approach requires different proceedings to be commenced in each State in which the debtor has assets or in which different

branches or establishments of the debtor are located. Another approach is a modified version where a State claims universal application of its own law, but does not recognize the same universal application of the laws of other States.

14. The existing diversity of approaches to this issue creates considerable uncertainty and undermines the effective application of national insolvency laws. However, as the differences between insolvency laws increasingly narrow and greater convergence emerges, there are fewer reasons for maintaining the territorial approach. It is increasingly desirable that an insolvency law provide that the insolvency estate comprise all assets of the debtor wherever located.<sup>2</sup> However, since divergence is likely to remain for some time, the UNCITRAL Model Law on Cross-Border Insolvency establishes a regime for effective cooperation 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 the documents included in annex III.

(e) *Recovered assets*

(i) *Avoidance proceedings*

15. The insolvency estate generally will include any assets or their value recovered through avoidance proceedings where the transaction involving the assets was of the type subject to avoidance under an insolvency law. Such transactions may include transactions that resulted in preferential treatment to some creditors, were prejudicial to the insolvency estate or were entered into in an effort to defeat the collective rights of creditors (see below, paras. 170-184).

(ii) *Unauthorized post-application and post-commencement transactions*

16. Many insolvency laws adopt measures intended to limit the extent to which a debtor subject to insolvency proceedings can deal with its assets, whether encumbered or not, without the authorization of the court or the insolvency representative (see below, paras. 70-73). These restrictions will generally apply after the commencement of insolvency proceedings, but may also apply after an 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. Some insolvency laws treat transactions that are not authorized as invalid and unenforceable as against the insolvency estate and enable any 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, depending upon how the suspect period is calculated (see below, para. 188).

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<sup>2</sup>See for example, EC Regulation 1346/2000, which relies on the principle of proceedings with universal scope, while retaining the possibility of opening secondary proceedings whose effects are limited to the territory of the member State concerned. There is automatic recognition of foreign decisions and special rules for coordination between liquidators.

### 3. *Assets excluded from the insolvency estate*

#### (a) *General exclusions*

17. The insolvency law may exclude certain assets from the estate. Insolvency laws adopt different approaches to this issue. Assets excluded from the estate may include, for example, 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 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.<sup>3</sup> They may also include assets subject, under some laws, to reclamation, such as goods supplied to the debtor before commencement, but not paid for and recoverable by the supplier (subject to identification and other applicable conditions).

#### (b) *Where the debtor is a natural person*

18. In the case of insolvency of a natural person, the insolvency law may exclude certain assets from the estate, such as post-application earnings from the provision of personal services by the debtor or monies received for public works by the debtor, 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 necessary to satisfy the basic domestic needs of the debtor and his or her family. Some jurisdictions also exclude torts of a personal nature such as defamation, injury to credit or reputation or personal bodily injury. The debtor remains personally entitled to sue and to retain what is recovered in such actions on the basis that the incentive to vindicate wrongdoing otherwise would be diminished, but the debtor may not be entitled to sue for any loss of earnings associated with those causes of action. Such exclusions generally would not be available to legal person debtors.

19. Where an insolvency law excludes certain assets from the estate of a natural person, those assets should be clearly identified and the number and value of the exclusions limited to the minimum necessary to preserve the personal rights of the debtor and allow the debtor to lead a productive life. In identifying such exclusions, consideration might need to be given to applicable human rights obligations, including international treaty obligations, which are intended to protect the debtor and relevant family members and may affect the exclusions that should be made.<sup>4</sup> A further consideration may be the economic effects of exclusions; some research suggests that the full or substantial exemption of personal assets from insolvency proceedings may have a positive effect on entrepreneurship and risk-taking.

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<sup>3</sup>Such an arrangement may be known as a bailment or *depositum*.

<sup>4</sup>In Europe, for example, the Convention for the Protection of Human Rights and Fundamental Freedoms of 1950 is relevant.

### *Joint assets*

20. Different approaches are adopted to the treatment of personal assets owned jointly by a natural person debtor and his or her spouse. That treatment may be specified by the insolvency law or law other than the insolvency law, such as that relating to matrimonial property or property ownership and, in some federal jurisdictions, may involve questions of both state and federal law. The relationship between those other laws and the insolvency law may determine how certain provisions of the insolvency law, for example avoidance provisions, will apply.

21. One approach to the treatment of joint assets is to exclude them completely 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 law other than the insolvency law, the assets can be divided for purposes of execution (where division of the assets will be conducted outside of the insolvency law and proceedings). The choice between these approaches may therefore depend upon the operation of law other than the insolvency law and factors such as the ease with which the assets may be divided (see below, para. 87).

#### *4. Time of constitution of the insolvency estate and collection of assets*

22. To provide certainty for the debtor and for creditors, the insolvency law should specify the date by reference to which the estate will be constituted. Some insolvency laws refer to the effective date of commencement of proceedings, while others refer to the date of the application for commencement or to an act of insolvency that forms the basis of the application. The significance of the difference between the dates relates to the treatment (and most importantly the protection) of the debtor's assets in the interim period between application and commencement. For that reason, some laws constitute the estate from the date of application. Other laws, for reasons of clarity and certainty, constitute the estate from the date of commencement, but also contain provisions that restrict the debtor's powers to dispose of property during the period after the application is made. The insolvency representative can reclaim assets disposed of in that period. A further consideration with respect to protection of assets between application and commencement is the relevance of avoidance provisions and the date from which the suspect period is calculated (see below, para. 188).

23. Whichever date is chosen for constitution of the estate, the estate may be expected to include assets of the debtor as at that date as well as assets acquired by the insolvency representative and the debtor after that date, whether in the exercise of avoidance powers or in the normal course of operating the debtor's business.<sup>5</sup>

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<sup>5</sup>Except for those assets excluded from the estate in the case of natural person debtors (discussed above, paras. 18-21).



24. Once the assets to be included in the estate are identified, they must be collected. To achieve this, the insolvency law may include powers enabling the insolvency representative to establish control over assets determined to be part of the estate, as well as obligations to ensure that the debtor and other relevant parties assist and cooperate with the insolvency representative in that regard. Where assets are located in a foreign country, additional measures will be required, such as those set forth in the UNCITRAL Model Law on Cross-Border Insolvency (see annex III).

### ***Recommendations 35-38***

#### **Purpose of legislative provisions**

The purpose of provisions relating to the insolvency estate is:

(a) To identify those assets which will be included in the estate, including the debtor's interests in encumbered assets and in third-party-owned assets; and

(b) To identify the assets, if any, that will be excluded from the estate.

#### **Contents of legislative provisions**

*Assets constituting the insolvency estate (paras. 1-16)*

35. The insolvency law should specify that the estate should include:

(a) Assets of the debtor,<sup>6</sup> including the debtor's interest in encumbered assets and in third-party-owned assets;

(b) Assets acquired after commencement of the insolvency proceedings; and

(c) Assets recovered through avoidance and other actions.

36. In the case of insolvency proceedings commenced where the debtor has its centre of main interests, the insolvency law should specify that the estate should include all assets of the debtor wherever located.<sup>7</sup>

*Time of constitution of the insolvency estate (paras. 22-24)*

37. The insolvency law should specify the date from which the estate is to be constituted, being either the date of application for commencement or the effective date of commencement of insolvency proceedings.

<sup>6</sup>Ownership of assets would be determined by reference to the relevant applicable law, where the term "assets" is defined broadly to include property, rights and interest of the debtor, including the debtor's rights and interests in third-party-owned assets.

<sup>7</sup>Where the insolvency law adopts a universal approach, as recommended here, the law should also address the issue of recognition of foreign proceedings, see the UNCITRAL Model Law on Cross-Border Insolvency (annex III).



*Assets excluded from the insolvency estate where the debtor is a natural person*<sup>8</sup> (paras. 18-21)

38. The insolvency law should specify the assets, if any, that are excluded from the estate where the debtor is a natural person.

## **B. Protection and preservation of the insolvency estate**

### *1. Introduction*

25. Essential objectives of an effective insolvency law are protecting the value of the insolvency estate against diminution by the actions of the various parties to insolvency proceedings and facilitating administration of those proceedings 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*

26. With regard to creditors, one of the fundamental principles of insolvency law is that insolvency proceedings are collective proceedings, which require the interests of all creditors to be protected against individual action by one of them. Many insolvency laws include a mechanism to protect the value of the insolvency estate that not only prevents creditors from commencing actions to enforce their rights through legal remedies during some or all of the period of the liquidation or reorganization proceedings, but also suspends actions already under way against the debtor. Such a mechanism is variously termed a “moratorium”, “suspension” or “stay”, depending on the effect of the mechanism. For the purposes of the *Legislative Guide*, the term “stay” is used in a broad sense to refer to both suspension of existing actions and a moratorium on the commencement of new actions.

#### *(i) Liquidation*

27. As a general principle, the emphasis in liquidation is on realizing the assets, in whole or in part, so that creditors’ claims can be satisfied from the proceeds of the estate as quickly as possible. Maximizing value is an overriding objective. The imposition of a stay can ensure a fair and orderly administration of the liquidation proceedings, providing the insolvency representative with adequate time to avoid making forced sales that fail 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

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<sup>8</sup>Exclusions are generally not provided for legal person debtors. On the types of asset that may be excluded in respect of natural persons, see above, paras. 18-21.

may be greater than if the assets were to be sold piecemeal. A stay also allows the insolvency representative to take stock of the debtor's situation, including actions already pending, and provides time for all actions to be fully considered, increasing the possibility of achieving a result that is not prejudicial to the interests of the debtor and creditors. The balance that is difficult to achieve in liquidation proceedings is between the competing interests of secured creditors, who will often hold a security interest in some of the most important assets of the business and wish to enforce that security interest, and unsecured creditors, who may benefit from retention of that asset to facilitate sale of the business as a going concern.

(ii) *Reorganization*

28. In reorganization proceedings, the application of a stay facilitates the continued operation of the business and allows the debtor a breathing space to organize its affairs, time for preparation and approval of a reorganization plan and for other steps such as shedding unprofitable activities and onerous contracts, where appropriate. As in liquidation, it also provides an opportunity to consider actions pending against the debtor. 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 proceedings will affect suppliers, customers and employees of the debtor's business.

29. The immediate benefits that accrue to the debtor by having a broad stay quickly imposed to limit the actions of creditors will need to be balanced against 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.

### 3. *Scope of application of the stay*

(a) *Actions to which the stay will apply*

30. Some States adopt the approach that, in order 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 the debtor from taking certain actions with respect to its assets, unsecured and secured creditors from enforcing their rights, as well as Governments from exercising priority rights.

31. Examples of the types of action and act 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 actions to make security interests effective against

third parties or to enforce 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 a security interest in respect of a debt incurred by the debtor prior to the commencement date; the transfer, encumbrance or other disposal of any assets by the debtor (in reorganization, this might be limited to transfer, encumbrance or disposal outside the ordinary course of business); the termination of a contract with the debtor by the counterparty<sup>9</sup> (except where the contract provides a termination date that happens to fall after commencement); and termination, suspension or interruption of supplies of essential services (e.g. water, gas, electricity and telephone) to the debtor. Article 20 of the UNCITRAL Model Law on Cross-Border Insolvency is an example of a stay provision, which 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. The types of individual action referred to above should cover those commenced both in the courts and before an arbitral tribunal.<sup>10</sup>

32. With respect to actions to make a security interest effective against third parties, some laws dealing with security interests provide specified time periods within which those security interests should be made effective against third parties, whether by registration, publicity or some other means. Where the law of a State includes such periods, the insolvency law may recognize them, permitting security interests to be made effective against the debtor and third parties after commencement of insolvency proceedings, but within the specified time period. Where the law does not include such time periods, the stay applicable on commencement of insolvency proceedings would operate to prevent the security interest from being made effective. The question of whether such an act in insolvency would make the security interest effective against third parties should be distinguished from the question of whether or not such acts should be permitted. The effect in insolvency will depend upon the act that is required to make the interest effective. Where, for example, effectiveness requires registration, it might be permitted to occur after commencement, but where it involves, for example, the secured creditor taking possession of an asset, a different view might be taken, as such an action would reduce the assets available for the estate.

33. One of the reasons for including continuation of proceedings within the scope of the stay is that the need for the insolvency representative to become involved in ongoing cases (where the debtor is divested of control) can distract and divert resources away from its task of administering the estate. In the absence of a stay, a default judgement, for example, could be entered against the debtor and form the basis of a creditor's claim in the proceedings without the insolvency representative being aware of the action. On a proper

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<sup>9</sup>Application of the stay would give the insolvency representative time to assess the contract's importance to the proceedings and the action to be taken, that is, continuation or rejection.

<sup>10</sup>It may not always be possible, however, to implement an automatic stay of arbitral proceedings, such as where the arbitration takes place in a foreign State rather than in the State in which insolvency proceedings are commenced.

adjudication of the issues by the court, the insolvency representative would have the opportunity to defend the action, which might be dismissed or judgment be entered for a smaller amount. Since most insolvency laws include a mechanism to process claims—addressing submission, verification and admission—and to make distributions, proceedings with respect to those claims conducted outside the insolvency case are rendered superfluous. Nevertheless, some insolvency laws provide that, where legal proceedings against the debtor (including both commencement and continuation of those proceedings) are within the scope of the stay, those proceedings can be commenced or continued at the discretion of the court if it is considered necessary to preserve a claim or establish the quantum of a claim.<sup>11</sup> The same result can be achieved by providing that the stay of proceedings halts the running of any applicable limitation period, so that the creditor's right to bring a claim against the debtor will be the same on the day the stay is lifted as it was on the day the stay became effective.

34. Other insolvency laws allow the commencement or continuation of legal proceedings (without leave of the court), but the application of the stay prevents enforcement of any resulting order. Some insolvency laws limit the actions that may be pursued and only 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. 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, such as those which are not designed to collect money for the estate but to protect vital and urgent public interests, restraining activities causing environmental damage or activities that are detrimental to public health and safety. As a procedural matter, some insolvency laws limit the initial scope of acts and actions to which the stay applies on commencement, but provide that upon application, the court might extend the stay to other types of action and act.

*(b) Exceptions to application of the stay*

35. To ensure transparency and predictability, it is highly desirable that an insolvency law clearly identify the actions that are to be included within and specifically excepted from the scope of the stay, irrespective of who may commence those actions, whether unsecured creditors (including priority creditors such as employees, legislative lien holders 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 others. Exceptions might include set-off rights and netting of financial contracts (see below, paras. 204-215); actions to protect public policy interests, such as to restrain environmental damage or activities detrimental to public health and safety; actions to

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<sup>11</sup>Article 20, paragraph 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 (see annex III).

prevent abuse, such as the use of insolvency proceedings as a shield for illegal activities; actions commenced in order to preserve a claim against the debtor; and actions against the debtor for personal injury or family law claims.<sup>12</sup> With respect to claims against the debtor that have the potential for very large compensation awards, such as mass tort claims, it is desirable that they be included within the scope of the stay.

(c) *Secured creditors*

36. The scope of rights that are affected by the stay varies considerably between insolvency laws. There is little debate regarding the need for the stay to apply to suspend or prevent the commencement of actions by unsecured creditors against the debtor or its assets. The application of the stay to actions by secured creditors, however, is potentially more difficult and requires a number of competing interests to be balanced. These include, for example, respecting the pre-insolvency priorities of secured creditors as regards their rights over the encumbered assets; minimizing the effect of the stay on the value of encumbered assets; and, in cases of reorganization, ensuring that all assets necessary for the successful reorganization of a viable debtor are available to the proceedings.

37. Creditors generally seek a security interest for the purpose of protecting their interests in the event that the debtor fails to repay. If a security interest is to achieve that objective, it can be argued that, upon commencement of insolvency proceedings, the secured creditor should not be delayed or prevented from immediately enforcing its rights against the encumbered asset. The secured creditor has, after all, bargained for a security interest in exchange for value that reflects the reliance on the security interest. For that reason, the introduction of any measure that will diminish the certainty of the secured creditor's ability to recover debt or erode the value of security interests, such as applying the stay to postpone enforcement, 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. Some of the insolvency laws that exempt actions by secured creditors from the stay focus, as an alternative to the stay, on encouraging pre-commencement negotiations between the debtor and creditors to achieve agreement on how to proceed.

(i) *Reorganization*

38. A growing number of insolvency laws accept, however, that in many cases permitting secured creditors to freely enforce their rights against the encumbered asset can frustrate the basic objectives of the insolvency

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<sup>12</sup>Some jurisdictions, for example, will exclude from the application of the stay the performance of obligations of the debtor that do not affect the estate, for example, to give parental access in a family law situation.

proceedings, in particular in reorganization. For that reason, actions by secured creditors are increasingly included within the scope of the stay, subject to certain protections. It may be worth noting that the increasing acceptance by banks and other financial institutions of moratoriums in voluntary restructuring negotiations conducted pursuant to, for example, the “London approach” (see part one, chap. II, para. 17) may be responsible, in part, for the growing acceptance by secured creditors of the application of the stay to them in insolvency proceedings.

(ii) *Liquidation*

39. Insolvency laws take different approaches to the application of the stay to actions by 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 enforce its rights against the encumbered asset to satisfy its claim without affecting the liquidation of other assets. Some insolvency laws thus except secured creditors from the scope of the stay. Where that approach is adopted, however, some flexibility may be needed in cases 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 secured creditors. 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.

40. Where actions by secured creditors are included within the scope of the stay in both liquidation and reorganization proceedings, an insolvency law can adopt measures that will ensure that the interests of the secured creditor are not diminished by the stay. These measures may relate to the duration of the stay, protection of the value of the encumbered assets, payment of interest and provision of relief from the stay where the encumbered assets are not sufficiently protected or where they are not necessary to the sale of the entire business or a productive part of it.

4. *Discretionary or automatic application of the stay*

41. 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 access an independent judiciary with insolvency experience, may affect the decision on this issue. Application of 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 the time of application and duration of the stay) 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 ultimately may apply; and may create a need for some mechanism, such as provisional measures, to address the period before the court decides on the application of the stay, as well as requiring notice to be given as to application of the stay.

42. An alternative approach that minimizes delay, helps to maximize the value of the assets and ensures that the insolvency proceedings are fair and ordered as well as transparent and predictable might be to provide for the stay to apply automatically to specified actions (either on application or commencement of proceedings), with the possibility of extension of the stay to other action 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 action that will be stayed automatically upon recognition of foreign main proceedings, while article 21 indicates examples of additional relief that may be ordered upon recognition, at the discretion of the court. The automatic stay is a feature of many modern insolvency law regimes and can be combined with provisions permitting relief from the application of the stay in specified circumstances (see below, paras, 60-62).

### 5. *Time of application of the stay*

43. A further concern related to application of the stay is the time at which it will apply in both liquidation and reorganization proceedings. There are essentially two approaches. Under the first, the stay applies from the time an application for commencement of proceedings is made and under the second from the time of the commencement of proceedings, with provisional measures being available to cover the period between application and commencement.

#### (a) *Specifying the exact time of effect of the stay*

44. As a preliminary issue, regardless of whether an automatic 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 to commence becomes publicly available. In yet other laws, the stay has effect retroactively from the first hour of the day the commencement order is made. A similar diversity of approaches is taken where the stay takes effect when an application for commencement of proceedings is made. Whichever approach is adopted, an insolvency law should contain a clear rule.

#### (b) *Application of the stay from the time an application for commencement is made*

45. With respect to the point in the proceedings at which the stay should take effect, one approach applies the stay from the time an application for either



liquidation or reorganization proceedings is made, 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 such a situation, it is desirable, if this approach is followed, that clear procedures for seeking relief from the stay on an expedited basis be included in the insolvency law.

*(c) Application from commencement*

46. The most common approach to application of the stay is for it 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. To address the period between application and commencement, some insolvency laws permit provisional measures to be ordered. While other provisions of insolvency law also may be relevant to protecting the insolvency estate before commencement, such as reclamation of assets, these generally will apply only after the event.

*(i) Provisional measures*

47. In some insolvency laws that do not provide for the proceedings to commence automatically when an application is made, the application of the stay on commencement is complemented by provisional measures that may be ordered between application and commencement to protect both the assets of the debtor that potentially will constitute the insolvency estate and the collective interests of creditors. Even where the commencement decision is made quickly, there is the potential in that period 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. The unavailability of provisional measures in such circumstances could frustrate the objectives of the insolvency proceedings. As with most provisional measures, the need for relief generally must be urgent and must outweigh any potential harm resulting from such measures.

48. Where an insolvency law permits provisional measures to be granted, it is important that it also include provision for periodic review and, if necessary, renewal of those measures by the court and that it address what happens to those measures on commencement of the insolvency proceedings. In many instances there will be no need for provisional measures to continue to apply after the commencement of proceedings, as they will be superseded by the measures applicable on commencement. If, however, provisional relief of a particular kind is not provided by the measures applicable on commencement



and that type of relief is still required after commencement, the court may extend the application of that provisional measure in appropriate circumstances. Provisional measures would also terminate when an application for commencement is denied or the order for provisional measures is successfully challenged.

*(ii) Types of provisional measure*

49. Provisional measures may be available on the application of the debtor, creditors or third parties or be ordered by the court on its own motion. They may include appointing an interim insolvency representative or other person (not including the debtor) to administer or supervise the debtor's business and to protect assets and the interests of creditors; prohibiting the debtor from disposing of assets; taking control of some or all of the debtor's assets; suspending enforcement by creditors of security rights against the debtor; staying any action by creditors against the debtor's assets, such as by a secured creditor or retention of title holder; and preventing the commencement or continuation of individual actions by creditors to enforce their claims.

50. Where an insolvency representative is appointed as a provisional measure, it may not have powers as broad as those of an insolvency representative appointed on commencement of proceedings and its functions may be limited to protecting assets and the interests of creditors. It may be given, for example, the power to use and dispose of the debtor's assets in the ordinary course of business and to realize assets in whole or in part in order to protect and preserve the value of those assets which, by their nature or because of other circumstances, are perishable, susceptible to devaluation or otherwise in jeopardy. In any event, it may be necessary to determine the balance of responsibilities between the interim insolvency representative and the debtor with respect to the operation of the debtor's business, bearing in mind that no determination as to commencement of insolvency proceedings has been made. Since significant harm to the debtor's business or to the rights of creditors may result in situations where the court ultimately decides to deny the application for commencement, it is desirable that the court only exercise the power to grant provisional measures if it is satisfied that the assets of the debtor are at risk. In general, the debtor would continue to operate its business and to use and dispose of assets in the ordinary course of business, except to the extent restricted by the court.

*(iii) Evidentiary requirements*

51. Since these measures are provisional in nature and are granted before the court's determination that the commencement criteria have been met, the law may require the court to be satisfied that there is some likelihood that the debtor will satisfy the commencement requirements. Where a party other than the debtor applies for the measure, the applicant may be required by the court to provide evidence that the measure is necessary to preserve the value or avoid dissipation of the debtor's assets. In that case, some form of security for

costs, fees or damages, such as the posting of a bond, may also be required in case insolvency proceedings are not subsequently commenced or the measure sought results in some harm to the debtor's business. Where provisional measures are improperly obtained, it may be appropriate to permit the court to assess costs, fees and damages against the applicant for the measure.

(iv) *Notice of application and orders for provisional measures*

52. The insolvency law may also need to consider the question of provision of notice, both in respect of an application for provisional measures and of an order for provisional measures (including the time at which those measures become effective) and the parties to be notified. As a general principle, the debtor should be given notice of an application for provisional measures and an opportunity to challenge the application. Only in exceptional circumstances is it desirable that notice to the debtor be dispensed with and the application proceeds on an *ex parte* basis. While many laws allow *ex parte* applications for provisional measures, they generally do so on the basis that the applicant provides security for costs and damages and can demonstrate requisite urgency, that is, that irreparable harm will result if the applicant is required to seek the requested measure under customary procedures requiring many days' notice.<sup>13</sup> Nevertheless, once an order for provisional measures has been made on an *ex parte* basis, the debtor would generally be entitled to notice of the order and an opportunity to be heard. Bearing in mind the need to avoid unnecessary damage to a debtor against whom insolvency proceedings are not subsequently commenced, notice of an order for provisional measures may need to be restricted to parties directly affected by the order. Notice should also be provided to other parties where their interests will be affected by the provisional measures being sought.

(v) *Relief from provisional measures*

53. Relief from the application of provisional measures, such as modification or termination, may be appropriate in cases where the interests of the persons to whom the measures are directed are being harmed by their application. Examples might include cases involving perishable goods; actions relating to preservation or quantification of a claim against the debtor; and, in some situations, secured creditors. The granting of such relief may need to be balanced against potential detriment to the interests of creditors generally or to the debtor's assets. Such relief might be available on the application of the affected party, the insolvency representative or on the motion of the court itself and would generally require that notice and an opportunity to be heard be given to the person or persons to be affected by the modification or termination. Where an order for provisional measures is successfully challenged, the measures would generally terminate or be modified by the court.

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<sup>13</sup>See UNCITRAL work on court-ordered interim measures in support of arbitration (A/CN.9/WG.II/WP.119, in the *UNCITRAL Yearbook 2002*, part two, available at [www.uncitral.org](http://www.uncitral.org)).

## 6. Duration of application of the stay

### (a) Unsecured creditors

54. Many insolvency laws provide that the stay applies to unsecured creditors throughout both liquidation and reorganization proceedings. In liquidation, this would generally mean until the liquidation of the assets had been completed and the proceedings closed. In reorganization, the duration of the proceedings is not so clear-cut; some laws provide that the proceedings end when the reorganization plan is approved and effective, while others delay conclusion until the plan is fully implemented. Application of the stay until that later time may be unnecessary on the basis that the claims of unsecured creditors should be addressed in an approved reorganization plan.

55. Relief from the application of the stay may be provided to unsecured creditors in particular instances such as those noted above with respect to quantification or preservation of a claim (see above, paras. 33 and 34).

### (b) Secured creditors

#### (i) Reorganization

56. It may be desirable for the stay to apply to secured creditors for a sufficient period of time to ensure that the reorganization can be conducted in an orderly manner without the possibility of assets being separated before it can be determined how those assets should be treated in reorganization and an appropriate plan approved. To avoid application of the stay for an uncertain or unnecessarily lengthy period and encourage a speedy resolution of the proceedings, there may be advantage in limiting the application of the stay to the time it may reasonably take for a reorganization plan to become effective, provided that that does not take a significant period of time and the proceedings are not allowed to continue for years without a plan being proposed and approved. Such a limitation may also have the advantage of providing secured creditors with a degree of certainty and predictability as to the duration of the period of postponement of their rights and the treatment of those rights in the plan. Alternatively a fixed time period might be specified. The difficulty with that approach, however, is that the time period may not always be sufficiently long, depending on the size and complexity of the reorganization and the plan required, and may be difficult to enforce. Solutions may include establishing clear time limits, with the possibility of extension (see below, para. 58) or providing for relief from the stay in certain circumstances (see below, paras. 60 and 61). It is important that the overall design of the insolvency law encourage speedy and efficient progress of the proceedings, enabling the period for application of the stay to secured creditors, in particular in reorganization, to be minimized.

#### (ii) Liquidation

57. Insolvency laws adopt different approaches to application of the stay to actions by secured creditors in liquidation. Of those laws applying the stay to

secured creditors, some 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. This period is to allow the insolvency representative to assume its duties, take stock of the assets and liabilities of the estate and determine the best means of achieving liquidation of the assets. In those cases where an encumbered asset is essential to the sale of the business as a going concern, some laws provide that application of the stay may be extended beyond the specified period. Where the encumbered asset is not required for the sale of the business, however, the stay could be lifted (see below, para. 60). 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 encumbered asset is being eroded and cannot be maintained.

### *7. Extension of the duration of the stay*

58. As noted above, where the stay applies for a specified period, the law may include provision for extension. Experience in some countries suggests that extension of the stay has been treated as a routine matter with the result that stays have regularly been extended for periods of up to several years, ultimately defeating the purpose of the insolvency proceedings and destroying any value that may have been available for creditors at the outset. To avoid such a situation, it is desirable that an insolvency law provide clear rules on the availability of extensions, limiting the parties that may apply and the grounds upon which an extension could be granted. An extension may be available, for example, on the application of the insolvency representative when it can be demonstrated that it 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 it is not detrimental to the interests of secured creditors. To provide additional protection and avoid the stay being applied for an uncertain or unnecessarily lengthy period, it is desirable that an insolvency law limit the period for which the stay can be extended and, possibly, the number of times extension is available.

### *8. Protection of secured creditors*

59. As noted above, where secured creditors are included in the scope of the stay, an insolvency law can adopt certain measures to protect their interests. In addition to limiting the duration of the stay, these measures may include allowing the stay to be lifted and adopting measures to ensure, where the value of the secured claim is more than or close to the value of the encumbered asset, that the value of the encumbered asset is protected against diminution as a result of the commencement of insolvency proceedings, either as a result of the use of the asset or because of the application of the stay. Since these measures are interrelated, it is desirable that an insolvency law adopt a coherent approach. Where the length of the application of the stay is short, for example, there may be no need for the law to require protection of the value of encumbered assets. Where the stay applies for a long time, however, lifting of the

stay may be a more cost effective remedy than providing protection for the value of the asset, provided the asset is not required for the proceedings. The interests of secured creditors can also be protected more generally, by consulting them on the use and sale of the encumbered assets; the payment of interest as far as the proceeds of the asset allow; and taking over the asset where the asset is worth less than the secured claim. These measures are discussed in the following sections. The desirability of approaches that provide protection for the value of the encumbered asset may need to be weighed against the potential cost and complexity of those measures, including valuation, and the need for the court to be able to make difficult commercial decisions on the question of protection. Where protection is provided, it may be desirable for an insolvency law to provide guidance on when and how creditors holding some type of security interest over the debtor's assets would be entitled to the types of protection described below.

(a) *Relief from the stay*

60. In liquidation and reorganization proceedings, circumstances may arise where it is appropriate to provide secured creditors with relief from the stay. For example, the secured creditor may be permitted to apply to the court for the stay to be lifted or the insolvency representative (without the approval of the court) may be permitted to release the asset. Relevant circumstances may include where the value of the secured creditor's claim exceeds the value of the encumbered asset; where the secured creditor is not receiving protection for the diminution in the value of the encumbered asset; where the provision of protection may not be feasible or would be overly burdensome to the estate; where the encumbered asset is not needed for the reorganization or sale of the business as a going concern in liquidation; where relief is required to protect or preserve the value of assets, such as perishable goods; or where, in reorganization, a plan is not approved within any applicable time limit.

61. Where relief from the stay is granted, the insolvency law may provide for the encumbered asset to be turned over to the secured creditor. The asset ceases to be part of the estate and the secured creditor will be free to enforce its rights. Under some insolvency laws the insolvency representative may be required to decide whether the asset should be turned over to the secured creditor or whether the asset can be relinquished, since the difference between these options may have cost implications for the estate. For example, where the asset is a large piece of equipment, turning it over to the creditor may require expenditure by the estate for transport, while relinquishment places the costs of removal on the creditor.

62. While provisions on relief from the stay principally address the interests of secured creditors, there are examples of insolvency laws that provide that relief from the stay may be granted to an unsecured creditor. This may be relevant, for example, where goods are perishable and, 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 for a claim against an insurer of the debtor to be pursued.

*(b) Protection of value*

63. Some insolvency laws adopt provisions specifically designed to address the negative impact of the stay on secured creditors by maintaining the economic value of secured claims during the period of the stay (in some jurisdictions referred to as “adequate protection”). Where the estate is able to maintain the value of encumbered assets, it can be approached in several ways.

*(i) Protecting the value of the encumbered asset*

64. One approach is to protect the value of the encumbered asset itself on the understanding that, upon liquidation, the proceeds of sale of the asset will be distributed directly to the creditor to the extent of the secured portion of their claim. This approach may require a number of steps to be taken.

65. During the period of the stay it is possible that the value of the encumbered asset 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 encumbered asset, that depreciation can prejudice the secured creditor. Some insolvency laws provide that the insolvency representative should protect secured creditors against any diminution either by providing additional or substitute assets or making periodic cash payments corresponding to the amount of the diminution in value. This approach is only necessary where the value of the encumbered asset is less than the amount of the secured claim. If the value exceeds the claim, the secured creditor will not be harmed by the diminution of value until that value becomes insufficient to pay the secured claim. Some States that preserve the value of the encumbered asset as outlined also allow for payment of interest during the period of the stay to compensate for delay imposed by the proceedings. Payment of interest may be limited, however, to the extent that the value of the encumbered asset exceeds the value of the secured claim. Otherwise, compensation for delay may deplete the assets available to unsecured creditors. Such an approach may encourage lenders to seek a security interest that will adequately protect the value of their claims.

*Valuation of encumbered assets*

66. Central to the notion of protecting the value of encumbered assets is the mechanism for determining the value of those assets to enable the court to consider whether and how much to provide to secured creditors as relief against the diminution of the value of encumbered assets during the proceedings. This is a potentially complex issue and involves questions of the basis on which the valuation should be made (e.g. going concern value or liquidation value); the party to undertake the valuation; and the relevant date for determining value, having regard to the purpose for which the valuation is required. In some cases, the parties may have valued assets before commencement of the

proceedings and that valuation may still be valid at commencement. There may be a need for an overall valuation shortly after commencement for the purpose of registering all assets and liabilities and preparing a net balance of the debtor's position, so that the insolvency representative will have some idea of the value of the estate. Assets, in particular encumbered assets, may need to be valued in the course of proceedings to determine the value of the secured claim (and any related unsecured claim) and issues of protection related to any diminution in that value. Assets may also need to be valued in support of the disposal of segments of the business or of specific assets other than in the ordinary course of business and at confirmation of an approved reorganization plan to satisfy applicable requirements. A related issue is the cost of valuation and the party that should bear that cost.

67. One approach is for the valuation, at least in the first instance, to be determined through agreement by the parties (being the debtor, or insolvency representative, and the secured creditor). Other laws provide different court-based approaches. For example, rather than undertaking the valuation itself, the court may specify a mode of determining the value, which might be carried out by appropriate experts. This could be supported by stating clear principles in the insolvency law as a basis for the valuation. An alternative approach is for the court, possibly following an initial estimate or appraisal of value by the insolvency representative, to determine the value on the basis of evidence, which might include a consideration of markets, market conditions and expert testimony. Some laws require a market valuation of an asset through sale, whereby the highest price available in the market for the asset is obtained via tender or auction. This valuation technique is less applicable to protection of either the value of the encumbered asset or the secured claim than it is to disposal of assets of the estate by the insolvency representative.

68. In some liquidation cases, the insolvency representative may find it necessary to use or sell encumbered assets (see below, paras. 83-86) 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 be maximized if the business continues to operate for a temporary period in liquidation, it may wish to sell inventory that is partially encumbered. In reorganization proceedings also, it may be in the best interests of the estate to sell encumbered assets of a similar nature to provide needed working capital. Thus, in cases where secured creditors are protected by preserving the value of the encumbered asset, it may be desirable for an insolvency law to allow the insolvency representative the choice of providing the creditor with substitute equivalent security interest, such as a replacement lien over another asset or the proceeds of the sale of the encumbered asset or paying out the full amount of the value of the assets that secure the secured claim either immediately or through an agreed payment plan. Other approaches focus on the use of the proceeds of the sale of the encumbered assets (see below, paras. 92 and 93). One method is for the court to prevent current or future use of those proceeds by the insolvency representative. Other laws grant secured creditors relief from the stay to pursue individual remedies regarding such proceeds or, where use of the proceeds is not authorized by either the secured creditor or the court, hold the debtor, its



management or the insolvency representative personally liable for the amount of the proceeds or make such debt non-dischargeable.

(ii) *Protecting the value of the secured portion of the claim*

69. A second 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. This approach avoids some of the complexities associated with ongoing valuation of the encumbered assets that may be required under the first approach noted above.

9. *Limitations on disposal of assets by the debtor*

70. In addition to measures designed to protect the insolvency estate against the actions of creditors and third parties, insolvency laws generally adopt measures that are intended to limit the extent to which the debtor can deal with assets of the estate (see above, para. 16). These measures generally will apply after proceedings have commenced, but may in some cases also apply between the application for commencement and commencement itself. For example, 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 generally have limited powers to deal with its assets (see above, para. 50). Under some insolvency laws, this period will only occur in the case of a creditor application because a debtor application will function to automatically commence the proceedings.

71. 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 only in the ordinary course of business. Transactions that do not fall into that category, such as the sale of significant assets that generally would be outside the ordinary course of business, may require authorization by the insolvency representative, the court or, in some cases, the creditors.

72. Where the debtor enters into an unauthorized transaction, whether between application and commencement or after commencement of proceedings, the effect would generally be that any property transferred should be returned to the insolvency representative and any obligations created would be unenforceable against the estate. There may be concerns, however, about the



counterparty to the transaction, especially where that party entered into the transaction in good faith and gave value for what was received. For that reason, some insolvency laws provide for those transactions to be valid in certain circumstances. These might include, for example, situations where the transfer was of an immovable and was made before the commencement of the insolvency was notified in the relevant registry or where a third party holding certain assets of the debtor transferred them to another party in good faith and without any knowledge of the commencement of insolvency proceedings. While operating to protect an innocent third party, such a provision nevertheless has the potential to reduce the assets available to creditors. For that reason, it is desirable that if any such provision is to be included in an insolvency law, it be narrowly framed. Because the delay between commencement and notification of commencement can be central to the occurrence of these transfers, it is essential that the requirements for giving notice of commencement result in early and effective notification (see chap. I, paras. 64-71).

73. Some insolvency laws address contracts entered into and transactions implemented by the debtor between application and commencement that are not authorized, whether by the insolvency law, the insolvency representative, the court or creditors (as required), in terms of the avoidance provisions, and apply the suspect period retrospectively from commencement of proceedings (see below, para. 188).

### ***Recommendations 39-51***

#### **Purpose of legislative provisions**

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

- (a) To establish measures to ensure that the value of the estate is not diminished by the actions of the debtor, creditors or third parties;
- (b) To determine the scope of those measures and the actions and parties to which they apply;
- (c) To establish the method, time and duration of application of those measures; and
- (d) To establish the grounds for relief from those measures.

#### **Contents of legislative provisions**

*Provisional measures*<sup>14</sup> (paras. 47-53)

39. The insolvency law should specify that the court may grant relief of a provisional nature, at the request of the debtor, creditors or third parties, where relief is needed to protect and preserve the value of the assets of the

<sup>14</sup>These articles follow the corresponding articles of the UNCITRAL Model Law on Cross-Border Insolvency, see article 19 (see annex III).

### ***Recommendations 39-51 (continued)***

debtor<sup>15</sup> or the interests of creditors, between the time an application to commence insolvency proceedings is made and commencement of the proceedings,<sup>16</sup> including:

(a) Staying execution against the assets of the debtor, including actions to make security interests effective against third parties and enforcement of security interests;

(b) Entrusting the administration or supervision of the debtor's business, which may include the power to use and dispose of assets in the ordinary course of business, to an insolvency representative or other person<sup>17</sup> designated by the court;

(c) Entrusting the realization of all or part of the assets of the debtor to an insolvency representative or other person designated by the court, in order to protect and preserve the value of assets of the debtor 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 or available on commencement of proceedings under recommendations 46 and 48.

#### *Indemnification in connection with provisional measures (para. 51)*

40. The insolvency law may provide the court with the power to:

(a) Require the applicant for provisional measures to provide indemnification and, where appropriate, to pay costs or fees; or

(b) Impose sanctions in connection with an application for provisional measures.

#### *Balance of rights between the debtor and insolvency representative (paras. 50 and 70-73)*

41. The insolvency law should clearly specify the balance of the rights and obligations between the debtor and any insolvency representative appointed as a provisional measure. Between the time an application for commencement of insolvency proceedings is made and commencement of those proceedings, the debtor is entitled to continue to operate its business and to use and dispose of assets in the ordinary course of business, except to the extent restricted by the court.

<sup>15</sup>The reference to assets in paragraphs (a)-(c) is intended to be limited to assets that would be part of the insolvency estate once proceedings commence.

<sup>16</sup>The insolvency law should indicate the time of effect of an order for provisional measures, for example, 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 (see above, para. 44).

<sup>17</sup>The term "other person" in recommendation 39, paragraphs (b) and (c), is not intended to include the debtor.

*Notice (para. 52)*

42. The insolvency law should specify that, unless the court limits or dispenses with the need to provide notice, appropriate notice is to be given to those parties in interest affected by:

(a) An application or court order for provisional measures (including an application for review and modification or termination); and

(b) A court order for additional measures applicable on commencement, unless the court limits or dispenses with the need to provide notice.

*Ex parte provisional measures (para. 52)*

43. The insolvency law should specify that, where the debtor or other party in interest affected by a provisional measure is not given notice of the application for that provisional measure, the debtor or other party in interest affected by the provisional measures has the right, upon urgent application, to be heard promptly<sup>18</sup> on whether the relief should be continued.

*Modification or termination of provisional measures (para. 53)*

44. The insolvency law should specify that the court, at its own motion or at the request of the insolvency representative, the debtor, a creditor or any other person affected by the provisional measures, may review and modify or terminate those measures.

*Termination of provisional measures (para. 53 and chap. I, para. 63)*

45. The insolvency law should specify that provisional measures terminate when:

(a) An application for commencement is denied;

(b) An order for provisional measures is successfully challenged under recommendation 43; and

(c) The measures applicable on commencement take effect, unless the court continues the effect of the provisional measures.

*Measures applicable on commencement (paras. 30-34)*

46. The insolvency law should specify that, on commencement of insolvency proceedings:<sup>19</sup>

(a) Commencement or continuation of individual actions or proceedings<sup>20</sup> concerning the assets of the debtor and the rights, obligations or liabilities of the debtor are stayed;

<sup>18</sup>Any time limit included in the insolvency law should be short in order to prevent the loss of value of the debtor's business.

<sup>19</sup>These measures would generally be effective as at the time of the making of the order for commencement.

<sup>20</sup>See UNCITRAL Model Law on Cross-Border Insolvency, article 20 (see annex III). It is intended that the individual actions referred to in subparagraph (a) of recommendation 46 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.

### ***Recommendations 39-51 (continued)***

(b) Actions to make security interests effective against third parties and to enforce security interests are stayed;<sup>21</sup>

(c) Execution or other enforcement against the assets of the estate is stayed;

(d) The right of a counterparty to terminate any contract with the debtor is suspended;<sup>22</sup> and

(e) The right to transfer, encumber or otherwise dispose of any assets of the estate is suspended.<sup>23</sup>

#### *Exceptions to application of the stay (para. 35)*

47. The insolvency law may permit exceptions to the application of the stay or suspension under recommendation 46 and, where it does so, those exceptions should be clearly stated. Paragraph (a) of recommendation 46 should not affect the right to commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor.<sup>24</sup>

#### *Additional measures available on commencement (para. 34)*

48. The insolvency law should specify that the court may grant relief additional to the measures applicable on commencement.<sup>25</sup>

#### *Duration of measures automatically applicable on commencement (paras. 54-58)*

49. The insolvency law should specify that the measures applicable on commencement of insolvency proceedings remain effective throughout those proceedings until:

<sup>21</sup>If law other than the insolvency law permits those security interests to be made effective within certain specified time periods, it is desirable that the insolvency law recognize those periods and permit the interest to be made effective where the commencement of insolvency proceedings occurs before expiry of the specified time period. Where law other than the insolvency law does not include such time periods, the stay applicable on commencement would operate to prevent the security interest being made effective. (For further discussion see above, paragraph 32, and the *UNCITRAL Legislative Guide on Secured Transactions*.)

<sup>22</sup>See below, paras. 114-119. This recommendation is not intended to preclude the termination of a contract if the contract provides for a termination date that happens to fall after the commencement of insolvency proceedings.

<sup>23</sup>The limitation on the right to transfer, encumber or otherwise dispose of assets of the estate may be subject to an exception in those cases where the continued operation of the business by the debtor is authorized and the debtor can transfer, encumber or otherwise dispose of assets in the ordinary course of business.

<sup>24</sup>See UNCITRAL Model Law on Cross-Border Insolvency, art. 20, para. 3, and Guide to Enactment, paras. 151 and 152 (see annex III). Where an issue arises as to quantification of a claim, the court may be requested to consider whether relief from the stay can be provided to enable an action or proceeding to be commenced for that purpose.

<sup>25</sup>The additional relief that may be available will depend upon the types of measure available in a particular jurisdiction and what measures, in addition to the measures applicable on commencement (such as under recommendation 46), might be appropriate in a particular insolvency proceeding.

(a) The court grants relief from the measures;<sup>26</sup>

(b) In reorganization proceedings, a reorganization plan becomes effective;<sup>27</sup> or

(c) In the case of secured creditors in liquidation proceedings, a fixed time period specified in the law expires,<sup>28</sup> unless it is extended by the court for a further period on 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 be protected against diminution of the value of the encumbered asset in which it has a security interest.

*Protection from diminution of the value of encumbered assets (paras. 63-69)*

50. The insolvency law should specify that, upon application to the court, a secured creditor should be entitled to protection of the value of the asset in which it has a security interest. The court may grant appropriate measures of protection that may include:

- (a) Cash payments by the estate;
- (b) Provision of additional security interests; or
- (c) Such other means as the court determines.

*Relief from measures applicable on commencement (paras. 60-62)*

51. The insolvency law should specify that a secured creditor may request the court to grant relief from the measures applicable on commencement of insolvency proceedings on grounds that may include that:

- (a) The encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business;
- (b) The value of the encumbered asset is diminishing as a result of the commencement of insolvency proceedings and the secured creditor is not protected against that diminution of value; and
- (c) In reorganization, a plan is not approved within any applicable time limits.

<sup>26</sup>Relief should be granted on the grounds included in recommendation 51.

<sup>27</sup>A plan may become effective upon approval by creditors or following confirmation by the court, depending upon the requirements of the insolvency law (see chap. IV, paras. 54 and following).

<sup>28</sup>It is intended that the stay should apply to secured creditors only for a short period of time, such as between 30 and 60 days, and that the insolvency law should clearly state the period of application.

## C. Use and disposal of assets

### 1. Introduction

74. Although as a general principle it is desirable that an insolvency law not interfere unduly with the ownership rights of third parties or the interests 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 (including by way of encumbrance) 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 for a short period to enable the value of the assets to be maximized even if they are to be sold piecemeal. For these reasons, it is desirable that an insolvency law include provisions on the use or disposal of assets of the insolvency estate (including encumbered assets), and third-party-owned assets, addressing the conditions upon which those assets may be used or disposed of and the provision of protection for the interests of third-party owners and secured creditors. Sale or disposal of assets would typically involve notifying creditors, whether generally or only affected creditors, of any proposed action. Where notice is to be given to creditors generally, it may be provided through any creditor committee formed to facilitate the proceedings (see chap. III, paras. 99-112). It may be important to note, in designing provisions on use and disposal, that other laws may affect the use of these powers in insolvency. For example, laws prohibiting or restricting foreign ownership in certain sectors of the economy may limit the price that can be obtained for certain assets and in turn affect distributions to creditors.

### 2. Assets of the insolvency estate

#### (a) Ordinary course of business

75. Some insolvency laws draw a distinction between use or disposal of assets of the estate in the ordinary course<sup>29</sup> of conducting the business of the debtor and use or disposal in other circumstances ("outside the ordinary course of business") in terms of who may make decisions as to use or disposal and the protections that are required. When the insolvency representative continues the operation of the debtor's business, either during reorganization proceedings or to enable a sale of the business as a going concern, decisions as to use and disposal of property in the ordinary course of business may be taken by the

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<sup>29</sup>This concept is discussed further in the context of avoidance proceedings; see below, paras. 164-168. States define the "ordinary course of business" with a varying emphasis on different elements. However, in most jurisdictions a common purpose of the definition is to determine what constitutes routine conduct of business and allow a business to make routine payments and enter into routine contracts, without subjecting those transactions to possible avoidance in insolvency. Those routine payments might include the payment of rent, utilities such as electricity and telephone and possibly also payment for trade supplies.

insolvency representative<sup>30</sup> without requiring notice to be given to creditors or approval of the court. Use and disposal outside the ordinary course of business, however, may require approval of the court or of creditors. Some laws extend these rights of use and disposal to a debtor under the supervision or control of an insolvency representative or to a debtor-in-possession. When the assets are subject to a security or other interest (e.g. a lease) the economic rights of the holder of that interest will need to be protected.

76. Including a distinction in the insolvency law between disposals made in or outside the ordinary course of business may facilitate the continuing day-to-day operation of the business, both in reorganization and in liquidation where it is to be sold as a going concern, without imposing the complexity of obtaining court approval to conduct routine activities. The requirement for approval in the case of non-routine disposal can act as a check against abuse, such as disposals to related parties. Nevertheless, an insolvency law needs to provide clear guidance on what constitutes dealing in the ordinary course of business in order to avoid disputes and ensure that the proceedings are conducted quickly and efficiently. Sale or other disposal of assets outside the ordinary course of business raises several complicated issues, which are discussed below, including the method of sale designed to generate the most value for the estate; the sale of encumbered assets when there is a dispute concerning the validity or amount of the secured claim or when the value of the estate will be enhanced by that sale; notice to parties in interest and an opportunity for interested buyers to submit higher and better offers; prompt sale in the case of perishable assets; and the power to abandon assets that have no value to the estate.

77. Some insolvency laws also distinguish between different types of asset in terms of how they may be used and the conditions that will apply. Special provisions may apply, for example, to perishable or other assets that will diminish in value if not sold quickly or to cash or to property held jointly by the debtor and another person or held by the debtor subject to a security interest. An insolvency law may provide that such assets can be sold outside the ordinary course of business without prior approval of creditors or of the court.

78. Any concerns with respect to possible misuse of powers of use and disposal or defalcation by the insolvency representative may be addressed in terms of the appointment criteria, including provision of a security bond (an approach adopted by many insolvency laws—see also chap. III, para. 62) and through other measures to address the liability of the insolvency representative.

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<sup>30</sup>The exercise of these rights by the insolvency representative depends upon the functions of that position under the insolvency law and may be restricted, for example, where the insolvency representative's role is that of a trustee or supervisor and also upon the relative roles assigned to the debtor and insolvency representative after commencement of insolvency proceedings, in particular in reorganization.

(b) *Methods of sale*

79. Where assets of the insolvency estate are to be sold it is important that, irrespective of which party may be required to supervise sales, the manner of sale chosen maximizes the value for the estate and that creditors receive adequate notice of the sale, enabling them to challenge the sale in court if they disapprove. Where a creditor committee is formed and the insolvency law provides for creditors to be consulted on the sale of assets outside the ordinary course of business, a requirement to notify creditors of any proposed sale might be satisfied by notifying the creditor committee in order to minimize costs and avoid any delay associated with notifying all creditors. Different procedures are adopted with respect to the sale of assets. Many insolvency laws require assets to be sold by auction, with some providing that the creditor committee, or some other creditor representative or the insolvency representative, can approve some other means of sale, such as by private contract, if it will be more profitable.

80. As noted above, some insolvency laws give the power of sale in the ordinary course of business 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 the court to supervise the sale or creditors to approve it. Other insolvency laws provide for the court to play a significant role in the sale of assets. The court fixes 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 any of the debtor's assets in the possession of a third party to that third party for a reasonable market price. Where assets might be subject to rapid deterioration of value, such as where they are perishable, susceptible to devaluation or otherwise in jeopardy, notification and/or approval of creditors or the court might prove difficult to achieve quickly. In such cases it may be desirable for the law to provide that prior approval is not necessary. While the sale could be confirmed after it has been completed, it would not be feasible to create a possibility of reversing or modifying the sale (except in cases of fraud or collusion) because of the consequential contractual uncertainty, and the very nature of the assets may discount the likelihood of any resale.

81. Although it may be suggested that an insolvency law should specifically preclude a sale to related parties to avoid collusion, absolute prohibition of such a sale may not be necessary, provided it is adequately supervised and carefully scrutinized before being allowed to proceed, to avoid fraud and collusion. Such supervision or scrutiny may require higher standards in terms of the valuation of assets and disclosure of business relationships.



82. While it may be expected that assets sold in the context of insolvency proceedings will achieve a lower sale price than similar assets sold under normal market conditions, an insolvency law can adopt a number of procedural protections to ensure that the proceedings are fair, that the maximum price is achieved and that, overall, the procedure for disposal of assets is transparent and well-publicized. Such protections include providing notice to creditors and to prospective purchasers in a manner that will ensure the information is likely to come to the attention of interested parties; allowing creditors to raise their objections or concerns (either with the insolvency representative or the court, as appropriate); requiring assets to be valued by neutral, independent professionals (especially in the case of real estate and specialized property); and, in the case of auctions, requiring pre-bidding qualification and minimum prices where appropriate and preventing and punishing collusion among bidders.

*(c) Use or disposal of encumbered assets*

83. An insolvency law will need to address the question of use or disposal (including by further encumbrance) of encumbered assets and, in particular, 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 encumbered assets in the insolvency estate; if not, the secured creditor will generally be free to enforce its security interest. Where encumbered assets are part of the estate, insolvency laws take different approaches to the issue. In some cases, the approach depends upon the application of other provisions of the insolvency law, such as application of the stay (while the stay applies only the insolvency representative can dispose of the assets), as well as law other than insolvency law, and whether encumbered assets can be sold 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 encumbered assets in both liquidation and reorganization. Other laws distinguish between liquidation and reorganization; the insolvency representative will be able to dispose of the assets during reorganization, but in liquidation this ability is time-limited. Once the insolvency representative's exclusive period has expired, the secured creditor may exercise its rights. Whichever approach is adopted, an insolvency law should require secured creditors to be notified of any proposed disposal and have an opportunity to object. Where the secured claim exceeds the value of the asset or the asset is not required for the proceedings, the insolvency representative may be permitted to relinquish the encumbered asset to the secured creditor without notice.

84. An insolvency law should also outline the conditions (including provision of notice and an opportunity for existing secured creditors to object) for further encumbrance of already encumbered assets, the most common being that the

existing secured creditor will have priority for the secured portion of its claim over any new secured creditor (see below, paras. 103 and 104).

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

85. Some insolvency laws permit the insolvency representative to 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 law other than the insolvency law; that the holder of the interest is notified of the proposed sale and consents; that the sale price is in excess of the value of the security interest; that the holder of the security interest could be compelled (in other legal proceedings) to accept cash or substitute equivalent security interest in settlement of its interest; and that the priority of interests in the proceeds of any sale will be preserved. Some laws also provide that, where the holder of the security interest does not consent to the sale, the insolvency representative may request the court to authorize 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 holder of the interest. Even where the court approves the sale, if the offer for the asset was inadequate, the law might permit the holder of the security interest to retain the right to offset the bid to protect its interest.

86. Some advantages of allowing the insolvency representative to sell free and clear are that assets sold subject to these interests are likely to obtain much lower prices and considerable uncertainty will exist for the buyer. Where encumbered assets are subject to conflicting claims (e.g. ownership, lease or lien), the ability to sell free and clear of interests will allow the assets (where they are not unique) to be sold without waiting for the claims to be resolved. The claimants can then dispute the distribution of the proceeds of sale.

*(e) Joint assets*

87. Where the debtor and another person own assets in some form of joint or co-ownership, different approaches may be taken to the disposal of the estate's interest. Where the assets can be divided, generally under law other than insolvency law, between the debtor and the co-owners for the purposes of execution, the estate's interest can be sold without affecting the co-owners. Some insolvency laws, however, provide that the insolvency representative may sell both the estate's interest and that of the co-owners, provided certain conditions are met. These conditions may include that division of the property between the estate and the co-owners is impractical; that 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 that the benefit to the estate of such a sale outweighs any detriment to the co-owner. An insolvency law

may also provide that the co-owner has an option or right to purchase the debtor's interest before completion of the sale to another party. As noted above (paras. 20 and 21), the disposal of such assets in insolvency may be affected by the application of law other than insolvency law.

(f) *Burdensome, no-value and hard-to-realize assets*

88. It may be consistent with the objective of maximizing value and reducing the costs of the proceedings to allow the insolvency representative to relinquish the estate's interest in certain assets, including land, shares, assets subject to a valid security interest, contracts and other property, where the insolvency representative determines relinquishment to be in the interests of the estate and additionally where a secured creditor obtains relief from the stay. The exercise of that power may be subject to approval by the court and to certain conditions, such as that the relinquishment does not violate any compelling public interest that may exist, for example, where the asset is environmentally dangerous or hazardous to public health and safety. An insolvency law may also need to address who might be entitled to claim the relinquished assets. Situations in which this approach may be appropriate include where assets are of no or an insignificant value to the estate (e.g. the security interest exceeds the value of the encumbered asset); 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 by the insolvency representative, such as where the asset is unique or does not have a readily apparent market or market value. Where a secured creditor is given an asset relinquished by an insolvency representative, the insolvency law might provide that the secured creditor's claim is reduced by the value of the relinquished asset. Creditors should be provided with notice of, and given an opportunity to object to, any proposal by the insolvency representative to relinquish assets.

(g) *Receivables*

89. Where the assets of the estate include receivables (the debtor's contractual right to payment of a monetary sum), permitting the insolvency representative to assign the rights to payment may enable value or a credit to be obtained for the estate. Different approaches are taken to the question of assignment in the context of insolvency (see below, paras. 139-142). 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 the contract cannot be assigned unless the parties to the original contract agree. Some laws also provide that, if the counterparty to the original contract 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. This approach is consistent with the approach taken

in the United Nations Convention on the Assignment of Receivables in International Trade, article 9.<sup>31</sup>

### 3. *Third-party-owned assets*

90. There will be insolvency cases where third-party-owned assets, similarly to encumbered assets, may be crucial to the continued operation of the business, in particular in reorganization proceedings but also to a lesser extent in those liquidation proceedings where the business is to be sold as a going concern. In those cases, it will be advantageous for the insolvency proceedings if an insolvency law includes a mechanism that will enable such assets to continue to be used. Some insolvency laws address this issue in terms of the types of asset to be included as part of the insolvency estate (see above, paras. 10-12 and 17) and therefore available for use by the insolvency representative. It should be noted that, for the purposes of the *Legislative Guide*, the debtor's interests in third-party-owned assets are considered to be assets. Other insolvency laws, where the possession of the asset by the debtor is subject to a contractual arrangement, address the question of use 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 (see below, paras. 114-119) or preventing the owner from reclaiming its assets in the insolvency (at least without the approval of the court or the insolvency representative) for a limited period of time after commencement through application of a stay.

91. Where third-party-owned assets are used in the insolvency proceedings, an insolvency law will need to consider protection of the interests of the owner of the assets against diminution in their value, in much the same way as protection is provided against diminution in the value of encumbered assets (see above, paras. 63-69). It is desirable that claims arising from the continued use of the asset be paid by the estate as an administrative expense (see below, para. 131).

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<sup>31</sup>Article 9, Contractual limitations on assignment, reads:

"1. An assignment of a receivable is effective notwithstanding any agreement between the initial or any subsequent assignor and the debtor or any subsequent assignee limiting in any way the assignor's right to assign its receivables.

"2. Nothing in this article affects any obligation or liability of the assignor for breach of such an agreement, but the other party to such agreement may not avoid the original contract or the assignment contract on the sole ground of that breach. A person who is not party to such an agreement is not liable on the sole ground that it had knowledge of the agreement.

"3. This article applies only to assignments of receivables:

"(a) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of real property;

"(b) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;

"(c) Representing the payment obligation for a credit card transaction; or

"(d) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties."

#### 4. Treatment of cash proceeds

92. Where “liquid” encumbered assets (i.e. encumbered assets, such as inventory, that are easily converted to cash) are sold in the course of insolvency proceedings, most laws provide that a secured creditor with an interest in those encumbered assets continues to hold an equivalent interest in any cash derived from the disposal of those assets.

93. Those cash proceeds can represent an important source of capital for the insolvency estate during the course of insolvency proceedings, especially in reorganization, and may be used for a number of purposes associated with the running of the business, such as payment of electricity and other service charges. In order to use cash proceeds, an insolvency representative must generally pursue one of two courses of action. Cash proceeds may be used with the consent of the relevant secured creditor on the terms agreed between the parties or, alternatively, following provision of notice to affected creditors, the debtor may seek court approval to use the cash proceeds. In general, a court will need to determine a number of matters before authorizing such use: both the relevant security interest and the value of the underlying property; the risk to the secured creditor; and whether sufficient measures are in place to protect the economic value of the secured claim (see above, paras. 63-69).

#### ***Recommendations 52-62***

##### **Purpose of legislative provisions**

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

- (a) Permit the use and disposal of assets, including encumbered assets in the insolvency proceedings and specify the conditions for their use and disposal;
- (b) Permit and specify the conditions for the use of third party owned assets;
- (c) Establish the limits to powers of use and disposal;
- (d) Notify creditors of proposed use and disposal, where appropriate; and
- (e) Provide for the treatment of burdensome assets.

##### **Contents of legislative provisions**

*Power to use and dispose of assets of the estate (para. 74)*

52. The insolvency law should permit:

- (a) The use and disposal of assets of the estate (including encumbered assets) in the ordinary course of business, except cash proceeds; and
- (b) The use and disposal of assets of the estate (including encumbered assets) outside the ordinary course of business, subject to the requirements of recommendations 55 and 58.

**Recommendations 52-62 (continued)***Further encumbrance of encumbered assets (para. 84)*

53. The insolvency law should specify that an encumbered asset may be further encumbered, subject to the requirements of recommendations 65-67.

*Use of third-party-owned assets (paras. 90-91)*

54. The insolvency law should specify that the insolvency representative may use an asset owned by a third party and in the possession of the debtor provided specified conditions are satisfied, including:

- (a) The interests of the third party will be protected against diminution in the value of the asset; and
- (b) The costs under the contract of continued performance of the contract and use of the asset will be paid as an administrative expense.

*Procedure for notification of disposal (para. 82)*

55. The insolvency law should specify that adequate notice of any disposal conducted outside the ordinary course of business be given to creditors<sup>32</sup> and that they have the opportunity to be heard by the court.

56. The insolvency law should specify that notification of public auctions be provided in a manner that will ensure that the information is likely to come to the attention of interested parties.

*General methods of sale (paras. 79-82)*

57. The insolvency law should specify methods of sale for sales conducted outside the ordinary course of business that will maximize the price obtained for assets being sold in insolvency proceedings, and permit both public auctions and private sales.

*Ability to sell assets of the estate free and clear of encumbrances and other interests (paras. 85 and 86)*

58. The insolvency law should permit the insolvency representative to sell an asset that is encumbered or subject to other interest free and clear of that encumbrance and other interest, outside the ordinary course of business, provided that:

- (a) The insolvency representative gives notice of the proposed sale to the holders of encumbrances or other interests;
- (b) The holder is given the opportunity to be heard by the court where they object to the proposed sale;
- (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.

<sup>32</sup>When the assets are encumbered assets or subject to other interests, recommendation 58 also applies.

*Use of cash proceeds (paras. 92 and 93)*

59. The insolvency law should permit the insolvency representative to use and dispose of cash proceeds if:

- (a) The secured creditor with a security interest in those cash proceeds consents to such use or disposal; or
- (b) The secured creditor was given notice of the proposed use or disposal and an opportunity to be heard by the court; and
- (c) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.

*Urgent sales (para. 77 and 80)*

60. The insolvency law should permit the urgent sale of an asset to be conducted outside the ordinary course of business, where the asset is, by its nature or because of other circumstances, perishable, susceptible to devaluation or otherwise in jeopardy. The insolvency law may provide that prior approval of the court or of creditors is not required in such circumstances.

*Disposal of assets to related persons (para. 81)*

61. The insolvency law should require any proposed disposal of an asset to a related person to be carefully scrutinized before being allowed to proceed.

*Burdensome assets (para. 88)*

62. The insolvency law should permit the insolvency representative to determine the treatment of any asset that is burdensome to the estate. In particular, the insolvency law may permit the insolvency representative to relinquish a burdensome asset following the provision of notice to creditors and the opportunity for creditors to object to the proposed action, except that where a secured claim exceeds the value of the encumbered asset and the asset is not required for a reorganization or sale of the business as a going concern, the insolvency law may permit the insolvency representative to relinquish the asset to the secured creditor without notice to other creditors.

## **D. Post-commencement finance**

### *1. Need for post-commencement finance*

94. The continued operation of the debtor's business after the commencement of insolvency proceedings is critical to reorganization and, to a lesser extent, 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. 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.

95. 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 be made at an early stage, in some cases even in the period between the time the application is made and commencement of proceedings. The availability of new finance will also be important in reorganization proceedings between commencement of the proceedings and approval of the plan; obtaining finance in the period after approval of the plan should generally be addressed in the plan, especially in those jurisdictions which prohibit new borrowing unless the need for it is identified in the plan.

96. Notwithstanding that it might be beneficial to the outcome of the proceedings for the debtor to be able to obtain new money, a number of jurisdictions restrict the provision of new money in insolvency or do not specifically address the issue of new finance or the priority for its repayment in insolvency, which creates uncertainty. Under some laws, for example, new money can only be provided on the basis of a security interest, as provision of a preference for new lending is prohibited. In those cases where there are no unencumbered assets, or no excess value in already encumbered assets, that the debtor can offer as security or with which the debtor can satisfy an administrative expense priority claim, the debtor has limited options. No new money will be available unless the lender is prepared to take the risk of lending without security or unless it can be obtained from sources such as the debtor's family or group companies. In the absence of enabling or clarifying treatment in the insolvency law, the provision of finance in the period before commencement of the insolvency proceedings may also raise difficult questions relating to the application of avoidance powers and the liability of both the lender and the debtor. Some insolvency laws provide, for example, that where a lender advances funds to an insolvent debtor in that period, it may be responsible for any increase in the liabilities of other creditors or the advance will be subject to avoidance in any ensuing insolvency proceedings. In other examples, the insolvency representative is required to borrow the money, potentially involving questions of personal liability for repayment.

97. Where an insolvency law promotes the use of insolvency proceedings that permit the insolvent business to continue trading, whether reorganization or sale of the business in liquidation as a going concern, it is essential that the issue of new funding is addressed and limitations such as those discussed above are considered. An insolvency law can recognize the need for such post-commencement finance, provide authorization for it and create priority or security 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 to encourage it to lend. To the extent that the solution adopted has an impact on 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 finance be balanced against a number of factors. These include 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. It is also important to consider the impact on unsecured creditors who may see the remaining unencumbered assets disappear to secure new lending, leaving nothing available for distribution, especially if the reorganization were to fail. This risk must be balanced against the prospect that preservation of going concern value by continued operation of the business will benefit those creditors.

98. In addition to issues of availability and priority or security for new lending, an insolvency law will need to consider the authorization required to obtain that new money (see below, paras. 105 and 106) and, where a reorganization fails and the proceedings are converted to liquidation, the treatment of funds that may have been advanced before the conversion (see below, para. 107).

## 2. Sources of post-commencement finance

99. 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 the post-commencement finance. 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 priority or security

100. A number of different approaches can be taken to attracting post-commencement finance and providing for repayment. Trade credit or indebtedness incurred in the ordinary course of business by an insolvency representative (or a debtor in possession) may be treated automatically as an administrative expense. When obtaining credit or incurring indebtedness is essential to maximizing the value of assets, and the credit or finance is not

otherwise available as an administrative expense or is to be incurred outside the ordinary course of business, the court may authorize that credit or debt to be incurred as an administrative expense, to be afforded super-priority ahead of other administrative expenses or to be supported by the provision of security on unencumbered or partially encumbered assets.

(a) *Establishing priority*

101. Where the business of the debtor continues to operate after commencement of insolvency proceedings, either incidental to an attempted reorganization or to preserve value by sale as a going concern, the expenses incurred in the operation of the business are typically entitled, under a number of insolvency laws, to be paid as administrative expenses. Administrative priority creditors do not rank ahead of a secured creditor with respect to its security interest, but generally are afforded a first priority (see chap. V, paras. 45-47 and 66) that ranks ahead of ordinary unsecured creditors and any statutory priorities, for example, taxes or social security claims. Suppliers of goods and services would only continue to supply those goods and services to the insolvency representative on credit if they had a reasonable expectation of payment ahead of pre-commencement unsecured creditors. In some cases, such a priority is afforded on the basis that the new credit or lending is extended to the insolvency representative, rather than to the debtor, and thus becomes an expense of the insolvency estate. Some insolvency laws require such borrowing or credit to be approved by the court or by creditors, while other laws provide that the insolvency representative may obtain the necessary credit or finance without approval. This may involve an element of personal liability for the insolvency representative and, where it does, is likely to result in reluctance to seek new finance.

102. Other insolvency laws provide for a “super” administrative priority if credit or finance is not available where it is ranked as an administrative claim that is *pari passu* with other administrative claims such as fees of the insolvency representative or professional employed in the case. The “super” priority ranks ahead of administrative creditors.

(b) *Granting security*

103. Where the lender requires security, it can be provided on unencumbered assets or as a junior or lower security interest on already encumbered assets where the value of the encumbered asset is sufficiently in excess of the amount of the pre-existing secured obligation. In that case, no special protections will generally be required for the pre-existing secured creditors, as their rights will not be adversely affected unless circumstances change at a later time (such as that the value of the encumbered assets begins to diminish) and they will retain their pre-commencement priority in the encumbered asset, unless they agree otherwise. Frequently, the only unencumbered assets that may be available for securing post-commencement finance will be assets recovered through avoidance proceedings. However, providing security on such assets is controversial under some insolvency laws and is not permitted.

104. Some insolvency laws provide that new lending may be afforded some level of priority over existing secured creditors, (sometimes referred to as a “priming lien”). In States where this latter type of priority is permitted, insolvency courts recognize the risk to the existing secured creditors 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 protection for any diminution of the economic value of encumbered assets, including by a sufficient excess in the value of the encumbered asset. In some legal systems, all of the priority, super-priority, security and priming lien options for attracting post-commencement finance are available to cover the new lending. As a general rule, the economic value of the rights of pre-existing secured creditors should be protected so that they will not be harmed. If necessary, this can be achieved, as noted above (see paras. 63-69), by making periodic payments or providing security rights in additional assets in substitution for any assets that may be used by the debtor or encumbered in favour of new lending.

#### 4. *Authorization for post-commencement finance*

105. It may be desirable to link the issue of authorization for new lending to the damage that may occur or the benefit that is likely to be provided as a result of the provision of new finance. A number of insolvency laws permit the insolvency representative (or a debtor-in-possession where that approach is followed) to determine that new money is required for the continued operation or survival of the business or the preservation or enhancement of the value of the estate and obtain unsecured credit without approval by the court or by creditors. Other laws require approval by the court or creditors in certain circumstances. Given that new finance may be required on a fairly urgent basis to ensure the continuity of the business, it is desirable that the number of authorizations required be kept to a minimum. An insolvency law may take a hierarchical approach to the authorization required, depending upon the security or priority to be provided and the level of credit or finance to be obtained. Although requiring court involvement may generally 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. Similarly, where secured creditors consent to revised treatment of their security interests, approval of the court may not be required. In any event, the court will generally not have access to expertise or information additional to that provided by the insolvency representative on which to base its decision.

106. The question of providing security over unencumbered assets or assets that are not fully encumbered is not one that generally should require approval of the court. Where the insolvency law establishes the level of priority that generally can be given, for example, an administrative priority, court approval may not be required. Should court approval be considered desirable, an intermediate approach may be to establish a monetary threshold above which

approval of the court is required. However, where the security or priority to be given affects the interests, for example, of existing secured creditors and those secured creditors do not support what is proposed, approval of the court should be required.

### 5. *Effects of conversion*

107. Some insolvency laws provide that any security or priority provided in respect of new lending can be set aside in a subsequent liquidation, and may give rise to liability for delaying the commencement of liquidation and potentially damaging the interests of creditors. Such an approach has the potential to act as a disincentive to commencing reorganization. A more desirable approach may be to provide that creditors obtaining priority for new funding will retain that priority in any subsequent liquidation. A further approach provides that the priority will be recognized in a subsequent liquidation, but will not necessarily be accorded the same level of and may rank, for example, after administrative claims relating to the costs of the liquidation or *pari passu* with administrative expenses.

#### ***Recommendations 63-68***

##### **Purpose of legislative provisions**

The purpose of provisions on post-commencement finance is:

- (a) To facilitate finance 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 estate;
- (b) To ensure appropriate protection for the providers of post-commencement finance; and
- (c) To ensure appropriate protection for those parties whose rights may be affected by the provision of post-commencement finance.

##### **Contents of legislative provisions**

*Attracting and authorizing post-commencement finance*  
(paras. 94-100, 105 and 106)

63. The insolvency law should facilitate and provide incentives for post-commencement finance to be obtained by the insolvency representative 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 estate. The insolvency law may require the court to authorize or creditors to consent to the provision of post-commencement finance.

*Priority for post-commencement finance (paras. 101 and 102)*

64. The insolvency law should establish the priority that may be accorded to post-commencement finance, ensuring at least the payment of the post-commencement finance provider ahead of ordinary unsecured creditors, including those unsecured creditors with administrative priority.

*Security for post-commencement finance (paras. 103 and 104)*

65. The insolvency law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower-priority security interest on an already encumbered asset of the estate.

66. The law<sup>33</sup> should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation 67.

67. The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:

- (a) The existing secured creditor was given 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 will be protected.<sup>34</sup>

*Effect of conversion on post-commencement finance (para. 107)*

68. The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the reorganization should continue to be recognized in the liquidation.<sup>35</sup>

## E. Treatment of contracts

### 1. Introduction

108. As an economy develops, more and more of its wealth is likely to be contained in or controlled by contracts. As a result, the treatment of contracts is of overriding importance to insolvency proceedings. There are two overall

<sup>33</sup>This rule may be in a law other than the insolvency law, in which case the insolvency law should note the existence of the provision.

<sup>34</sup>See above, paras. 63-69.

<sup>35</sup>The same order of priority may not necessarily be recognized. For example, post-commencement finance may rank in priority after administrative claims relating to the costs of the liquidation.

difficulties in developing legal policies in that regard. The first difficulty is that, unlike all other assets of the insolvency estate, contracts are usually 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. 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.

109. Achieving the objectives of maximizing the value of the estate and reducing liabilities and, in reorganization, enabling the debtor to survive and continue its affairs to the maximum extent possible in an uninterrupted manner may involve taking advantage of those contracts which are beneficial and contribute value to the estate (including contracts that will enable the continued use of crucial property that may be owned by a third party) and rejecting those which are burdensome or those where the ongoing costs of performance exceed the benefit to be derived from the contract. As an example, in a contract where the debtor has agreed to purchase particular goods at a price that is half the market price at the time of the insolvency, obviously it would be advantageous to the insolvency representative to be able 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 to require performance of the contract demands no more of the counterparty than that it observe the bargain it made prior to insolvency. In many systems it will not be permitted to escape performance of the contract, 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.

110. 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. Other competing interests may need to be weighed to ensure that an appropriate balance is achieved between general public policy goals, the goals of insolvency and predictability in commercial relations. These interests include the relative importance of reorganization and the participation of secured creditors in insolvency; particular social concerns raised by some types of contract such as labour contracts (see below, para. 144, and chapter V, paras. 72 and 73); the effect of permitting interference with the continuing performance of contracts on the predictability of commercial and financial relations, and on the cost and availability of credit (the wider the powers to continue 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 the powers to affect the performance of contracts will enhance the reuse of assets.

111. Where an insolvency law adopts the approach of permitting interference with the performance of contracts that may be contrary to general contractual principles, the extent of those powers and the types of contract that can be affected require careful consideration. It is almost inevitable that, at the commencement of insolvency proceedings, the debtor will be a party to at least one contract where neither it nor the counterparty have fully performed their respective obligations, other than the payment of money for goods delivered. 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. 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 may be subject to the stay in a manner that prevents the counterparty from exercising a right of termination, allowing performance to continue or the contract to be rejected (or possibly assigned, although this is not widely permitted). Typically, the insolvency representative is charged with making this evaluation of how the contract should be treated. Jurisdictions differ, however, on the question of whether court approval is also required.

112. In reorganization, where the objective of the proceedings is to enable the debtor to survive and continue its affairs to the extent possible, the continuation of contracts that are beneficial or essential to the debtor's business and contribute value to the estate may be crucial to the success of the proceedings. These may include contracts for the supply of essential goods and services or contracts concerning the use of property crucial to the continued operation of the business, including property owned by third parties. Similarly, 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. 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 debtor's 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.

113. As to the types of contract to be affected, a common solution is for insolvency laws to provide general rules for all kinds of contract and exceptions for certain special contracts. The ability to reject labour contracts, for example, may need to be limited in view of concerns that insolvency can be used as a means of expressly eliminating the protections that these contracts



afford to employees. Other types of contract requiring special treatment may include financial contracts (see below, paras. 208-215), 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, as well as contracts for loans and insurance.

## 2. *Automatic termination, acceleration or similar clauses*

114. Many contracts include a clause that defines events of default giving the counterparty an unconditional right, for example, of termination or acceleration of the contract (sometimes referred to as “ipso facto” clauses). These events of default commonly include the making of an application for commencement, or commencement, of insolvency proceedings; the appointment of an insolvency representative; the fact that the debtor satisfies the criteria for commencement of insolvency proceedings; and even indications that the debtor is in a weakened financial position. Some laws uphold the validity of these types of clause and where, for example, it is desirable that a contract continue to be performed after commencement of insolvency proceedings, this will only be possible if the counterparty does not elect, or can be persuaded not to elect, to exercise its rights of termination under the contract or if the insolvency law includes a mechanism that can be used to persuade the counterparty to allow the contract to continue. In the case of termination clauses, such a mechanism may include establishing a priority for payment for services provided after the commencement of 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).

115. The approach of upholding these types of clause 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 that are profitable and rejecting others (an advantage that is not available to the 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, especially one with respect to an intangible.

116. Under a different approach, the insolvency law overrides those clauses, making them unenforceable. Where the clause provides, for example, for termination on the occurrence of the defined event, the contract can be continued over the objection of the counterparty. Although the approach of overriding such clauses can be regarded as interfering with general principles of contract law, such interference may be crucial to the success of the proceedings. In reorganization, for example, where the contract is a critical lease or involves the use of intellectual property embedded in a key product, continued performance of the contract may 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 all creditors; and assist in locking all creditors into a reorganization.

117. 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 disposal of the business.

118. Although some insolvency laws do permit these types of clause to be overridden if insolvency proceedings are commenced, this approach has 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 general contract rules. While this issue is clearly one that 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 to be performed will be crucial to the success of reorganization and also, but perhaps to a lesser extent, liquidation where the business is to be sold as a going concern. For these reasons, it is desirable that an insolvency law permit such clauses to be overridden. Any negative impact of a policy of overriding these types of 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 to be performed after commencement of insolvency proceedings, or including exceptions to a general override of these clauses for certain types of contracts, such as contracts to lend money and, in particular, financial contracts (see below, paras. 208-215).

119. 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.

### 3. Continuation or rejection of contracts

#### (a) Procedure for continuation or rejection of contracts

120. Insolvency laws adopt different approaches to continuation and rejection 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 an insolvency law expressly provides different rules, such as an express power to override automatic termination clauses or to reject a contract.

121. Other laws link continuation and rejection in a common procedure that requires the insolvency representative to take some positive action with respect to a contract, such as providing notice to the counterparty that the contract is to continue to be performed (and in some cases be adopted by the insolvency estate) or be rejected. Under laws that adopt this approach, the stay would apply to the counterparty's right to terminate, allowing the insolvency representative time to consider what action should be taken with respect to the contract. One disadvantage of the approach of requiring the insolvency representative to take positive action on all contracts is that in practice there may be many cases where no decision can be taken because the contract cannot be performed. To require an explicit choice to be made on every contract could also be excessively costly and cumbersome. A further difficulty associated with this approach relates to whether or not the insolvency representative is well informed of all contracts to which the debtor is a party and is therefore in a position to take action with respect to each one. The manner in which the law deals with contracts of which the insolvency representative is not aware, in particular in terms of default rules, is therefore important.

*(i) Specifying time periods*

122. Some laws requiring a positive action by the insolvency representative also require that action to be taken within a specified period of time (with perhaps provision for extension in certain circumstances), which would generally be longer in reorganization than in liquidation. Examples of specific time periods vary from 28 to 60 days. Other laws provide for the time period to be determined by the court. 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 performance of the contract within a reasonable period after commencement of proceedings.

*(ii) Default rules*

123. A number of laws adopt a default rule to the effect that failure of the insolvency representative to act within the specified time results in the contract being treated, for example, as rejected or unenforceable. Where a default rule is adopted, a distinction between liquidation and reorganization might be made, as well as a distinction between those contracts of which the insolvency representative is aware and those of which it is not aware. In liquidation, since 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, contracts could be automatically rejected unless action is taken to preserve a contract. That result would be consistent with the goal of liquidation where it requires piecemeal sale of the assets.

124. The same assumption may not always be appropriate in reorganization or sale of the business as a going concern and 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 proceedings.

Accordingly, 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 the performance costs of the contract up to the time of rejection are paid 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.

*(iii) Right of the counterparty to request a decision*

125. Some laws provide that the counterparty has an unconditional right to request the insolvency representative to make a decision on a particular contract within a specified period of time. Such a rule may apply even where the insolvency law specifies a time limit for the insolvency representative to make a decision, as it will enable the counterparty to seek a decision without having to wait for the time limit to expire. This may be of particular importance where the contract in question involves provision of an ongoing service and the failure of the insolvency representative to act may lead to the accrual of unnecessary expense (e.g. rent for property that is leased by the debtor can be a significant administrative cost if a lease is not promptly terminated) or to the termination of an essential service. Where the insolvency representative fails to decide within the specified time period, the insolvency law may either permit the counterparty to apply to the court to require a decision to be made or apply a default rule that the contract be treated either as continued or rejected.

*(iv) Continuation and rejection of contracts as a whole*

126. Whatever rules are adopted with respect to continuing performance or rejection of contracts, it is desirable that any powers 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 performing certain parts of a contract and reject others.

*(v) Contracts known to the insolvency representative*

127. It is also desirable that the insolvency representative's power with respect to contracts is limited to those contracts which are known to it or the court (where the insolvency law requires the court to make determinations with respect to contracts). If this limitation is not adopted, the consequences of failure to take a decision with respect to a contract of which the insolvency representative has no knowledge might be a claim for damages and possible professional liability. Where the insolvency representative is not aware of a particular contract, it also may be undesirable for the law to apply a default rule that will lead to continued performance or rejection before the insolvency representative has had the opportunity to assess the contract. One solution to this issue (to the extent that the debtor complies) would be to include in the law a requirement for the debtor to provide to the insolvency representative a list of contracts that have not been fully performed (see chap. III, para. 24).

*(b) Timing and notice of continuation and rejection*

128. Where the law permits the insolvency representative to reject a contract, it will be desirable to establish the time from which the rejection will be effective, whether from the time of making the decision or retroactively. One approach is to make rejection retroactive to the time the application for commencement of proceedings is made, with the result that no post-application liability will arise under a contract, except in respect of post-application goods or services supplied to the benefit of the estate.

129. Where the law requires the insolvency representative to take a decision as to continuation or rejection of a contract, it is desirable that it also include a requirement that the counterparty or counterparties be notified of that decision. The notice should inform the counterparty of its rights, including the right to challenge the insolvency representative's decision with respect to the contract and to submit a claim in the insolvency (either with respect to a pre-commencement default or arising from the decision on the contract) and any related formalities.

*(c) Continuation of contracts where the debtor is in breach*

130. Where the debtor is in breach under a contract at the time the application for insolvency is made, there is a policy issue of whether it is fair to require the counterparty to continue to deal with an insolvent debtor in such circumstances. As a condition of continuing the performance of such a contract for the remainder of the contract term, some insolvency laws require the insolvency representative to cure any breach by the debtor under the contract (returning the counterparty to the economic position it was in before the breach occurred) and guarantee future performance by providing, for example, a bond or guarantee. Other insolvency laws do not require past breaches to be cured, but may impose restrictions as to the circumstances in which performance can be continued. One example is contracts that can be divided into severable units, such as contracts for the supply of utilities, which are billed on a monthly basis. Insolvency laws often specifically allow the continuation of such contracts for the provision of essential services, such as telephone, electricity, gas, water and waste collection. There is some justification for assuring the debtor continuing access to these services without requiring cure of the breach (especially in the case of a creditor application for commencement), provided it can perform its post-commencement obligations. An insolvency law should clearly address the circumstances in which the debtor is required to cure a breach in order for the contract to be continued. Some insolvency laws also require the insolvency representative to guarantee future performance and, in some cases, accept personal liability in the event of future breach.

*(d) Performance prior to continuation or rejection*

131. Although it is not common for insolvency laws to do so, it may also be desirable to address the question of the obligations of the counterparty in the period between commencement of proceedings and a decision as to treatment

of a contract (in those cases where such a decision is required), in particular whether the counterparty is required to commence or continue its performance. Such an approach would satisfy objectives of certainty and predictability for all parties concerned. Where a contract continues to be performed prior to a determination to continue or reject that contract, the costs of continued performance arising under the contract should be payable as an administrative expense. The rationale for such an approach is that it is fair to assume that post-commencement performance of a contract is of benefit to the estate, otherwise it should have been rejected. If the insolvency representative uses third-party-owned assets that are in the possession of the debtor subject to contract, the costs under the contract of continued performance of the contract should be payable as an administrative expense, and the third party should be protected against diminution of the value of those assets, to the extent that that issue is not covered by the contract.

*(e) Effect of continuation or rejection on the counterparty*

*(i) Continuation*

132. Under those laws which require a positive action by the insolvency representative, contracts that the insolvency representative elects to continue to perform are treated as ongoing post-commencement obligations of the debtor that must be performed both by the estate and the counterparty. Claims arising from performance of those contracts are treated in a number of insolvency laws as an administrative expense (not as 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, if this approach is followed, only contracts that will be profitable or essential to the continued operation of the debtor continue after commencement of insolvency proceedings. In those jurisdictions where the general rules of contract law will apply and no decision as to continuation is required from the insolvency representative, the insolvency law may provide that such claims will have no priority and be ranked with other unsecured claims.

133. Since continuation of a contract with a party subject to insolvency proceedings may involve an element of risk for the counterparty that would not otherwise have arisen, such as non-payment, it may be appropriate for the insolvency law to consider whether certain measures of protection should be afforded the counterparty. A number of factors will need to be weighed, including the importance of the contract to the proceedings; the cost to the proceedings of providing the necessary protections; whether the debtor or the estate will be able to perform the obligations under the continued contract; and the impact on commercial contracting of forcing the counterparty to assume the risk of non-payment. If the contract provides, for example, for the seller to extend credit to the debtor for a certain period of time before requiring payment or provides for payment on delivery, the seller may incur substantial costs and suffer harm if, by the time of the payment or the delivery, the insolvency representative is no longer able to pay. Some laws address these issues by requiring the insolvency representative to guarantee payment or

performance to the counterparty, such as through a bank guarantee or letter of credit. Under other laws, the insolvency representative may be personally liable for performance. This approach may discourage continuation of contracts where there is some risk of a failure of performance and thus have a negative affect on reorganization. Personal liability may be particularly onerous in the case of contracts such as labour contracts. Under a further approach, the counterparty is required to assume the risk of non-payment on the basis that that risk is a usual risk of commercial dealings. Providing an administrative priority for claims and payments relating to post-commencement performance under a continued contract may afford a measure of protection to the counterparty (although it may be limited if assets available for the payment of such expenses are limited).

(ii) *Rejection*

134. Where a contract is rejected, the counterparty is generally excused from performing the remainder of the contract and the principal issue to be determined is the remedies that will be available to the counterparty. Many laws provide that the counterparty is only entitled to a remedy in damages, even if other remedies would have been available outside of insolvency. One of the reasons for this approach is that allowing other remedies, such as delivery of goods manufactured but not delivered prior to commencement of insolvency proceedings, would amount to paying the full claim of the counterparty, a result not available to other unsecured creditors and one that represents a departure from the principle of equal treatment. Some laws, however, do permit such a remedy in respect of the delivery of goods, while other laws permit performance in the case of contracts for the sale of land.

135. Where the remedy is one of damages, calculation of the unsecured damages that result from the rejection might be determined in accordance with applicable law other than the insolvency law and the counterparty becomes an unsecured creditor with a claim equal to the determined amount. In addition to damages resulting from the rejection, the counterparty may have a claim with respect to performance of the contract in the period before rejection (which may rank as an administrative claim).<sup>36</sup>

(f) *Amendment of continuing contracts*

136. A further issue to be considered in respect of continued contracts is the circumstances in which an insolvency representative may alter the terms and conditions of those contracts. As noted above, the terms and conditions of the contract as a whole must be respected and, 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 under the contract. The insolvency representative would generally be required to negotiate any amendment with the counterparty and any modification without the consent of that

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<sup>36</sup>See chap. V, paras. 62-79, on ranking of claims.

other party will constitute a breach of contract for which the counterparty may seek applicable remedies.

#### 4. *Leases of land and premises*

137. Some insolvency laws include specific provisions on unexpired leases of land and premises, distinguishing between residential and commercial leases. Commercial leases in particular are often of significance in reorganization cases. For example, leases at below market price represent an asset that might be sold and return a benefit to the estate. In contrast, the ability to escape a lease of a money-losing location may be an advantage where the debtor needs to reduce the size of its business to ensure the success of reorganization.

138. Under some laws, a lease of which the debtor is the lessee can be rejected without reference to the expiry date, 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. 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 will ordinarily have the opportunity to mitigate losses by re-letting the property.

#### 5. *Assignment*

139. The ability of the insolvency representative to elect to assign a contract notwithstanding insolvency-triggered termination provisions or restrictions on transfer contained in the contract can have significant benefits to the estate and therefore to the beneficiaries of the proceeds of distribution following liquidation or as part of a reorganization. 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.

140. 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. It may be undesirable to compel 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 the issue of assignment. 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 counterparty or all parties to the original contract agree. Some of these laws also provide, however, that if the counterparty does not consent to assignment, the court may approve the assignment if, for example, it can be shown that the counterparty is withholding consent unreasonably; the counterparty will not be substantially disadvantaged by the assignment; or the insolvency representative can demonstrate to the counterparty that the assignee can adequately perform the contract.<sup>37</sup>

141. Where an insolvency law allows assignment of contracts, it would be highly desirable to also require the debtor to cure any breach prior to the assignment of a contract. This would help ensure a successful, problem-free substitution of the assignee for the debtor as the contracting party.

142. 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 prohibited by the operation of law. Some States, for example, prohibit the assignment of government procurement contracts.

#### *6. General exceptions to the power to continue performance, reject or assign contracts*

143. Exceptions to the powers of the insolvency representative with respect to treatment of contracts generally fall into two categories. The first relates to specific types of contract, the second to contracts that cannot be performed. In respect of the first, where the insolvency law provides that automatic termination provisions are overridden, specific exceptions may be desirable for contracts, such as short-term financial contracts (e.g. swap and futures contracts—see below, paras. 208-215), insurance contracts and contracts for the making of a loan. Exceptions to the power to reject may also be appropriate in the case of labour agreements, 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, in particular where the advantage to the debtor may be relatively minor, and contracts with government, such as licensing agreements and procurement contracts.

144. To enhance the transparency of the insolvency regime, it is desirable that the limitations on the powers of the insolvency representative to deal with the types of contract discussed in this section are stated clearly in the insolvency law.

##### *(a) Labour contracts*

145. As noted above, one important exception to the powers discussed in this section is that of labour contracts. These contracts are important not only in

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<sup>37</sup>This approach is consistent, for example, with the approach taken in the United Nations Convention on the Assignment of Receivables in International Trade, article 9 (for the text of art. 9, see above, footnote 31).



reorganization, but also in liquidation where the insolvency representative is attempting to sell the debtor's business as a going concern. A higher price may be obtained if the insolvency representative is able to terminate onerous labour contracts to achieve necessary reduction 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 contract, but also the usually mandatory provisions of other laws that protect the position of employees. These may relate, for example, to 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 have an impact on 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. For these reasons, a number of States have adopted special regimes to deal with the protection of employees' claims in insolvency (see chap. V, paras. 72 and 73, on priority of employee claims) and, in order to avoid insolvency proceedings being used as a means of eliminating employee protection, these laws 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, for example, where the employee's remuneration is excessive compared with what the average employee would receive for the same work. In some States 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.

*(b) Contracts for irreplaceable and personal services*

146. The second category relates to those contracts where, irrespective of how an 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 or provision of services by a person with highly specialized skills or by a named person with a particular skill).

*7. Post-commencement contracts*

147. A further category of contracts in insolvency, in addition to contracts that are not fully performed, is contracts entered into after the proceedings have commenced. In reorganization and where the business is to be sold as a going concern in liquidation, there is often a need to enter into contracts (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 costs and expenses incurred in their performance are paid in full as an expense of the insolvency administration.

## **Recommendations 69-86**

### **Purpose of legislative provisions**

The purpose of provisions on treatment of contracts is:

(a) To establish the manner in which contracts, under which both 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 applicable law, with the objective of maximizing the value and reducing the liabilities of the estate;

(b) To 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) To identify the types of contract that should be excepted from the exercise of these powers; and

(d) To identify the kinds of protection that will be available to counterparties to continued contracts.

### **Contents of legislative provisions**

#### *Treatment of contracts not fully performed (paras. 108-112)*

69. The insolvency law should specify the treatment of contracts under which both the debtor and its counterparty have not yet fully performed their respective obligations.

#### *Automatic termination and acceleration clauses (paras. 114-119)*

70. The insolvency law should specify that any contract clause that automatically terminates or accelerates a contract upon the occurrence of any of the following events is unenforceable as against the insolvency representative and the debtor:

(a) An application for commencement, or commencement, of insolvency proceedings;

(b) The appointment of an insolvency representative.<sup>38</sup>

71. The insolvency law should specify the contracts that are exempt from the operation of recommendation 70, such as financial contracts, or subject to special rules, such as labour contracts.

#### *Continuation or rejection (paras. 120-122, 126 and 127)*

72. The insolvency law should specify that the insolvency representative may decide to continue the performance of a contract of which it is aware

<sup>38</sup>This recommendation would apply only to those contracts where such clauses could be overridden (see commentary above, paras. 143-145, on exceptions) and is not intended to be exclusive, but to establish a minimum: the court should be able to examine other contractual clauses that would have the effect of terminating a contract on the occurrence of similar events.

where continuation would be beneficial to the insolvency estate.<sup>39</sup> The insolvency law should specify that:

- (a) The right to continue applies to the contract as a whole; and
- (b) The effect of continuation is that all terms of the contract are enforceable.

73. The insolvency law may permit the insolvency representative to decide to reject a contract.<sup>40</sup> The insolvency law should specify that the right to reject applies to the contract as a whole.

*Timing and notice of decision to continue or reject (paras. 128 and 129)*

74. The insolvency law should specify a time period within which the insolvency representative is required to make a decision to continue or reject a contract, which time period may be extended by the court.

75. The insolvency law should specify the time at which the rejection will be effective.

76. The insolvency law should specify that where a contract is continued or rejected, the counterparty is to be given notice of the continuation or rejection, including its rights with respect to submitting a claim and the time in which the claim should be submitted, and permit the counterparty to be heard by the court.

*Right of the counterparty to request a decision (para. 125)*

77. Notwithstanding recommendation 74, the insolvency law should permit a counterparty to request the insolvency representative (within any specified time limit) to make a prompt decision and, in the event that the insolvency representative fails to act, to request the court to direct the insolvency representative to make a decision to continue or reject a contract.

*Consequences of failure to make a decision (paras. 123, 124 and 127)*

78. The insolvency law should specify the consequences of the failure of the insolvency representative to make a decision within the specified time period with respect to contracts of which it is aware. Failure by the insolvency representative to act within the specified time period should not operate to continue a contract of which the insolvency representative was not aware.<sup>41</sup>

<sup>39</sup>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, unless the contract has a termination date that happens to fall after the commencement of insolvency proceedings.

<sup>40</sup>An alternative to providing a power to reject contracts is the approach of those jurisdictions which provide that performance of a contract simply ceases unless the insolvency representative decides to continue its performance.

<sup>41</sup>See chap. III, para. 24, which refers to the debtor's obligation to provide information, including a list of contracts not fully performed.

**Recommendations 69-86 (continued)***Continuation of contracts where the debtor is in breach (para. 130)*

79. The insolvency law should specify that where the debtor is in breach of a contract the insolvency representative can continue the performance of that contract, provided the breach is cured, the non-breaching counterparty is substantially returned to the economic position it was in before the breach and the estate is able to perform under the continued contract.

*Performance prior to continuation or rejection (para. 131)*

80. The insolvency law should specify that the insolvency representative may accept or require performance from the counterparty to a contract prior to continuation or rejection of the contract. Claims of the counterparty arising from performance accepted or required by the insolvency representative prior to continuation or rejection of the contract should be payable as an administrative expense:

(a) If the counterparty has performed the contract the amount of the administrative expense should be the contractual price of the performance; or

(b) If the insolvency representative uses assets owned by a third party that are in the possession of the debtor subject to contract, that party should be protected against diminution of the value of those assets and have an administrative claim in accordance with subparagraph (a).

*Damages for subsequent breach of a continued contract (paras. 132 and 133)*

81. The insolvency law should specify that where a decision is made to continue performance of a contract, damages for the subsequent breach of that contract should be payable as an administrative expense.

*Damages arising from rejection (paras. 134 and 135)*

82. The insolvency law should specify that any damages arising from the rejection of a pre-commencement contract would be determined in accordance with applicable law and should be treated as an ordinary unsecured claim. The insolvency law may limit claims relating to the rejection of a long-term contract.

*Assignment of contracts (paras. 139-142)*

83. The insolvency law may specify that the insolvency representative can decide to assign a contract, notwithstanding restrictions in the contract, provided the assignment would be beneficial to the estate.

84. Where the counterparty objects to assignment of a contract, the insolvency law may permit the court to nonetheless approve the assignment provided:

(a) The insolvency representative continues the contract;

- (b) The assignee can perform the assigned contractual obligations;
- (c) The counterparty is not substantially disadvantaged by the assignment; and
- (d) The debtor's breach under the contract is cured before assignment.

85. The insolvency law may specify that, where the contract is assigned, the assignee will be substituted for the debtor as the contracting party with effect from the date of the assignment and the estate will have no further liability under the contract.

*Post-commencement contracts (para. 147)*

86. The insolvency law should specify that contracts entered into after the commencement of insolvency proceedings are post-commencement obligations of the estate. Claims arising from those contracts should be payable as an administrative expense.

## **F. Avoidance proceedings**

### *1. Introduction*

148. Insolvency proceedings (both liquidation and reorganization) may commence long 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 or gifts to relatives and friends or pay certain creditors to the exclusion of others. There may also be opportunities 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, generally disadvantages ordinary unsecured creditors who were not party to such actions and do not have the protection of a security interest.

149. 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 transfer, payment, encumbrance, guarantee, loan or release, and may include a composite series of such transactions.

150. Many insolvency laws include provisions that apply retroactively from a particular date (such as the date of application for, or commencement of, insolvency proceedings) for a specified period of time (often referred to as the "suspect" period) and are designed to overturn those past transactions to which the insolvent debtor was a party or which involved the debtor's assets where they have certain effects. These effects include reducing the net worth of the debtor (e.g. 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 rank (e.g. by payment of a debt to a particular unsecured creditor or granting a security interest to a creditor who is otherwise unsecured when other unsecured creditors remain unpaid and unsecured). Many non-insolvency laws also address these types of transaction as being detrimental to creditors outside 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.

151. It is a generally accepted principle of insolvency law that collective action is more efficient in maximizing the assets available to creditors than a system that leaves creditors free to pursue their individual remedies and that it requires all like creditors to receive the same treatment. Provisions dealing with avoidance powers are designed to support these collective goals, ensuring that creditors receive a fair allocation of an insolvent debtor's assets consistent with established priorities and preserving the integrity of the insolvency estate. Avoidance provisions may also have a deterrent effect, discouraging creditors from pursuing individual remedies in the period leading up to insolvency if they know that these may be reversed or their effects nullified on commencement. Transactions are typically made avoidable in insolvency to prevent fraud (e.g. 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 general 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 States, 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.

152. 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 that is part of appropriate standards for the governance of commercial entities. It should be noted that, in the cross-border context, jurisdictions with insolvency laws that do not provide for avoidance of certain types of transaction, may encounter difficulties with recognition of proceedings and cooperation with courts and insolvency officials of jurisdictions where those transactions are subject to avoidance.

153. Notwithstanding the generally accepted rationale of avoidance provisions, it is important to bear in mind that many of the transactions that may be subject to avoidance in insolvency are perfectly normal and acceptable when they occur outside that context, but become suspect only 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 the interests of creditors that would be available under general civil or commercial law.

154. 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 types of transaction that may be avoided. 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, on 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, the possible undermining of contractual predictability and certainty. It may also require a balance to be reached between avoidance criteria that are easily proven and will result in a number of transactions being avoided and narrower avoidance criteria that are difficult to prove but more restricted in the number of transactions that will be avoided successfully. To minimize the potentially negative effects of avoidance powers on contractual predictability and certainty, it is desirable that as far as possible the categories of transactions to be avoidable (irrespective of whether they are broadly or narrowly defined) and the exercise of avoidance powers be subject to clear criteria that will enable business and commercial risks to be ascertained.

155. The decision whether or not to commence avoidance proceedings with respect to a particular transaction requires a number of different considerations to be weighed. In the case of actions to restore assets to the insolvency estate, these considerations will include whether avoidance of the transaction will be beneficial to the estate (such as where the taking of an avoidance action may disrupt reorganization proposals, especially where the action can be taken by creditors without the consent of the insolvency representative); the likely cost of avoidance proceedings 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.

## 2. *Avoidance criteria*

156. Approaches to establishing the criteria for avoidance actions vary considerably between insolvency laws both in terms of specific criteria and the manner in which they are combined in each law. In terms of the specific criteria, they can be grouped broadly as objective and subjective criteria.

### (a) *Objective criteria*

157. 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 the suspect period or whether the transaction evidenced any of a number of general characteristics set forth in the law (e.g. whether appropriate value was given for the assets transferred or the obligation incurred, whether the debt was mature or the obligation due or whether there was a special relationship between the parties to the transaction). While such generalized criteria may be easier to apply than criteria that rely upon proof, for example, of intent, they can also have arbitrary results if relied upon exclusively. So, for example, legitimate and useful transactions



that fall within the specified suspect period might be avoided, while fraudulent or preferential transactions that fall outside the period are protected.

*(b) Subjective criteria*

158. Another approach emphasizes case-specific, subjective criteria such as whether there is evidence of intention to hide assets from creditors, whether the debtor was insolvent when the transaction took place or became insolvent as a result of the transaction, whether the transaction was unfair in relation to certain creditors and whether the counterparty knew that the debtor was insolvent at the time the transaction took place or would become insolvent as a result of the transaction. This individualized approach may require detailed consideration of the intent of the parties to the transaction and of other factors such as the debtor's financial circumstances at the time the transaction occurred, the financial effect of the transaction on the debtor's assets and what might constitute the normal course of business between the debtor and particular creditors.

*(c) Combining the elements*

159. 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. In some States, a heavy reliance upon subjective criteria has led to considerable litigation and the imposition of extensive costs on insolvency estates. In order to avoid these costs, some laws have recently adopted a strictly objective approach of a short suspect period, such as three to four months, which in some cases is 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. Additionally, the short suspect period may be used to create a presumption of necessary intent or knowledge, especially of insolvency, on the part of the debtor or the counterparty to the transaction or both, which may be rebutted by appropriate evidence.

160. Some laws adopt a two-tiered approach combining the short period within which all transactions are avoided and no defences are available to creditors, with a longer period in which certain additional elements have to be proven. The law may specify that a certain type of transaction occurring within, for example, a six-month period before commencement, is avoided without requiring the insolvency representative to show anything other than that it is a transaction as defined for the purposes of the legislation and that it occurred within the time limit. No defences are available to the counterparty. For transactions occurring within, for example, a one-year period, the insolvency representative is required to show that the transaction was not in the ordinary course of business and that it had a certain effect, for example, the creation of a preference. To defeat the claim the counterparty must show that it has a relevant defence. As with subjective criteria, however, too great a reliance on objective criteria can also produce negative outcomes. Experience in several States has shown that where certain types of transaction are



automatically or easily avoided under the insolvency law, insolvency representatives can avoid each transaction occurring within a suspect period without any individual analysis or calculation of the potential cost or benefit of recovery for creditors generally. Furthermore, such an approach may result in the avoidance of essentially “fair” commercial transactions and impose the burden and expense of challenging avoidance actions on individual creditors.

161. A number of insolvency laws also combine these different approaches to address different types of transaction. 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 questions of the intent of both the debtor and the counterparty. One insolvency law that adopts a combination of those elements provides, for example, that transactions such as gifts, granting of a security interest for existing debts and extraordinary payments (those which 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 was insolvent at the time of the transaction, if the transaction was unfair or improper in relation to a group of creditors and if the counterparty knew that the debtor was insolvent at the time the transaction occurred.

162. Whatever criteria are used, insolvency laws should attempt to achieve a balance between the interests of individual creditors and those of the estate which, in terms of the recovery of assets through avoidance actions, coincide with the collective interests of all creditors. While in its most simple form, this might appear to be a decision as to the party on which to impose the costs of challenging an avoidance action, other factors need to be taken into account. The principal of these is funding for avoidance actions. Criteria that require proof of a number of elements for a successful avoidance action require court proceedings to be commenced by the insolvency representative for every transaction it wishes to overturn, potentially representing a major expense for the estate with no guarantee of a return. In jurisdictions that follow such an approach, lack of funding is a major reason for avoidance actions not proceeding. A different approach in which all transactions occurring within the defined period are automatically suspect, however, does not require the use of assets of the estate or of other funds. Further factors relevant to the setting of criteria include the defences available to creditors subject to an avoidance action and the duties placed upon the insolvency representative. For example, some insolvency laws discourage misuse of the avoidance provisions by imposing certain duties on the insolvency representative. Professional regulation may also be relevant, as well as the ability of the court to order costs against an insolvency representative where the attempted avoidance action is found to have been unjustified or to have caused unnecessary costs.

163. Whichever approach is taken, it is highly desirable that an insolvency law provide certainty to all parties through clearly defined criteria for avoidance, including the elements that will need to be proved by the insolvency representative and the defences available to the creditors.

(d) *Ordinary course of business*

164. Many insolvency laws use the concept of the “ordinary course of business” in defining their avoidance criteria, so that an extraordinary payment, as noted above, may be subject to avoidance. The concept has wider relevance to an insolvency regime as it may also be used, for example, to draw a distinction between the exercise of powers regarding the use and disposition of assets during the insolvency proceedings in the “ordinary course of business” and in other circumstances, both in terms of who may exercise such powers and the protections that are required (see above, paras. 75 and 76).

165. States define the “ordinary course of business” with varying emphasis on different elements. However, in most jurisdictions a common purpose of the definition is to determine what constitutes routine conduct of business and allow a business to make routine payments and enter into routine contracts, without subjecting those transactions to possible avoidance in insolvency. Those routine payments might include the payment of rent, utilities such as electricity and telephone and possibly also payment for trade supplies.

166. To define what constitutes “ordinary course of business” with respect to a particular debtor, some laws focus on the prior conduct of the debtor and the parties with which it deals, focusing on elements of their relationship such as the method, quantity and regularity of supply and payment. In such a case, any variation from contract, custom or what may be deemed to be regular practice between the parties, for example a payment by abnormal means, will be regarded as being outside the “ordinary course of business”. Another approach focuses on the intention of one or both of the parties and asks whether the creditor had knowledge, or ought to have had knowledge, of the debtor’s financial state or whether the debtor intended to prefer one creditor to others.

167. A further approach is to apply standards based upon usual industry or even general commercial practice to the terms of the transaction and the circumstances in which it was entered into. Other laws regard any payment exceeding a certain percentage of the value of the debtor’s assets as extraordinary.

168. It is important that a test for the “ordinary course of business” balance flexibility, so as to not unduly restrict new developments in commercial practice, with an overriding requirement for certainty.

(e) *Defences*

169. Where an insolvency law provides defences to avoidance for individual counterparties, those defences may have the potential to dilute the efficacy of avoidance provisions. Defences that involve elements that may be subject to dispute, such as whether the transaction occurred in the ordinary course of business, or the counterparty acted in good faith, or involving the state of the counterparty’s actual or implied knowledge, can create uncertainty for all parties and will require determination by the court. The likelihood of such

uncertainty occurring has been increased in some jurisdictions by the courts adopting a wide interpretation of such defences in favour of counterparties. Insolvency representatives may be reluctant to use avoidance provisions as an effective tool in an insolvency, because of associated costs or because the procedures are inefficient and unpredictable. These potential difficulties underscore the desirability of an insolvency law adopting clear and predictable avoidance criteria and defences that will enable all parties to assess potential risks and avoid disputes, for example objective criteria focusing on the effect or result of transactions rather than on the intent of the parties. Where elements such as “ordinary course of business” are included they should be clearly defined and circumscribed by an insolvency law.

### 3. Types of transaction subject to avoidance

170. Although variously defined, there are three broadly common types of avoidable transaction that are found in most legal systems and are used in the *Legislative Guide* as the basis for discussion. They are transactions intended to defeat, hinder or delay creditors from collecting their claims; transactions at undervalue; and transactions with certain creditors that 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 that 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<sup>42</sup> or to otherwise prejudice the interests of that creditor and the transaction occurs when the debtor 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. Where there is a clear intent to hinder, defeat or delay creditors, these transactions may fall into the first category of transactions. In cases such as these, the insolvency representative may be able to choose the category under which a particular transaction is to be avoided and thus take advantage of the variations in requirements of proof and suspect periods that typically apply.

171. To achieve as much clarity and certainty as possible and avoid unnecessary overlap it is desirable that, in determining the categories of transaction to be subject to avoidance provisions, an insolvency law specify the particular characteristics of a transaction (including the effect of the transaction) that are essential for it to be avoided, rather than relying on broader labels, such as “fraudulent” or “preferential”.

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<sup>42</sup>A potential creditor may be a party that was not a creditor at the time the avoidable transaction took place, but who was about to become a creditor through, for example, negotiation of a loan agreement with the debtor. The debtor may have transferred assets to avoid them becoming subject to that agreement.

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

172. Transactions intended to defeat, hinder or delay creditors involve the debtor transferring assets to any third party with the intention of putting them beyond the reach of creditors. The effect of such transactions will generally be to disadvantage all unsecured creditors. These transactions generally cannot be avoided automatically 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 circumstances that are common to these types of transaction. Although differing between jurisdictions, there are a number of common indicators, including:

(a) The relationship between the parties to the transaction, where a transaction took place directly with a related person or via a third party to a related person;

(b) The lack or inadequacy of the value received for the transaction;

(c) The financial condition of the debtor both before and after the transaction was entered into, in particular where the debtor was already insolvent or became insolvent after the transaction occurred;

(d) 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;

(e) The general chronology of the events and transactions under inquiry, where for example, the transaction occurred shortly after a substantial debt was incurred;

(f) The transaction is concealed by the debtor, especially when it was not made in the ordinary course of business, or fictitious parties were involved; or

(g) The debtor absconds.

173. Some laws also specify circumstances or types of transaction where the requisite intent or bad faith is deemed, or may be presumed, to exist, for example, in the case of transactions involving related persons occurring within a specified period of time prior to the commencement of proceedings (discussed further below, paras. 182-184). Under other laws it may be sufficient for a transaction to be avoided if the debtor could, and therefore should, have realized 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 realized 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 to a person who had no notice or was unaware of any intent to defraud creditors.

(b) *Undervalued transactions*

(i) *Criteria*

174. A debtor who is in need of cash may sell assets quickly at a price significantly below the real value in order to achieve a quick result, without ever having any intention to defeat or delay creditors. The result, however, may be a clear reduction of the assets available to creditors in insolvency. For this reason, many insolvency laws focus on the exchange of value in a transaction. Transactions would generally be avoidable where the value received by the debtor as the result of the transaction with a third party was either nominal or non-existent, such as a gift, or much lower than the true value or market price, provided the transaction occurred within the suspect period. Other laws also require a finding that the transaction had a catastrophic effect on the debtor, such as that the debtor was left with an unreasonably small amount of capital as a result of the transaction, was insolvent at the time the transaction occurred or became insolvent as a result of the transaction. These undervalued transactions include those with both creditors and third parties.

175. An important question in respect of these types of transaction is what constitutes a sufficient “undervalue” for the purposes of avoidance and how it can be determined. In many States, it is left to the courts to determine by reference to standards such as reasonable or market value prevailing at the time the transaction occurred on the basis of appropriate expert evidence. Where the relevant amounts in a transaction may not be certain, one approach to assist the court may be for the insolvency representative to provide the court with an estimated valuation of such amounts, which could be disputed upon the presentation of further evidence by the counterparty to the transaction. The court might also be given a power to specify a mode of determining the valuation rather than necessarily having to determine the value itself. Given the difficulties in proving undervalue, in some jurisdictions it may be easier to avoid a transaction on the grounds of preferential effect if it was entered into at a time when the debtor was unable to pay its due debts. Further, some laws presume less than fair, or no, consideration to be evidence of a transaction intended to defeat, hinder or delay creditors.

(ii) *Defences*

176. Some insolvency laws provide that these types of transaction 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; and that there were reasonable grounds for believing that the transaction would benefit the debtor’s ordinary business.

(c) *Preferential transactions*

(i) *Criteria*

177. Preferential transactions may be subject to avoidance where: (a) the transaction took place within the specified suspect period; (b) the transaction

involved a transfer to a creditor on account of a pre-existing debt; and (c) as a result of the transaction, the creditor received 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 was insolvent or close to insolvent when the transaction took place and some further require that the debtor have an intention to create a preference. The rationale for including these types of transaction 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 similarly situated creditors by giving one member of a class more than they would otherwise legally be entitled to receive.

178. Examples of preferential transactions may include payment or set-off of debts not yet due; performance of acts that the debtor was under no obligation to perform; granting of a security interest to secure existing unsecured debts; unusual methods of payment, for example, 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, in some circumstances, payment of debts in response to extreme pressure from a creditor, such as litigation or attachment, where that pressure has a doubtful basis. A set-off, 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 set-offs. A set-off may also be subject to avoidance where it occurs in irregular circumstances, such as where there is no contract between the parties to the set-off.

#### (ii) *Defences*

179. One defence to an allegation that a transaction was preferential 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 ordinary 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 to the commencement of insolvency proceedings. This approach encourages suppliers of goods and services to continue to do business with a debtor that may be having financial problems, but which is still potentially viable. Other defences available under insolvency laws include that the counterparty extended credit to the debtor after the transaction and that credit has not been paid (the defence is limited to the amount of the new credit); that the counterparty gave new value for which it was not granted a security interest; the counterparty can show that it did not know a preference would be created; that the counterparty did not know or could not have known that the debtor was insolvent at the time of the transaction; or that the debtor's assets exceeded its liabilities at the time of the transaction. Some of these latter defences, in particular those involving the intent of the parties to the transaction, suffer

from the disadvantage of being difficult to prove and may make avoidance proceedings complex, unpredictable and lengthy.

*(d) Security interests*

180. While security interests effective and enforceable under the laws permitting the grant of a security interest 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. The purpose of such an approach is to prevent a debtor that is not able to pay its debts from encumbering assets, unless the security interest provided is in consideration of new funds being advanced. Otherwise, the encumbered assets will not be available to creditors generally and will place restrictions on the debtor's use of those assets. A transaction granting a security interest might be avoided on the basis that it is a transaction intended to defeat, delay or hinder creditors, or a preferential or undervalued transaction. In many cases, it will be a preferential transaction because it involves an existing creditor. Examples of preferential transactions may include the grant of a security interest shortly before commencement of proceedings, which although otherwise valid, may be found to have favoured unfairly a certain creditor at the expense of the rest; the grant of a security interest to secure a prior debt or on the basis of past consideration (permitted in some legal systems, but not in others); payments to a secured creditor, if the secured creditor is undersecured and is paid in full within the suspect period. Where the security interest is granted to a new creditor, the transaction may not be preferential within the meaning of that category of transaction, but may be covered by another category. There are examples of laws that include provisions dealing specifically with the avoidance of such transactions, especially in the context of security interests in favour of directors (which might also be covered by provisions on transactions with related persons) to which different criteria apply in terms of provision of value and the suspect period.

181. Avoidance provisions may also apply to a security interest that has not been made effective against third parties under the relevant secured transactions law and, under some laws, to a secured interest that was made effective within a short period before the commencement of proceedings, as well as to transfers to a secured creditor from the proceeds of an encumbered asset, where the transaction creating the security interest was tainted.

*(e) Transactions with related persons*

182. As noted above, one criterion relevant to avoidance of certain transactions is the relationship between the debtor and the counterparty. Where the types of transaction subject to avoidance involve related persons (sometimes referred to as connected persons or insiders), insolvency laws often provide stricter rules, in particular with regard to the length of suspect periods and treatment of any claim by the related person (see chap. V, para. 48), as well as presumptions or shifted burdens of proof (see below, paras. 199-201) to facilitate avoidance proceedings and dispensing with requirements that the



debtor was insolvent at the time of the transaction or was rendered insolvent as a result of the transaction. 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.

183. 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 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.

184. Where the debtor is a natural person, other legislation (such as that dealing with marital property) may be relevant and may affect the operation of the insolvency law in terms of transactions that can be avoided, such as by supplementing or limiting the avoidance provisions of the insolvency law. It is desirable for such laws to be aligned with the insolvency law and for any effect on the insolvency law to be clearly stated in the insolvency law.

#### *4. Transactions exempt from avoidance actions*

185. It may be desirable for an insolvency law to include specific exemptions from the operation of avoidance powers for certain types of transaction. Transactions essential to the functioning of financial markets, such as close-out netting of securities and derivative contracts (see chap. II below, paras. 208-215) are one example of transactions that should be exempted from the operation of avoidance provisions. Another example might be transactions that occur in the course of implementing a reorganization plan, where implementation of the plan fails and the proceedings are subsequently converted to liquidation.

#### *5. Effect of avoidance: void or voidable transactions*

186. 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 where the counterparty fails to return the assets or pay for their value.

187. In those laws where the transaction is voidable, the insolvency representative will be required to decide whether 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, under some laws, it may be responsible for its failure to do so.

### *6. Establishing the suspect period*

188. Most insolvency laws explicitly specify the duration of the suspect period with reference to the particular types of transaction 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 or date, such as the date the application for commencement of proceedings is made, the effective date of commencement of insolvency proceedings or the date decided by the court as being the date on which the debtor ceased paying its debts in the normal way ("cessation of payments"). The event or date specified by the law will depend upon other design features of the insolvency regime such as the requirements for commencement, including whether there is a potential for delay between the application for, and commencement of, insolvency proceedings. For example, if commencement typically takes several months from the time of application and the suspect period is a fixed period relating back from the effective date of commencement, then several months of that period will be taken up by the period of delay between application and commencement, thus limiting the potential effectiveness of the avoidance powers. However, if the proceedings commence automatically when an application is made, the same delay will not occur. To address situations where there is the potential for delay to occur, an insolvency law could stipulate that the suspect period applies retroactively from the date an application is made and address transactions between application and commencement in other terms, such as whether they were fraudulent or whether they were in the ordinary course of business or, where an interim insolvency representative is appointed, in terms of unauthorized transactions (see above, paras. 70-73). Where commencement occurs shortly after application, the suspect period could apply retroactively from the effective date of commencement.

189. Some insolvency laws provide one suspect period for all types of avoidable transaction, while others have different periods depending upon the type of transaction and whether the transferee was a related person. As noted above, there are also examples of laws that adopt the approach of combining a short suspect period within which certain types of transaction are automatically

avoided (and no defences are available) and a longer period where additional elements have to be proved. Because some transactions involve intentionally wrongful conduct, many insolvency laws do not limit the time period within which these types of transaction must have occurred in order for them to be avoided. Other insolvency laws establish a very long limit (examples range from 1 to 10 years) where the suspect period is generally calculated from the date of commencement of proceedings. With the exception of transactions involving intentionally wrongful behaviour, it is highly desirable that suspect periods be of a reasonably short duration to ensure commercial certainty and to reduce any negative impact that avoidance provisions will have on the availability and cost of credit.

190. Where preferential and undervalued transactions involve creditors who are not related persons, it is desirable that the suspect period be relatively brief, perhaps no more than several months (e.g. from three to six months). However, where related persons are involved, stricter rules may apply and the suspect period will be longer (e.g. two years as opposed to three to six months for the same transaction when it does not involve a related person). For transactions intended to defeat, hinder or delay creditors, the suspect period could be longer, for example, one to two years.

191. 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 that 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 extension of the suspect period be limited to transactions intended to defeat, hinder or delay, where issues of commercial certainty are of less concern.

## 7. *Conduct of avoidance proceedings*

### (a) *Parties who may commence*

192. Avoidance of a particular transaction generally requires an application to the court to declare the transaction void and insolvency laws adopt a variety of approaches to the party that may commence such a proceeding. Recognizing the central role played by the insolvency representative with respect to the administration of the estate, many insolvency laws provide that proceedings for the avoidance of specified transactions should be taken by the insolvency representative, although some do require the insolvency representative to gain the agreement of creditors or a majority of creditors before any proceeding can be commenced. There are also laws that permit avoidance proceedings to be

commenced by creditors (and, in some cases, the creditor committee), some of which limit the right to commence to those creditors whose debt precedes the challenged transaction in time. Some of the laws that permit creditors to commence such proceedings require the prior consent of the insolvency representative. Should it be regarded as desirable to include such permission in an insolvency law, requiring consent ensures that the insolvency representative is informed as to what creditors propose and gives it the opportunity to refuse permission, thus avoiding any negative impact of avoidance proceedings on administration of the estate.

193. Where the consent of the insolvency representative is required, but not obtained, some insolvency laws permit a creditor to seek court approval to commence avoidance proceedings. The insolvency representative has a right to be heard in any resulting court hearing to explain why it believes the proceedings should not go ahead. At such a hearing, the court might give leave for the avoidance proceeding to be commenced or may decide to hear the case on its own merits. Such an approach may work to reduce the likelihood of any deal-making between the various parties. Where creditor-initiated avoidance actions are permitted, some laws require creditors to pay the costs of those proceedings or allow sanctions to be imposed on creditors to discourage potential abuse of avoidance proceedings.

194. Where the insolvency representative has the sole power to commence avoidance proceedings and, based on the balance of the considerations discussed above (i.e. for reasons other than negligence, bad faith or omission),<sup>43</sup> decides not to commence proceedings in respect of certain transactions, insolvency laws adopt different approaches to the conduct and funding of those proceedings. The manner in which they could be funded may be of particular importance where the insolvency estate has insufficient assets to do so (funding is discussed further below). 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.

195. Where creditors are permitted to commence avoidance proceedings, either on an equal basis with the insolvency representative or because the insolvency representative decides not to commence such proceedings, insolvency laws adopt different approaches to the assets or value recovered. The most common approach is to treat the assets or value recovered by the creditor as part of the estate on the basis that the principal justification of avoidance proceedings is to return value or assets to the estate for the benefit of all creditors, rather than to provide a benefit to individual creditors. Other laws provide that whatever is recovered can be applied in the first instance to satisfy the claim of the creditor that commenced the proceedings, or that the priority of the claim of the creditor or creditors pursuing the action can be modified.

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<sup>43</sup>See chap. III, paras. 49-52, on the duties and functions of the insolvency representative.

(b) *Funding of avoidance proceedings*

196. The most crucial restriction in a number of States on the efficacy of avoidance provisions has been the unavailability of funds with which to challenge potentially avoidable transactions. Different approaches to the question of funding have been adopted. Some States make public funds available to the insolvency representative to commence avoidance proceedings, while others require those proceedings to be funded from the insolvency estate. This latter approach may be appropriate where sufficient funds exist, but in some circumstances would 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 avoidance proceedings. 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 avoidance proceedings. There are clearly significant differences between countries in the availability of public resources to fund avoidance proceedings that may justify use of some of these alternative mechanisms. 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, avoiding abuse, investigating unfair conduct and furthering good governance.

(c) *Time limits for commencement of avoidance proceedings*

197. Some insolvency laws establish specific time periods within which avoidance proceedings should be commenced, while others are silent on this issue. Those laws which do specify time periods provide, for example, that the proceedings should be commenced within a specified period after the effective date of commencement of insolvency proceedings (e.g. 3 or 12 months) or no later than a specified time period (e.g. 6 months) after the insolvency representative is able to discover, assess and pursue claims. If an insolvency law is to establish specific time periods, rather than relying on those applicable under law other than the insolvency law, an approach that combines different periods, such as a fixed time period after commencement and a fixed time period after the discovery of the transaction by the insolvency representative, would be desirable. Such an approach provides sufficient flexibility to address those transactions which are concealed from the insolvency representative and discovered only after the expiration of the specified time period. Whichever approach is adopted, it is desirable that the time period be relatively short, as in the examples noted above, to avoid uncertainty and ensure that the insolvency proceedings are conducted expeditiously.

(d) *Satisfying the criteria for avoidance*

198. Insolvency laws adopt different approaches to establishing the elements that have to be proved in order to avoid a particular transaction. The approach adopted will depend upon how the balance is struck between undoing transactions that are unfair or financially harmful to the insolvency estate on the one hand and protecting commercial transactions that are not regarded as wrong or harmful outside the insolvency context on the other. Whichever approach an

insolvency law adopts to satisfying the avoidance criteria, it is highly desirable that the law state precisely which parts of the criteria have to be proved by which party, so that it is clear what is required of the insolvency representative in seeking to avoid a particular transaction and what is required of the counterparty seeking to defend a transaction from avoidance.

199. In some laws, the onus is on the debtor to prove that the transaction did not fall into any category of avoidable transactions and, for example, was a transaction in the ordinary course of business. Other insolvency laws provide that the insolvency representative or other person permitted to challenge the transaction, such as a creditor, is required to prove that the transaction satisfies the requirements for avoidance. Where these elements include intent, it will often be very difficult to prove and the party with the burden of proof will most often lose. To overcome this difficulty, 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. As a practical matter, however, the debtor's inability to satisfactorily explain the commercial purpose of a particular transaction, which extracted value from the estate, may point to the requisite intent.

200. Another approach is to provide that the requisite intent or bad faith is deemed or presumed to exist where certain types of transaction are undertaken within the suspect period and the counterparty to the transaction will have the burden of proving otherwise. These types of transaction may include, for example, transactions with related persons, payment of unmatured debts and payment of gratuitous or onerous transactions. A further approach is to provide that where a certain type of transaction occurred within the suspect period and had a certain effect, such as conferring a preference, a rebuttable presumption as to intention to prefer will arise. Unless the counterparty can rebut the presumption, the transaction will be avoided and the insolvency representative can recover the assets involved in the transaction or obtain judgement for the value of the asset involved.

201. Where the counterparty's knowledge of the debtor's insolvency is a required element of avoidance, some insolvency laws include a presumption that the counterparty knew of the poor financial condition of the debtor if the transaction entered into with that person had certain characteristics. These may include that the repayment was in respect of an unmaturing debt or made in an unusual manner, or that the transaction occurred within a short period before an application for commencement or before commencement of insolvency proceedings.

### *8. Liability of counterparties to avoided transactions*

202. 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 that the transaction will be reversed and the counterparty

will be 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 a counterparty that 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 in the case of a preference and to the extent of the consideration paid in an undervalued transaction. Where the counterparty fails to disgorge assets or return value to the insolvency estate, most of the remedies available are under non-insolvency law. Some insolvency laws provide, however, that in addition to avoidance of the transaction, a claim by the counterparty (for amounts owed in addition to those involved in the voidable transaction) cannot be admitted in the insolvency.

### 9. Conversion of reorganization to liquidation

203. Where reorganization proceedings are converted to liquidation proceedings, some consideration may need to be given to the effect of that conversion on the exercise of avoidance powers in respect of payments made in the course of the reorganization proceedings and the timing of the suspect period.

#### **Recommendations 87-99**

##### **Purpose of legislative provisions**

The purpose of avoidance provisions is:

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

##### **Contents of legislative provisions**

*Avoidable transactions*<sup>44</sup> (paras. 170-179)

87. The insolvency law should include provisions that apply retroactively and are designed to overturn transactions, involving the debtor or assets of the

<sup>44</sup>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, granting of a security interest, a guarantee, a loan or a release or an action to make a security interest effective against third parties and may include a composite series of transactions.

estate, and that have the effect of either reducing the value of the estate or upsetting the principle of equitable treatment of creditors. The insolvency law should specify the following types of transaction as avoidable:

(a) Transactions intended to defeat, delay or hinder the ability of creditors to collect claims where the effect of the transaction was to put assets beyond the reach of creditors or potential creditors or to otherwise prejudice the interests of creditors;

(b) Transactions where a transfer of an interest in property or the undertaking of an obligation by the debtor was a gift or was made in exchange for a nominal or less than equivalent value or for inadequate value that occurred at a time when the debtor was insolvent or as a result of which the debtor became insolvent (undervalued transactions); and

(c) Transactions involving creditors where a creditor obtained, or received the benefit of, more than its pro rata share of the debtor's assets that occurred at a time when the debtor was insolvent (preferential transactions).

*Security interests (para. 180)*

88. The insolvency law should specify that, notwithstanding that a security interest is effective and enforceable under law other than the insolvency law, it may be subject to the avoidance provisions of insolvency law on the same grounds as other transactions.

*Establishing the suspect period (paras. 188-191)*

89. The insolvency law should specify that the transactions described in recommendation 87, subparagraphs (a)-(c), may be avoided if they occurred within a specified period (the suspect period) calculated retroactively from a specified date, being either the date of application for, or commencement of, the insolvency proceedings. The insolvency law may specify different suspect periods for different types of transaction.

*Transactions with related persons (paras. 182-184)*

90. The insolvency law may specify that the suspect period for avoidable transactions involving related persons is longer than for transactions with unrelated persons.

91. The insolvency law should specify the categories of persons with sufficient connection to the debtor to be treated as related persons.<sup>45</sup>

*Transactions exempt from avoidance actions (para. 185)*

92. The insolvency law should specify the transactions that are exempt from avoidance, including financial contracts.

<sup>45</sup>“Related person” is defined in the glossary (see Introduction, para. 12 (jj)).



***Recommendations 87-99 (continued)****Conduct of avoidance proceedings (paras. 192-195)*

93. The insolvency law should specify that the insolvency representative has the principal responsibility to commence avoidance proceedings.<sup>46</sup> The insolvency law may also permit any creditor to commence avoidance proceedings with the agreement of the insolvency representative and, where the insolvency representative does not agree, the creditor may seek leave of the court to commence such proceedings.

*Funding of avoidance proceedings (para. 196)*

94. The insolvency law should specify that the costs of avoidance proceedings be paid as administrative expenses.

95. The insolvency law may provide alternative approaches to address the pursuit and funding of avoidance proceedings.

*Time limits for commencement of avoidance proceedings (para. 197)*

96. The insolvency law or applicable procedural law should specify the time period within which an avoidance proceeding may be commenced. That time period should begin to run on the commencement of insolvency proceedings. In respect of transactions referred to in recommendation 87 that have been concealed and that the insolvency representative could not be expected to discover, the insolvency law may provide that the time period commences at the time of discovery.

*Elements of avoidance and defences (paras. 198-201)*

97. The insolvency law should specify the elements to be proved in order to avoid a particular transaction, the party responsible for proving those elements and specific defences to avoidance. Those defences may include that the transaction was entered into in the ordinary course of business prior to commencement of insolvency proceedings. The law may also establish presumptions and permit shifts in the burden of proof to facilitate the conduct of avoidance proceedings.

*Liability of counterparties to avoided transactions (para. 202)*

98. The insolvency law should specify that a counterparty to a transaction that has been avoided must return to the estate the assets obtained or, if

<sup>46</sup>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.



the court so orders, make a cash payment to the estate for the value of the transaction. The insolvency law should determine whether the counterparty to an avoided transaction would have an ordinary unsecured claim.

99. The insolvency law may specify that, where the counterparty does not comply with the court order avoiding the transaction, in addition to avoidance and any other remedy, a claim by the counterparty may be disallowed.

### **G. Rights of set-off**

204. The enforcement under insolvency law of rights of set-off of mutual obligations arising out of pre-commencement transactions or activities of the debtor is important not only to commercial predictability and the availability of credit, but also because it avoids the strategic misuse of insolvency proceedings. For these reasons, it is highly desirable that an insolvency law afford protection to such set-off rights.

205. In the majority of jurisdictions, set-off rights are not affected by the stay in insolvency and may be exercised after the commencement of insolvency proceedings, irrespective of whether the mutual obligations arose under a single contract or multiple contracts and irrespective of whether the mutual obligations matured before or after commencement of insolvency proceedings. In some jurisdictions a distinction is made; post-commencement set-off of obligations maturing prior to the commencement of insolvency proceedings is permitted, but post-commencement set-off of obligations maturing after the commencement of insolvency proceedings is limited or disallowed.

206. An alternative approach preserves set-off rights regardless of whether the mutual obligations matured prior to or after the commencement of insolvency proceedings, but applies the stay to the exercise of those rights in the same manner as the stay applies to the exercise of rights of secured creditors. In systems adopting this alternative approach, the creditor is treated as secured to the extent of its own valid but unexercised set-off rights and those rights are protected in a manner similar to the protections afforded to security interests.<sup>47</sup>

207. Insolvency laws almost universally include provisions that permit the insolvency representative to seek to avoid the effects of certain pre-commencement actions by creditors designed to enhance set-off rights (such as purchasing claims at a discount with the intention of building up set-off rights). The nature and scope of such provisions varies.

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<sup>47</sup>See above, paras. 59-69.

### ***Recommendation 100***

#### **Purpose of legislative provisions**

The purpose of provisions on set-off is:

(a) To provide certainty with respect to the effect of the commencement of insolvency proceedings upon the exercise of set-off rights;

(b) To specify the types of obligation that may be set off after commencement of insolvency proceedings; and

(c) To specify the effect of other provisions of the law (e.g. avoidance provisions and the stay) on the exercise of rights of set-off.

#### **Contents of legislative provisions**

100. The insolvency law should protect a general right of set-off existing under law other than the insolvency law that arose prior to the commencement of insolvency proceedings, subject to the application of avoidance provisions.

## **H. Financial contracts and netting**

208. Financial contracts have become an important component of international capital markets. Among other things, they enhance the availability of credit and are an important means of hedging against exchange rate, interest rate and other market fluctuations. Because of the way these transactions are structured and documented, it is imperative that there be certainty as to what happens when one of the parties to such contracts fails to perform—including for reasons of insolvency.

209. Financial contracts include, among other things, securities contracts, commodities contracts, forward contracts, options, swaps, securities repurchase agreements, master netting agreements and other similar contracts. Debtors often enter into multiple financial contracts with a given counterparty in a single course of dealing and the availability of credit is enhanced if rights under those contracts are fully enforceable in accordance with their terms, thereby permitting counterparties to extend credit based on their net exposure from time to time after taking into account the value of all “open” contracts.

210. Upon commencement of insolvency proceedings, counterparties seek to “close-out” open positions and “net” all obligations arising under financial contracts with the debtor. “Close-out netting” embraces two steps: firstly, termination of all open contracts as a result of the commencement of insolvency proceedings (close-out); secondly, the set-off of all obligations arising out of the closed out transactions on an aggregate basis (netting).

211. Permitting “close-out netting” after the commencement of insolvency proceedings is an important factor in mitigating systemic risks that could threaten the stability of financial markets. The value of or exposure under a financial contract may vary significantly from day to day (and sometimes from hour to hour) depending on conditions in the financial markets. Accordingly, the value of these contracts can be highly volatile. Counterparties typically mitigate or hedge the risks associated with these contracts by entering into one or more “matching” or “hedge” contracts with third parties, the value of which fluctuates inversely with the value of the debtor’s contract.<sup>48</sup>

212. Whether or not the debtor performs its contract with the counterparty, the counterparty must perform the hedge contract it enters into with third parties. If the debtor becomes insolvent and cannot perform its contract with the counterparty, the counterparty becomes exposed to market volatility because its hedge positions are no longer “covered” by its contract with the debtor. Under such circumstances, the counterparty typically seeks to “cover” the hedge contracts by entering into one or more new contracts so as to limit its exposure to future market fluctuations. The counterparty cannot, however, cover in this manner until it determines with certainty that it will not be required to perform its contract with the debtor. The counterparty relies on the ability to close out the debtor’s contract, which permits it to cover promptly after the commencement of insolvency proceedings.

213. Without the ability to close out, net and set off obligations in respect of defaulted contracts promptly after commencement of insolvency proceedings as described above, a debtor’s failure to perform its contract (or its decision to perform profitable contracts and not perform unprofitable ones) could lead the counterparty to be unable to perform its related financial contracts with other market participants. The insolvency of a significant market participant could result in a series of defaults in back-to-back transactions, potentially causing financial distress to other market participants and, in the worst case, resulting in the financial collapse of other counterparties, including regulated financial institutions. This domino effect is often referred to as systemic risk, and is cited as a significant policy reason for permitting participants to close out, net and set off obligations in a way that normally would not be permitted by insolvency law.

214. Systemic risk can also arise from concerns over the finality of payments and settlements of financial contracts that take place in central payment and settlement systems. These systems employ either bilateral or multilateral netting arrangements. The netting of financial contracts through these systems and the finality of clearing and settlement through them should be recognized and protected upon the insolvency of one of the participants in the system in order to prevent systemic risk.

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<sup>48</sup>The reference to a “contract” in this section includes the possibility of one or more contracts.

215. In many States, the application of general insolvency rules will allow the financial contracts to be performed in accordance with their terms following commencement of insolvency proceedings by giving effect to contract termination clauses triggered by insolvency (see above, paras. 114-119 and recommendations 70 and 71) and by allowing the set-off of obligations, whether a claim for breach is based on an automatic termination clause or arises pre-commencement. Other jurisdictions, with insolvency provisions that limit the effect of automatic termination clauses or that stay or limit the exercise of set-off rights and other creditor remedies, require specific exceptions in their insolvency laws to permit full enforcement of remedies in respect of financial contracts. It is also desirable that the exceptions extend to avoidance provisions that otherwise might apply to financial contracts and any restrictions that would limit the extent to which security can be applied to unsatisfied financial contract obligations remaining after set-offs are completed. The exceptions for financial contracts should be drafted broadly enough to protect the significant interests of parties that deal in financial contracts and to prevent systemic risk.

### ***Recommendations 101-107***

#### **Purpose of legislative provisions**

The purpose of provisions on netting and set-off in the context of financial transactions on financial markets is to reduce the potential for systemic risk that could threaten the stability of financial markets by providing certainty with respect to the rights of parties to a financial contract when one of those parties fails to perform for reasons of insolvency. These recommendations are not intended to apply to transactions that are not financial contracts and they would remain subject to the law applicable to set-off and netting.

#### **Contents of legislative provisions**

101. The insolvency law should recognize contractual termination rights associated with financial contracts that permit the termination of those contracts and the set-off and netting of outstanding obligations under those contracts promptly after the commencement of insolvency proceedings. Where the insolvency law stays the termination of contracts or limits the enforceability of automatic termination clauses on commencement of insolvency proceedings, financial contracts should be exempt from such limitations.<sup>49</sup>

<sup>49</sup>This will allow market participants to extend credit based on “net” positions and make it impossible for the debtor to “cherry-pick” contracts by performing some and breaching others, which is especially important with regard to financial contracts because of systemic risk.

102. Once the financial contracts of the debtor have been terminated by a counterparty, the insolvency law should permit the counterparty to net or set off obligations under those terminated financial contracts to establish a net exposure position relative to the debtor. This termination and set-off to establish a net exposure should be permitted regardless of whether the termination of the contracts occurs prior to or after the commencement of insolvency proceedings. Where the insolvency law limits or stays the exercise of set-off rights upon commencement of insolvency proceedings, set-off and netting of financial contracts should be exempt from such limitations.

103. Once the financial contracts of the debtor have been terminated, the insolvency law should permit counterparties to enforce and apply their security interest to obligations arising out of financial contracts. Financial contracts should be exempt from any stay under the insolvency law that applies to the enforcement of a security interest.

104. The insolvency law should specify that routine pre-bankruptcy transfers consistent with market practice, such as the putting up of margin for financial contracts<sup>50</sup> and transfers to settle financial contract obligations,<sup>51</sup> should be exempt from avoidance.

105. The insolvency law should recognize and protect the finality of the netting, clearing and settlement of financial contracts through payment and settlement systems upon the insolvency of a participant in the system.

106. Recommendations 101-105 should apply to all transactions that are considered to be “financial contracts”, whether or not one of the counterparties is a financial institution.<sup>52</sup>

107. Financial contracts should be defined broadly enough to encompass existing varieties of financial contract and to accommodate new types of financial contract as they appear.

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<sup>50</sup>“Margin” is the process of posting additional cash or securities as a security for the transactions in accordance with a contractual formula that accounts for fluctuations in the market value of the contract and the existing security. For example, on a swap, a margin of 105 per cent might be required to maintain the termination value of the contract. If the security position falls to 100 per cent, an additional margin might have to be posted.

<sup>51</sup>In some circumstances, a settlement payment might be viewed as a preference. In the example of a swap, settlement payments are to be made monthly or upon termination of the contract based on the market value of the contract. These payments are not value for value transfers, but rather payment of an accrued debt obligation that has matured. In countries that have a fixed suspect period for all transactions occurring before commencement, such a payment might also be subject to avoidance.

<sup>52</sup>Even if a given financial contract does not involve a financial institution, the impact of the insolvency of a counterparty could entail systemic risk.



### III. Participants

#### A. The debtor<sup>1</sup>

##### 1. Introduction

1. Insolvency laws adopt different approaches to the role the debtor plays in the insolvency proceedings, 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 of the debtor in management. The debtor will also have a role to play in assisting the insolvency representative to perform its own functions and providing information on the business to the court or the insolvency representative. In addition to obligations, the debtor will have certain rights with regard to those proceedings, such as to be heard in proceedings, to access information and to retain personal property. To ensure the efficient and effective conduct of the proceedings and provide certainty for all parties involved, it is desirable that an insolvency law establish clearly the extent of the debtor's rights and obligations.

##### 2. *Continued operation of the debtor's business and the role of the debtor*

###### (a) *Liquidation*

2. Once liquidation proceedings have commenced, the conservation of the estate requires comprehensive measures to protect the estate not only from the actions of creditors, but also from the debtor. 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, those 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, any transaction involving assets of the estate, including transfer of those assets, that is not authorized by the insolvency representative, the court or creditors (depending on the requirements of the insolvency law) generally will

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<sup>1</sup>Because the insolvency law will cover different types of business, whether sole traders, 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 *Legislative 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.

be void (or under some laws subject to avoidance) and the assets transferred (or their value) subject to recovery for the benefit of the insolvency estate (see chap. II, paras. 70-73).

3. 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.

*(b) Reorganization*

4. 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 and the manner in which that role is balanced with the roles of other participants. That ongoing role may depend in large part upon the debtor acting in good faith during the reorganization proceedings; where it does not, its continuing role may be of questionable value. It may also depend upon the existence of a strong, independent governance regime that can address incompetent or self-serving behaviour. Sometimes the advantages of a continuing role may also depend upon whether the debtor commenced the proceedings or whether they were commenced on the application of creditors. In the latter case the debtor may be uncooperative or even hostile to an extent that makes its continued participation pointless. The decision on which approach to take may depend upon a number of factors, including local corporate culture; the role of banks; the existence and effectiveness of corporate governance regimes; the effectiveness of insolvency institutions; the level of supervision provided by, or required of, the courts; the effectiveness and accessibility of the courts; and the extent to which incentives to commence insolvency proceedings are determined to be of importance to the design of the insolvency regime.

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

5. There are a number of potential advantages in allowing the debtor to have an ongoing role. 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 sole traders and small partnerships and, in the interests of business continuity, may 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. In such circumstances, total displacement of



the debtor, notwithstanding its role in the financial difficulties of the business, may not only eliminate an 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.

6. 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 those difficulties) 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. One factor that may affect creditors' views of this option is the effectiveness of any applicable corporate governance regime and the responsiveness of the debtor to that regime. Where there is no effective governance regime, creditors may prefer an appointed insolvency representative to displace the debtor or to have significant supervisory powers over the debtor.

7. A system that is perceived to be excessively pro-debtor may result in creditors being apathetic about the proceedings 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 proceedings, adding to costs and delay. A debtor may have its own agenda that clashes with the objectives of the insolvency regime and in particular with the maximization of returns for creditors. The debtor's 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 possessing the knowledge and experience to utilize the insolvency law to work through its financial difficulties. A related factor to be considered is whether the insolvency proceedings were commenced on application of the debtor or of creditors (in which case the debtor may be hostile to creditors).

8. 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 of the plan, 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, the limits applicable to the debtor's control and management of the business may cease to apply and the debtor will be responsible for implementation of the approved plan.

9. 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. The choice between these various approaches has implications for the structure of the insolvency regime and in particular for the balance to be achieved between the various participants and the extent to which checks and balances, whether provided by the court or creditors, will apply. It should be borne in mind in considering the debtor's role that, where the debtor is a legal entity, the management at the time of commencement of the insolvency will not necessarily remain in place throughout the proceedings.

(ii) *Approaches to a continuing role for the debtor*

a. *Total displacement of the debtor*

10. This 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, total displacement of the debtor may cause disruption to the business and repercussions detrimental to its continuing operation at a critical point in its survival.

b. *Supervision of the debtor by the insolvency representative*

11. 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 that 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 ordinary course of business. If they are not in the ordinary 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.

12. 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 such transactions and provide appropriate sanctions for the debtor's behaviour. While one insolvency law provides, for example, that in such circumstances the court can discontinue the insolvency proceedings altogether, the appropriateness of this remedy depends not only upon whether the proceedings were commenced on the application of the

debtor or creditors (the debtor should not be able to frustrate proceedings commenced on an application by creditors by failing to observe the insolvency law or orders of the court), but also upon what is in the best interests of all parties involved in the proceedings and the availability of other mechanisms in the insolvency law for addressing that type of behaviour by the debtor (including the possibility of converting reorganization proceedings to liquidation).

13. 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. 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 permit 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.

14. 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.

15. 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 management and control of the business will be unclear.

*c. Full control by the debtor*

16. 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 commence (often known as "debtor in possession"). Where the insolvency law permits a debtor to remain in control of the business, it is desirable that the functions of an insolvency representative that may be performed by that debtor in possession are specified. In some circumstances, that approach may enhance the chances of a successful reorganization by recognizing the debtor's familiarity with the business provided it can be relied

upon to carry on the business in an honest manner and obtain the trust, confidence and cooperation of creditors.

17. There may be, however, disadvantages to this approach, which include it being used in situations where the outcome is clearly not likely to be successful or 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. Some of 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; permitting the court, in certain circumstances, to appoint an insolvency representative to supervise the debtor; giving the creditors a significant role in supervising or overseeing the debtor; or providing for conversion of the proceedings to liquidation.

18. It should be noted that, where this approach is adopted, the management of the debtor at the commencement of the proceedings is often not the same management that is charged with implementation of an approved plan and some of the factors noted above will not be as compelling as they would be in circumstances where the debtor's management remains in place throughout the proceedings. Nevertheless, the debtor-in-possession approach is a complex one that requires detailed consideration not only because it depends upon strong corporate governance rules and institutional capacity, but also because it affects the design of a number of other provisions of an insolvency regime (e.g. preparation of the reorganization plan, exercise of avoidance powers, treatment of contracts and obtaining post-commencement finance) that are not addressed in detail in the *Legislative Guide*.

### 3. *Rights of the debtor*

19. To preserve what are regarded in some States as fundamental rights of the debtor and to ensure its fair and impartial treatment, and perhaps more importantly to encourage debtor confidence in insolvency proceedings, it is desirable that the role of the debtor in the proceedings and the rights it will have with respect to the conduct of the proceedings be clearly enumerated in the insolvency law. In many States, 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<sup>2</sup> and the European Convention on Human Rights.<sup>3</sup>

#### *Right to be heard, to access information and to retain personal property*

20. 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

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<sup>2</sup>United Nations, *Treaty Series*, vol. 999, No. 14668.

<sup>3</sup>*Ibid.*, vol. 213, No. 2889.

decision-making that is a necessary part of the proceedings, in particular reorganization proceedings. 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 of creditors. As noted above (chap. II, paras. 18-21), where the debtor is a natural person, certain assets are generally excluded from the insolvency estate in order to enable the debtor to preserve its personal rights and those of its family and it is desirable that the right to retain those excluded assets be made clear in the insolvency law.

21. 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 present 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. Similarly, in cases where the debtor is no longer operational and cannot be heard as such, or where the equity holders and owners of the business will not participate in any distribution in the proceedings, an absolute requirement to be heard may not serve any useful purpose. For these reasons, while it is 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 in exceptional cases to avoid the requirement to observe the right adversely affecting the conduct of the proceedings.

#### 4. *Obligations of the debtor*

22. 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. The obligations should arise on the commencement of the proceedings and continue to apply throughout the proceedings. 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) *Cooperation and assistance*

23. To ensure that insolvency proceedings can be conducted effectively and efficiently, some insolvency laws that provide for some level of displacement or supervision of the debtor impose on the debtor a general obligation to cooperate 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 cooperate will be to enable the insolvency representative to take effective control of the insolvency estate by the debtor surrendering control of assets, business records and books. Where the assets of the debtor are located in a foreign jurisdiction, it may not be possible for the debtor to surrender control of those assets, but the obligation should refer to facilitating or cooperating with the insolvency representative in the recovery of those assets located abroad (see the UNCITRAL Model Law on Cross-Border Insolvency, annex III). The obligation to cooperate may also require the debtor to assist the insolvency representative to prepare a list of creditors and their claims, as well as a list of the debtor's debtors (see below, para. 49).

(b) *Provision of information*

24. To facilitate a thorough, independent assessment of the business activities of the debtor, including its immediate liquidity needs and the advisability of obtaining 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, it is desirable that in both liquidation and reorganization, but in particular in reorganization and where the business is to be sold as a going concern in liquidation, 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; income and disbursements; 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 involved the debtor or assets of the debtor, including those which may be capable of avoidance under the insolvency law; and information concerning outstanding contracts, transactions involving related persons and ongoing court, arbitration or administrative 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, as noted above, to prepare, often in cooperation with the insolvency representative, a list of creditors against which claims can be verified, as well as a list of its debtors. The debtor may also be required to update the list of claims from time to time as claims are verified and admitted or denied.

25. Although it may not be necessary for an insolvency law to detail exhaustively the information that is to be provided by the debtor, an approach of

listing the type of information required may be useful to provide guidance and, potentially, to avoid disputes. In that regard, some laws have developed standardized information forms 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.

26. 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, subject to allowing the debtor the time necessary to collect the relevant information. 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.

27. The procedure for eliciting the information outlined above may be central to the ultimate usefulness of that information. If, for example, members of the management of the debtor are responsible for the debtor's current financial situation, they may be unwilling to give full and frank disclosure or to disclose information that may be self-incriminating (although many criminal laws provide that self-incriminating evidence may not be used in subsequent criminal proceedings in order to encourage frank disclosure). Accordingly, in addition to the debtor's obligation to provide information, it may be desirable for an insolvency law to give the insolvency representative and the creditors or the creditor committee the corresponding right to demand and receive information from the debtor, with appropriate sanctions where the requested information is not forthcoming. The debtor's obligation may be supplemented by additional measures that include appointing an independent person to examine the debtor as to its financial affairs or requiring 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 meeting of creditors to answer questions (except where this is not physically possible for geographical reasons).

(c) *Confidentiality*

28. Often the information to be provided by the debtor or concerning the debtor will be of a commercially sensitive nature, confidential or subject to obligations owed to other persons (such as trade secrets, lists of customers and suppliers, research and development information, professional secrets or privileged or otherwise confidential information) and may belong either to the debtor or to a third party, but be in the control of the debtor. It is desirable that an insolvency law include provisions to protect these types of information from abuse by creditors or other parties who are in a position to take advantage of it in insolvency. In order to balance the debtor's obligation of protection against its obligation to provide information to the insolvency representative, the court or to creditors, the obligation to observe confidentiality and protect this information may also need to apply to parties connected to the debtor, the insolvency representative, creditors generally, creditor committees and third parties.



(d) *Ancillary obligations*

29. A number of insolvency laws impose additional obligations that are ancillary to the debtor's obligation to cooperate and assist. These may include an obligation (applying either to a natural person debtor or the managers and directors of a legal person debtor) not to leave their habitual place of residence without the permission of the court or the insolvency representative or to provide notice to the court or the insolvency representative if they propose or are forced to leave that residence, to disclose all correspondence to the insolvency representative or the court and other limitations touching upon personal freedom. In the case of a legal person debtor, limitations may also apply to movement of the headquarters of that legal person and an insolvency law may require consent of the court or the insolvency representative where such movement is proposed. 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 for these ancillary duties to 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.

30. Some insolvency laws specify these obligations as automatically applicable, while others provide that they may be ordered at the discretion of the court where they are determined to be necessary for the administration of the estate. Some laws also distinguish between natural and legal person debtors; where the debtor is a natural person, limitations will only apply by order of the court, but where the debtor is a legal person, some limitations may apply automatically, such as the requirement to disclose correspondence.

(e) *Employment of professionals to assist the debtor*

31. To assist the debtor in carrying out its duties in relation to the proceedings generally, some insolvency 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 others by the court or the creditors.

(f) *Failure to observe obligations*

32. Where the debtor fails to comply with its obligations, the insolvency law may need to consider how that failure should be treated, taking into account the nature of different obligations and appropriate sanctions. As noted above, where information is withheld by the debtor, a mechanism to compel the provision of relevant information such as a "public examination" of the debtor by the court or the insolvency representative may be appropriate. In more serious cases of withholding of information a number of States impose criminal sanctions. Similar approaches may be appropriate for the breach of other obligations. In reorganization, conversion to liquidation (see chap. IV,



paras. 72-75) may be an appropriate sanction, provided it is in the best interests of creditors. There will be cases where continuation of the reorganization, notwithstanding the debtor's failure to cooperate or to otherwise observe its obligations, will be in the best interests of creditors.

33. 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. For example, contracts entered into by the debtor after the commencement of proceedings might be addressed in the context of avoidance proceedings or as unauthorized transactions. Consideration may also need to be given to the parties to whom the sanctions should apply in the case of a legal person debtor, for example, any person who generally might be described as being in control of the debtor, including directors and management.

### 5. Debtor's liability

34. When a business entity is solvent, the owners of the business are its principal financial stakeholders and relations with 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 is primarily a matter of law and policy outside the insolvency regime. It is not desirable that an insolvency law be used to remedy defects in that area of legal regulation or to police corporate governance policies, exhaustively although some insolvency laws might include an obligation to commence insolvency proceedings at an early stage of financial difficulty. If the consequence of the past conduct and behaviour of persons connected with an insolvent debtor is damage or loss to the creditors of the debtor (e.g. 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 persons concerned.

#### ***Recommendations 108-114***

##### **Purpose of legislative provisions**

The purpose of provisions concerning the debtor is:

- (a) To establish the rights and obligations of the debtor during the insolvency proceedings;
- (b) To address the remedies for failure of the debtor to meet its obligations; and
- (c) To address issues relating to management of the debtor in insolvency proceedings.

## ***Recommendations 108-114 (continued)***

### **Content of legislative provisions**

#### *Rights*

##### *Right to be heard (paras. 20 and 21)*

See recommendation 137.

##### *Right to participate and request information (para. 20)*

108. The insolvency law should specify that the debtor is entitled to participate in the insolvency proceedings, and to obtain information relating to those proceedings from the insolvency representative and the court.

##### *Right to retain property to preserve the personal rights of the debtor (para. 20)*

109. Where the debtor is a natural person, the insolvency law should specify that the debtor is entitled to retain those assets excluded from the estate by the law.<sup>4</sup>

#### *Obligations of the debtor (paras. 22-27, 29 and 30)*

110. The insolvency law should clearly specify the debtor's obligations in respect of insolvency proceedings. Those obligations should arise on the commencement of, and continue throughout, those proceedings. The obligations should include obligations:

(a) To cooperate with and assist the insolvency representative to perform its duties;

(b) To provide accurate, reliable and complete information relating to its financial position and business affairs that might be requested by the court, the insolvency representative, creditors and/or the creditor committee, including lists of:<sup>5</sup>

- (i) Transactions occurring prior to commencement that involved the debtor or the assets of the debtor;
- (ii) Ongoing court, arbitration or administrative proceedings, including enforcement proceedings;
- (iii) Assets, liabilities, income and disbursements;
- (iv) Debtors and their obligations; and
- (v) Creditors and their claims prepared in cooperation with the insolvency representative and revised and amended by the debtor as claims are verified and admitted or denied;

(c) To cooperate with the insolvency representative to enable the insolvency representative to take effective control of the estate and to facilitate or

<sup>4</sup>See chap. II, paras. 17-21 and recommendation 38.

<sup>5</sup>Subject to allowing the debtor the time necessary to collect the relevant information.

cooperate in the recovery by the insolvency representative of the assets, or control of the assets of the estate, wherever located<sup>6</sup> and business records; and

(d) Where the debtor is a natural person, to provide notice to the court if it proposes or is forced to leave its habitual place of residence and, where the debtor is a legal person, to obtain the consent of the court or the insolvency representative to the movement of its the headquarters.

*Confidentiality (paras. 28, 52 and 115)*

111. The insolvency law should specify protections for information provided by the debtor or concerning the debtor<sup>7</sup> that is commercially sensitive or confidential.

*The debtor's role in continuation of the business (paras. 2-18)*

112. The insolvency law should specify the role of the debtor in the continuing operation of the business during insolvency proceedings. Different approaches may be taken, including:

(a) Retention of full control of the business (debtor in possession), with appropriate protections including varying levels of control of the debtor and provision for displacement of the debtor in specified circumstances;<sup>8</sup>

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

(c) Total displacement of the debtor from any role in the business and the appointment of an insolvency representative.

113. The insolvency law should specify, where the debtor is a debtor in possession, those functions of the insolvency representative that may be performed by the debtor in possession.

*Sanctions for the debtor's failure to comply with its obligations (paras. 32 and 33)*

114. The insolvency law should permit the imposition of sanctions for the debtor's failure to comply with its obligations under the insolvency law.

<sup>6</sup>See the UNCITRAL Model Law on Cross-Border Insolvency (annex III).

<sup>7</sup>Information provided by the debtor may include information in control of the debtor, owned by the debtor or a third party and information concerning the debtor may be provided by creditors, financial institutions and others.

<sup>8</sup>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 discussion, see above, paras. 16-18).

## B. The insolvency representative

### 1. Introduction

35. 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 the *Guide* to refer to the person fulfilling the range of functions that may be performed in a broad sense without distinguishing between those different functions in different types of proceeding. The insolvency representative may be an individual or, in some jurisdictions, a corporation or other separate legal entity. However appointed, the insolvency representative plays a central role in the effective and efficient implementation of an insolvency law, with certain powers over debtors and their assets and a duty to protect those assets and their value, as well as the interests of creditors and employees, and to ensure that the law is applied effectively and impartially. Accordingly, it is essential that the insolvency representative be appropriately qualified and possess the knowledge, experience and personal qualities that will ensure not only the effective and efficient conduct of the proceedings and but also that there is confidence in the insolvency regime.

### 2. Qualifications

36. The qualifications required of a person who can be appointed as an insolvency representative may vary depending upon the design of an insolvency law with regard to the role of the insolvency representative (including whether the proceedings are liquidation or reorganization) and the 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, paras. 44-47). Where the insolvency law provides for a public official to be appointed as insolvency representative, the specific qualifications discussed below will generally not be relevant to that appointment (although they may be relevant to the employment of the official by the government agency).

37. 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 of the insolvency representative may be an important factor in achieving the required balance.

#### (a) *Interim insolvency representative*

38. Where an insolvency representative is appointed on an interim basis by the court before insolvency proceedings commence, the powers and functions

of that person will generally 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, as well as liability and rates of remuneration, as a representative appointed after commencement.

(b) *Knowledge and experience*

39. The complexity of many insolvency proceedings makes it highly desirable for the insolvency representative to be appropriately qualified, with knowledge of the law (not only insolvency law, but also relevant commercial, finance and business law), as well as adequate experience in commercial and financial matters, including accounting. The insolvency representative will be required to demonstrate competence in carrying out its assigned functions in a range of different cases and circumstances that are likely to be contentious, in both liquidation and reorganization, where time limits may be imposed by the insolvency law, where commercial requirements have to be balanced against legal considerations and where there is a need to serve the interests of others, such as creditors and maybe a public interest. 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 a person to be appointed as an insolvency representative in a particular case to have expertise and skills suited to that case, such as knowledge of the debtor's particular business, its assets and the type of market in which it operates.

(c) *Ensuring appropriate qualifications*

40. 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; specialized training courses and certification examinations; and 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. There may also be requirements for ongoing professional education to ensure familiarity with current developments in relevant areas of law and practice. 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 under legislation other than the insolvency law. A number of these systems are relatively complex and it is beyond the scope of the *Legislative Guide* to consider them in any detail.

(d) *Personal qualities*

41. In addition to having the requisite knowledge and experience, it may also be desirable for the insolvency representative to possess certain personal qualities, such as integrity, impartiality, independence and good management skills.

Integrity should require that the insolvency representative has a sound reputation and no criminal record or record of financial wrongdoing or, in some States, no previous insolvency or removal from a position of public administration. The occurrence of such an event would generally be sufficient to disqualify the proposed appointee from appointment.

*(e) Conflict of interest*

42. An essential element of these personal qualities is that the insolvency representative is able to demonstrate independence from vested interests, whether of an economic, familial or other nature. To that end, it is desirable that the insolvency law impose an obligation to disclose existing or potential conflicts of interest, which would apply to a person proposed for appointment as an insolvency representative at the commencement of the proceedings and to the appointed person on a continuing basis throughout the proceedings. The law should specify to whom the disclosure should be made. This may vary depending upon the procedure for selection and appointment of the insolvency representative. The circumstances that amount to a conflict of interest vary between laws, as do the consequences of a conflict being disclosed at the commencement of proceedings or discovered at some later stage.

43. A conflict of interest may arise, for example, from a number of prior or existing relationships with the debtor. Prior ownership of the debtor; a prior or existing business relationship with the debtor (including being a party to a transaction with the debtor that may be subject to investigation in the insolvency proceedings and being a creditor or debtor of the debtor); a relationship with a creditor of the debtor; prior engagement as a representative or officer of the debtor; prior engagement as an auditor of the debtor; and a relationship with a competitor of the debtor may be sufficient to establish a conflict of interest. In some States that conflict of interest will preclude the appointment of the person as an insolvency representative or disqualify an appointee from continuing in that role. In others, the person may still be appointed, provided the conflict of interest is disclosed on the basis that the disclosure supports their integrity and any impartiality or lack of independence can be assessed against the circumstances disclosed. In order to enhance the transparency, predictability and integrity of an insolvency regime, it is desirable that an insolvency law specify the degree of relationship that gives rise to such a conflict of interest, including specifying those relationships which will disqualify a person from being appointed. It is generally left to the courts to determine whether or not a conflict of interest or a basis for demonstrating lack of independence exists in a particular case.

*3. Selection and appointment of the insolvency representative*

44. Insolvency laws adopt a number of different approaches to selection and appointment of an insolvency representative. The first step involves determining the pool of potential candidates for appointment. 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). In some jurisdictions, the insolvency law provides that a particular public official (variously titled the “official trustee”, the “official receiver” or the “official assignee”) will automatically be appointed to all insolvency cases or to certain types of insolvency case. In many States, the insolvency representative must be a natural person, but some States 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.

(a) *Court selection and appointment*

45. The second step is to determine the procedure for appointing an insolvency representative from among the pool of those eligible. 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, 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 is compiled and upon the qualifications required of insolvency professionals in order to be included on that roster and it may not be as important an issue where the estate does not have sufficient assets to fund the cost of the administration.

(b) *Independent appointing authorities*

46. 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. This approach may have the advantage of 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 asset; 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 obviously depend upon the existence of an appropriate body or institution that has both the resources and infrastructure necessary to perform the required functions or will require the establishment of such body or institution.

(c) *Role of creditors*

47. 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. Both this approach and the one that relies upon the independent appointing authority



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 familiarize 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 an insolvency representative in those circumstances. These concerns may be addressed by permitting creditors, in appropriate circumstances, to replace an insolvency representative appointed by the debtor.

#### *4. Oversight of the insolvency representative*

48. In addition to the requirements for qualifications and personal qualities applicable on appointment, oversight of the insolvency representative's performance of its functions (and its demonstration of the qualities indicated above) can occur in respect of individual cases through the design of an insolvency law and the respective roles assigned to participants. Insolvency laws adopt a variety of approaches, for example, to the relationship between the insolvency representative and the court and, in particular, to the delineation of powers between them, as well as to the role that creditors might play in overseeing certain decisions of the insolvency representative and on other issues, such as remuneration and even removal from office. Since it normally has the most information regarding the situation of the debtor, the insolvency representative is often 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. Notice may be required to be given to the court or to creditors before the insolvency representative takes certain decisions; the insolvency representative may be required to report to the court and to creditors on a regular basis or in respect of certain activities; the court generally would be required to adjudicate disputes arising in the conduct of the proceedings; and its approval is often required at a number of stages during the proceedings. Even in States where the court plays a more restricted role in insolvency proceedings, there is a limit to the amount of authority that would normally be conferred upon an insolvency representative.

#### *5. Duties and functions of the insolvency representative*

49. Insolvency laws often specify the duties and 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 those duties and functions efficiently and effectively. The duties and functions with respect to the administration of the proceedings and preservation and protection of the estate may generally include those set out below (although the list is not intended to be exhaustive and in some cases the different functions



will overlap or may not be relevant because of the design of the insolvency law) and some may be more relevant to liquidation than to reorganization:

(a) Taking immediate control of the assets comprising the insolvency estate and the debtor's business records;

(b) Representing the insolvency estate;

(c) Obtaining post-commencement finance;

(d) Exercising rights for the benefit of the insolvency estate in respect of court, arbitration or administration proceedings under way;

(e) 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;

(f) Taking all steps necessary to protect and preserve the assets of the insolvency estate and the debtor's business, including preventing unauthorized disposal of those assets and exercising avoidance powers;

(g) Registering rights of the estate (where registration is necessary to perfect the rights of the estate against bona fide purchasers);

(h) Appointing and remunerating accountants, attorneys and other professionals that may be necessary to assist the insolvency representative in performing its functions;

(i) Examining contracts that are not fully performed with a view to deciding whether to continue performance or reject;

(j) Dealing with employees and their rights and entitlements, including pension rights;

(k) In liquidation, realizing the assets of the insolvency estate;

(l) Verifying and admitting claims and maintaining an updated list of claims verified and admitted;

(m) Periodically providing information to the court and to creditors detailing the conduct of the proceedings. The information would 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 creditor committee may reasonably require; receipts and disbursements; and assets remaining to be administered;

(n) Attending meetings of creditors;

(o) Continuing operation and management of the business in reorganization and in liquidation where the business is to be sold as a going concern;

(p) In reorganization, preparing or assisting to prepare 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);

(q) Supervising approval of the reorganization plan and, where required, the implementation of the plan;

(r) Distributing the proceeds of realization of the estate in liquidation and closing the estate promptly, efficiently and in accordance with the best interests of the various constituencies in the case;

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

(t) Any other matters that may be referred to the insolvency representative by the creditors or the court.

50. 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 assets of the insolvency estate and a duty to get the best price reasonably obtainable on the sale of assets of the estate.

51. Where reorganization involves a debtor in possession and no insolvency representative is appointed, many of the functions listed above will be performed by the debtor, with varying degrees of supervision by the court or by creditors.

## 6. Confidentiality

52. The need to impose an obligation of confidentiality on the debtor has been noted above. It may also be appropriate for an 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 of a commercially sensitive nature, confidential or subject to obligations owed to other persons (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. Where the information is to be disclosed to creditors, those creditors should be under the same obligation of confidentiality as the insolvency representative. 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 proceedings 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 and employees of the insolvency representative (see below, para. 66) and to other parties as ordered by the court (including creditors, see below, para. 115).

## 7. Remuneration of the insolvency representative

### (a) Determination of quantum

53. 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 should achieve a balance between risk and reward in order to attract appropriately qualified professionals. Several methods are adopted for calculating that remuneration. It may be fixed by reference to an approved scale of fees set 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 that 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 be a fixed percentage and include provision for increase or decrease depending upon the particular case. In each of these cases, the insolvency law generally makes provision for further investigation upon the application either of a party in interest or the insolvency representative itself, depending upon the method of calculation. Such an approach will be important to ensure transparency. At the same time, however, it is important to avoid a situation where the party with the right of final determination can influence the conduct of the proceedings.

(i) *Time-based systems*

54. 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 maximize the time spent on administration without necessarily achieving a proportional return of value to the estate.

(ii) *Commission-based systems*

55. 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 that are not directly related to increasing returns to creditors, such as obligations to report to both the court and to creditors and to assist regulatory authorities with investigations into the debtor's affairs and possible misconduct. This method of calculation may also lead, in very large cases, to significantly large fees being paid out of the estate, which can deter both creditor and debtor applications.

*(iii) Involvement of creditors*

56. In some States, the creditors (or the creditor committee) 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 remuneration setting and approval. Remuneration could also be reviewed periodically during the course of the proceedings, with any problems being addressed and resolved as they arise, perhaps by arbitration or some other form of dispute resolution between the insolvency representative and the creditors. Care should be taken to avoid a situation where the right of final determination enables one party to unduly influence conduct of the proceedings.

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

*(b) Means of payment*

58. Payment of the remuneration of the insolvency representative is often a source of complaint from unsecured creditors; the most common source of available funds is often unencumbered assets and payment of the remuneration may result in nothing being left 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 value of the unencumbered 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 they are included in the insolvency estate, remuneration could be paid from unencumbered assets; a surcharge could be levied against assets to pay for the administration or sale of those assets where the administration or sale would be of benefit to the creditors; a surcharge also could be levied on creditors making an application to commence insolvency proceedings to cover at least initial costs and performance of basic administration functions; or encumbered assets may be subject to payment of a proportionate or defined share of remuneration. Another approach is to pay the insolvency representative from a fund maintained for that purpose by the State, an approach that may be particularly

relevant in the case of debtors with insufficient assets to pay for administration of the estate (see chap. I, paras. 72-75).<sup>9</sup>

(c) *Review of remuneration*

59. Depending upon the manner in which the insolvency representative's remuneration is fixed, it may be desirable to provide a review procedure to address dissatisfaction of the insolvency representative itself or of creditors. 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 per cent of the total debts. Where the remuneration is set by the court in the first instance, different approaches are taken; some laws permit the insolvency representative to appeal that decision, other laws do not. Some insolvency laws also 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.

8. *Liability of the insolvency representative*

60. 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 that the difficult circumstances in which the insolvency representative finds itself when fulfilling its role are taken into account and balanced against payment of an appropriate level of remuneration and the need to attract qualified persons to act as insolvency representatives. A balance is also desirable between a standard that will ensure competent performance of the duties of the insolvency representative and one that is so stringent it invites law suits against the insolvency representative and raises the costs of its services. An insolvency law will also need to take into consideration the fact that the liability of the insolvency representative may often involve the application of law outside insolvency or, where the insolvency representative is a member of a professional organization, the relevant professional standards of the organization.

61. Under many legal systems, the insolvency representative will be liable in a civil action for damages arising from its misfeasance or malfeasance, although different approaches are taken to setting the standard required. To some extent, the measure adopted will depend upon the how the insolvency

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<sup>9</sup>Such a fund may be financed by a number of means, for example, payments by the directors of debtors being liquidated; increased filing fees for insolvency applications; requiring all monies realized in liquidation to be deposited into a common account, with interest going to the fund; or imposing a levy on lodgement of annual corporate returns.

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 States, however, may require a higher standard of prudence in such a case because the insolvency representative is not dealing with its own assets, but with assets belonging to another person. 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 to determine negligence.

62. One means of addressing the issue of liability for damages may be to require the insolvency representative to post a bond or take out insurance to cover loss of assets of the estate or possible damages payable as a result of a breach of its duties. A number of insolvency laws require both payment of a bond and insurance where the bond will cover one kind of damage and the insurance another, while others require only insurance. In some cases the level of the bond required relates to the book value of the assets of the insolvency estate. 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 or even in the insolvency law. A further distinction between the two approaches may relate to the procedure for making a claim for damages and whether it is different for claiming against a bond or against insurance. Paying a bond or obtaining personal indemnity insurance, however, may not be possible in all States and other solutions will be needed. In designing the solution to this issue, a balance may be desirable between controlling the costs of the service provided by insolvency representatives and distributing the risks of the insolvency proceedings among the participants, rather than placing it entirely upon the insolvency representative on the basis of availability of personal indemnity insurance.

63. Another issue of liability is whether the insolvency representative will be personally liable for obligations incurred in the ordinary course of insolvency proceedings, in particular in reorganization, such as those relating to the ongoing operation of the business. The advantages of adopting an approach that makes the insolvency representative personally liable would be that it creates certainty for suppliers to the debtor and may operate as a check to the incurring of debt. At the same time, however, it may also operate as a disincentive if the risk of personal liability far exceeds the fees that may be earned. One solution is to make only the assets of the estate liable, rather than the personal assets of the insolvency representative.

64. A further issue of liability relates to liability of the insolvency representative for wrongful acts of the debtor, which may depend upon the level of control the insolvency representative exercises over the debtor's activities. Under some laws, the insolvency representative may be made liable for the wrongful acts of the debtor during the period of its control, but it is not desirable that the insolvency representative be liable for acts of the debtor,

such as environmental damage, occurring prior to its appointment as insolvency representative.

65. Where an action is commenced against the insolvency representative in its official capacity, consideration may need to be given to determining which court will have jurisdiction over the action. To avoid uncertainty and confusion, it may be desirable to ensure that it is the same court that appointed the insolvency representative (where the court plays a role in such appointments).

### 9. *Agents and employees of the insolvency representative*

66. 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 establish 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. The requirements for disclosure of conflicts of interest or circumstance giving rise to a lack of independence that apply to the insolvency representative are also relevant to professionals employed or proposed for employment by the insolvency representative, as are obligations of confidentiality.

#### (a) *Liability for acts or omissions*

67. 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.

#### (b) *Remuneration*

68. Different approaches may be adopted towards payment of the professionals employed by the insolvency representative. Some laws require an application to and approval by the court of the amount of the remuneration, while another approach may be to require approval by creditors. Professionals may be paid periodically during the proceedings or may be required to wait until the proceedings are completed. In terms of how they are to be paid, some insolvency laws provide that the insolvency representative will pay the professional and seek reimbursement from the estate, while under other laws the professional will have an administrative claim against the estate.

### 10. *Review of the insolvency representative's administration*

69. 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.

70. 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 creditor 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.

71. In the second category are those laws which provide, normally in addition to the grounds related to specific wrongdoing, that creditors can test (typically in the courts) any decision, act or omission of the insolvency representative that 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.

72. Most laws provide the courts, in reviewing an insolvency administration and enforcing the substantive rights of creditors, with 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. Many insolvency laws provide that the insolvency representative is personally liable for damages intentionally or negligently caused to creditors through the performance of its duties. Some insolvency laws also provide that in those circumstances the court may impose a monetary penalty on the insolvency representative.

### *11. Removal of the insolvency representative*

73. Some insolvency laws permit the insolvency representative to be removed in certain circumstances. These may include that the insolvency representative had violated or failed to comply with its legal duties under the insolvency law; had demonstrated gross incompetence or gross negligence; had not disclosed a conflict of interest; 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. The latter may occur, for example, where the proceedings are converted from liquidation to reorganization, which requires skills the insolvency representative may not have or, in the case of a debtor-in-possession reorganization, which do not require an insolvency representative to be appointed. 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 a party in interest, or a decision taken by an appropriate majority of unsecured creditors. Whichever approach is adopted, removal operates as a sanction against the insolvency representative and it is therefore appropriate that the insolvency representative have the right to be heard and to present its case. In cases where the insolvency representative is subject to professional or regulatory supervision, it may be removed as the result of an investigation and review, which may also result in a licence or other authorization being taken away.

### *12. Replacement of the insolvency representative*

74. In the event of the resignation or removal of the insolvency representative or the occurrence of any other event that might cause the insolvency representative to be unable to perform its duties, such as death or serious illness, disruption and delay of the proceedings may be avoided by providing a successor insolvency representative to be appointed, either by the court or by creditors. Some insolvency laws require the courts also to approve the resignation of the insolvency representative, while other laws do not. 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, 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 and remuneration for work undertaken during the appointment.

#### ***Recommendations 115-125***

##### **Purpose of legislative provisions**

The purpose of provisions concerning the insolvency representative is:

- (a) To specify qualifications required for appointment;
- (b) To establish a mechanism for selection and appointment;
- (c) To specify powers and functions; and
- (d) To provide for remuneration, liability, removal and replacement.

## ***Recommendations 115-125 (continued)***

### **Contents of legislative provisions**

#### *Qualifications (paras. 36-41)*

115. The insolvency law should specify the qualifications and qualities required for appointment as an insolvency representative, including integrity, independence, impartiality, requisite knowledge of relevant commercial law and experience in commercial and business matters. The insolvency law should also specify the grounds upon which a proposed insolvency representative may be disqualified from appointment.

#### *Conflict of interest (paras. 42 and 43)*

116. The insolvency law should require the disclosure of a conflict of interest, a lack of independence or circumstances that may lead to a conflict of interest or lack of independence by:

(a) A person proposed for appointment as an insolvency representative or a person appointed as an insolvency representative where the conflict of interest or the circumstances that may lead to a conflict of interest or lack of independence arise in the course of insolvency proceedings; and

(b) Persons proposed for employment by the insolvency representative or the estate, including professionals or a person employed by the insolvency representative or the estate, where the conflict of interest or the circumstances that may lead to a conflict of interest or lack of independence arise in the course of insolvency proceedings.

117. The insolvency law should specify that the obligation to disclose set forth in recommendation 116 should continue throughout the insolvency proceedings. The insolvency law should specify the consequences of a conflict of interest or lack of independence.

#### *Appointment (paras. 44-47)*

118. The insolvency law should establish a mechanism for selection and appointment of an insolvency representative. 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 insolvency law, where the insolvency representative is a government or administrative agency or official.

#### *Remuneration (paras. 53-59)*

119. The insolvency law should establish a mechanism for fixing the remuneration of the insolvency representative and establish priority for payment of that remuneration.

#### *Duties and functions of the insolvency representative (para. 49)*

120. The insolvency law should specify that the insolvency representative has an obligation to protect and preserve the assets of the estate. The insolvency law should specify the insolvency representative's duties and

functions with respect to the administration of the proceedings and preservation and protection of the estate, including continued operation of the debtor's business.

*Right to be heard (para. 116)*

See recommendation 137.

*Confidentiality (paras. 28, 52 and 115)*

See recommendation 111.

*Liability (paras. 60-65)*

121. The insolvency law should specify the consequences of the insolvency representative's failure to perform, or to properly perform, its duties and functions under the law and any related standard of liability imposed.

*Removal and replacement (paras. 73 and 74)*

122. The insolvency law should establish the grounds and procedure for removal of the insolvency representative. The grounds may include:

- (a) Incompetence, failure to perform or failure to exercise the proper degree of care in the performance of its powers and functions;
- (b) Inability to perform;
- (c) Lack of a particular or specialized qualification required by a specific case;
- (d) Engaging in illegal acts or conduct;
- (e) Conflict of interest or a lack of independence that would justify removal; or
- (f) Where the function of the insolvency representative changes.<sup>10</sup>

123. The insolvency law should establish a mechanism for removal of the insolvency representative that reflects the manner in which the insolvency representative was appointed and provides a right for the insolvency representative to be heard.

124. In the event of the death, resignation or removal of the insolvency representative, the insolvency law should establish a mechanism for appointment of a replacement and specify whether or not court approval of the replacement is necessary.

*Estates with insufficient assets to meet the costs of administration (para. 45 and chap. I, paras. 72-75)*

125. Where the insolvency law provides for an insolvency representative to be appointed to administer an estate with insufficient assets to meet the costs of administration, the insolvency law should also establish a mechanism for appointment and remuneration of that representative.

<sup>10</sup>Such as where the proceedings are converted from liquidation to reorganization.

## C. Creditors: participation in insolvency proceedings

### 1. Introduction

75. Creditors have a significant interest in the debtor's business once insolvency proceedings are commenced. As a general proposition, many insolvency laws provide that such interests are safeguarded by the appointment of an insolvency representative. For a number of different reasons, many insolvency laws facilitate direct creditor involvement in the proceedings. As the party with the primary economic stake in the outcome of the proceedings, creditors may lose confidence in proceedings 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 insolvency proceedings and excessive administrative costs, as well as a means of processing and distributing information. The desirability of facilitating high levels of creditor participation must be balanced against the need to ensure that the creditor representation mechanism remains efficient and cost-effective and avoids creditors involving themselves in matters that will not have an impact on their interests (although often it may be difficult to draw a clear distinction between those matters which do have such an impact and those which do not).

76. Where the insolvency law facilitates creditor participation in the proceedings, that participation may take different forms. Under some laws it includes only the right to be heard and to appear in the proceedings, while under others it also includes the right to vote on specified matters, to provide advice to the insolvency representative as requested or on matters specified in the insolvency law, and other functions and duties as determined by the insolvency law, the courts or the insolvency representative.

### 2. *Extent of involvement of creditors in decision-making*

#### (a) *Functions to be performed by creditors*

77. There are varying degrees of possible creditor involvement in decision-making in insolvency proceedings, based upon the functions it is determined should be performed by creditors. In general, a determination as to which functions should be given to creditors involves a consideration of the overall design of the insolvency law and the balance to be achieved between the roles of the court, the insolvency representative, the debtor and creditors, in particular in terms of oversight and supervision. To some extent, the different functions given to creditors reflect different insolvency cultures and traditions and, in particular, different expectations on the part of creditors as to the level of their participation in insolvency proceedings. However, creditor participation is increasingly regarded as an important element of an insolvency law, especially

as a counter-balance to the roles assigned to other participants under the law and as an important means of safeguarding creditor interests.

78. One approach allows creditors only a low level of participation. Under such insolvency laws, the insolvency representative is required to make all key decisions on uncontested general matters of administration, with creditors playing a marginal role and having little influence. A low level 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 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 proceedings and its participants.

79. Other approaches afford creditors greater participation in the proceedings. Such participation may range from participation at an initial meeting where certain matters are considered, to an ongoing role, which may require creditors to perform an advisory function or, at a higher level, to approve certain acts and decisions of the insolvency representative. Where creditors perform a general advisory function, for example, the insolvency representative may refer matters to the creditors, but will not be bound by any decision they take or advice they give. 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).

80. Under other laws, the creditors may have specific functions to perform with regard to the conduct of the proceedings, which may involve cooperation and coordination with the insolvency representative. The insolvency representative may be required to consult with creditors on those matters before taking its decision or, alternatively, the decision-making power may reside with creditors. Other functions require the creditors to oversee the acts and decisions of the insolvency representative. These acts and decisions generally involve administration of the proceedings and issues that affect the interests of creditors. They may include the sale of assets outside the ordinary course of business; verification of claims; approval of administrative expenses; continuation of the business in liquidation; post-commencement financing; 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; appointment of a committee or representatives of creditors; supervision of acts of the insolvency representative; distribution of assets; and consideration (and approval) of the insolvency representative's final report and accounting.

81. Creditors may have functions with respect to selection and appointment of the insolvency representative, as well as being 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 by the court, for example, that the reorganization be converted to liquidation or that avoidance proceedings be commenced by the insolvency representative or by creditors on behalf of the estate.

82. Where the regime provides for the actions or decisions of the insolvency representative to be supervised or approved by creditors generally, the creditor committee or other creditor representative, 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. Some level of disagreement between the insolvency representative and individual creditors is almost impossible to avoid, in particular 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. 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 decisions 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 accommodation reached between these possibly competing factors.

83. Whatever functions are to be performed by the creditors, it is desirable that an insolvency law clearly state whether creditors are required to undertake each of the 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. In particular, it may be desirable to address disputes between the insolvency representative and creditors. Where the dispute involves a matter that falls within the functions to be performed by a creditor meeting, many laws give precedence to decisions taken by creditors. Where the insolvency law provides creditors with the power to object to acts or decisions of the insolvency representative, the course of action available to creditors where the insolvency representative does not agree with or accept such an objection and the applicable procedural and evidential requirements should be specified in the insolvency law.

*(b) Participation in liquidation and reorganization*

84. 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 proceedings or participate in decision-making, they can provide a valuable source of expert advice and information on the debtor's business, in particular where it is to be sold as a going concern. It may also be desirable for creditors to receive reports

on the conduct of the liquidation to ensure their confidence in the proceedings, as well as its transparency. In reorganization, however, requiring the input of creditors is both useful and necessary, as it is creditors that generally will be asked to approve a proposed reorganization plan.

(c) *Encouraging creditor participation*

85. An important issue that may need to be considered where an insolvency law allows creditors to play an active role in the proceedings is how to overcome creditor apathy and encourage participation. It is not uncommon for creditors to adopt the view that, even where the insolvency law provides for active participation, 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 (for example, see above, paras. 2-18) and by specific measures relating, for example, to selection of the creditor committee and the functions it is to perform (or by creditors generally where there is no committee), as well as use of electronic means to facilitate communication and voting where required. A further concern may relate to possible liability for participating in the proceedings, especially as a member of a creditor committee. This concern can be addressed by providing immunity from liability except in clearly defined circumstances, such as fraudulent or wilful behaviour.

(d) *Need for information and notice*

86. It will be essential, in order to enable creditors to perform specific functions, that they be provided, either directly or through a creditor committee or other form of creditor representation, with relevant, current and accurate information on the debtor's business and financial affairs, and with notice of issues that affect their interests and on which they may be required to decide or advise. That notice may be provided through a creditor committee or other representative. Issues of confidentiality, as noted above with respect to the debtor and the insolvency representative, will also be relevant to creditors or the creditor committee where they are provided with such information (see below, para. 115).

(e) *Secured creditors*

87. It is desirable that an insolvency law determine the extent to which secured creditors can or should participate at meetings of creditors or in a creditor committee. As a general rule, secured creditors are not represented on a creditor committee if they are fully secured or over-secured. In such cases, their interests are significantly different from those of unsecured creditors and their ability to participate in and potentially alter the outcome of decisions by creditors may not be in the best interests of all creditors. Recognizing this divergence of interests, some insolvency laws require secured creditors to surrender their security interest before they can participate in the proceedings



and vote on matters requiring a creditor vote. Where they are under-secured, however, their interests are more likely to align with those of unsecured creditors and their participation in the committee or in voting by creditors may be appropriate, at least to the extent that they are under-secured. In reorganization, secured creditors will have a direct interest where their rights may be modified by a reorganization plan or where the encumbered asset will be key to the successful implementation of the plan (see chap. IV, paras. 34-39).

### 3. *Mechanisms to facilitate participation*

88. In terms of the mechanisms for participation, some insolvency laws provide for full meetings of creditors to be convened at key points in the proceedings. Other laws permit the formation of a committee, on which creditors sometimes may share representation with equity holders and possibly other parties in interest, comprising a smaller number of creditors (which number may be specified in the insolvency law) to facilitate the participation in the administration of the estate. The former approach is most useful in cases with small numbers of creditors or where creditors are located in the same geographical region. The latter may be more useful where there are large numbers of creditors or creditors are located in different regions or even different countries. The mechanism used for participation will also depend upon the immediate issue before creditors. Many insolvency laws include both of these approaches, with significant issues, such as approval of a reorganization plan, to be considered by meetings of creditors (see below, para. 96). Where a committee is appointed it should have the right to act independently of the insolvency representative in order to ensure fair and unbiased representation of creditors' interests.

89. An alternative to formation of a creditor committee is the appointment (whether by creditors or by the court at the request of creditors) of a single person (in some laws referred to as an intervenor or inspector) to represent certain creditors or groups of creditors (e.g. those holding at least 10 per cent of the debt) in the insolvency proceedings. In one law where this approach has been adopted the rationale was to facilitate more orderly and timely participation by creditors and to avoid the delays and disputes that had previously been encountered. The representative fulfils a role analogous to that of the creditor committee, acting on behalf of all the creditors it represents to undertake functions such as monitoring the administration of the estate by the insolvency representative or the debtor; requesting hearings; bringing actions against the debtor; requesting provision of information on issues affecting the creditors' interests; or calling for meetings of creditors. Under some laws, creditors are required to cover the fees of their representative in order to avoid excessive charges to the estate, while under others those fees are to be paid by the estate.

90. The choice between these different approaches may involve balancing factors such as time, cost, efficiency, transparency and democracy. The approach of appointing a representative, for example, may be more efficient and cost-effective and lead to more orderly proceedings with fewer disputes



than the creditor committee approach. The latter approach, however, may be a more transparent and democratic means of representing creditor interests. A further relevant factor may be the availability of well-trained insolvency professionals and effective institutional infrastructure to assist the administration and conduct of insolvency proceedings. In some cases, a scarcity of professionals or a weak institutional capacity may be assisted by according creditors a greater role in the proceedings. Where the conditions in an insolvency regime support its existence, the most effective arrangement for facilitating creditor participation may be the creditor committee.

#### 4. *Creditor meetings*

91. Many insolvency laws provide that the functions allocated to creditors should be performed at general meetings of creditors. As noted above (see chap. I, paras. 64-66 and 69-71), 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 included in insolvency laws range from five days to one month from the effective date of commencement). Under a number of insolvency laws, that initial meeting is the only meeting of all creditors that takes place. Where such a meeting is to be convened, it is desirable that the insolvency law specifies the matters to be discussed and resolved at that meeting.

92. Where the insolvency law provides for other meetings of creditors to be held, different approaches are taken. Under some laws, those other meetings are to be convened by the court or the insolvency representative for specific purposes, while 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 the conditions that must be fulfilled before a meeting can be called. These conditions may include the expiry of a defined period of time after a certain step in the proceedings was to be taken; upon the completion of defined acts or decisions by 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 10 per cent of creditors by value, creditors with no less than 25 per cent of total claims or at least 25 per cent of unsecured claims). A further approach gives any party in interest the right to apply to the court to summon a meeting of creditors. Whichever approach is adopted, it is important that a balance be achieved between facilitating creditor participation and protection of the interests of creditors on the one hand and efficient and effective conduct of proceedings without undue delay, on the other.

93. 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 creditors is required, it is

desirable that an insolvency law establish the eligibility to vote and the voting mechanism, including in particular whether creditors are required to attend in person to vote or whether proxies and other means, such as electronic mail (e-mail) or the Internet, can be used. Where certain kinds of creditors are included among a debtor's creditors, such as public bond holders, special rules may be required to facilitate their participation in the proceedings, especially where they exist in large numbers. It may be appropriate, for example, to permit duly authorized representatives to represent a certain percentage for the purposes of complying with requirements for the participation of specified numbers or percentages of creditors at a general meeting of creditors. The same considerations would also apply to requirements for voting; requirements for participation and voting in person could significantly complicate insolvency proceedings where the debtor's liabilities include publicly traded bonds.

94. It may also be desirable for an insolvency law to permit creditors to establish rules governing the actual conduct of their meetings. Issues to be covered by such rules may include: eligibility to attend and participate; voting eligibility; the requisite majority for a quorum; chairing; and general conduct of the meeting. Rules addressing these issues would also be relevant to the creditor committee and the conduct of its meetings.

### 5. *Matters requiring a vote by creditors*

95. An insolvency law will need to identify the matters on which a vote of creditors is required and establish the voting requirements applicable in each case.

96. 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 be 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; approval of a reorganization plan; approval of post-commencement finance; and on other significant events such as sale of substantial assets outside the ordinary course of business.

97. A number of different approaches can be taken 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. The practicality of requirements for voting in person will clearly be challenged where there are large numbers of creditors, and especially of certain kinds of creditor such as public bond holders, as well as foreign creditors. It will be increasingly desirable to permit voting to take place using electronic means, including e-mail and the Internet, subject to appropriate security measures.

98. Different approaches are taken to the type of voting result that is required to bind creditors to different decisions, with some insolvency laws distinguishing between the different types of decision to be taken. Under some laws, 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. 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, for example, secured creditors will only generally participate in the vote on specified matters such as selection of the insolvency representative and matters affecting their security interests.

### 6. *Creditor committee*

99. As noted above, the formation of a creditor committee or the election or appointment of a creditor representative is designed to facilitate active creditor participation in insolvency proceedings, whether liquidation or reorganization. A creditor committee or other form of creditor representation may not be required in all insolvency cases, but may be appropriate where, for example, 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 allow creditors to determine whether or not they will appoint a committee or representative, while other laws provide for the committee to be appointed by the court. However appointed, the creditor committee should be able to act independently of the insolvency representative to ensure fair and unbiased representation of creditors' interests. It may be desirable for an insolvency law to permit creditors to establish rules addressing the matters noted above (see para. 94) with regard to the conduct of committee meetings.

100. 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 that are not formally recognized by the court or the insolvency representative and whose costs are not reimbursed by the insolvency estate but paid by the creditors themselves; other laws provide that the costs of the creditor committee are to be paid by the estate. The question of who should pay 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 or are assisted by the formation of a committee and other factors determining whether a committee is to be formed in any particular proceeding. Where the costs are to be borne by the estate, it is desirable for the court to have the authority to limit excessive expenditure.

#### (a) *Creditors that may be appointed to a creditor committee*

101. An insolvency law that provides for the formation of a creditor committee will need to consider which creditors will be entitled to be appointed to that

committee. Different approaches are taken to that issue and, to a great extent, depend upon the role to be played by creditors in the proceedings. Relevant factors include the status of a creditor's claim and the nature of a claim. 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 creditor committee. To ensure equality of treatment of creditors, however, it is desirable that creditors such as those whose claims have only been provisionally admitted and foreign creditors are eligible for appointment to the committee. The choice between these different approaches is closely related to the functions to be performed by creditors in the proceedings.

102. A second issue relates to the types of creditor to be represented. 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 creditor 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. Nevertheless, it is also recognized that in certain circumstances, as already noted, the participation of secured creditors will be appropriate either because their interests are affected or for other reasons.

103. Other insolvency laws provide for both types of creditor to be represented on the same committee. One rationale of this approach is that, where the creditor committee is responsible for participating in decision-making and for making important decisions, the exclusion of secured creditors may negatively affect their interests (in particular where they are not fully secured). A further approach may be for an insolvency law not to specify those creditors which can 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 common problem of creditor apathy) and to provide for enlargement or reduction of the size of the committee as required. Where the types of creditor requiring representation are too diverse to accommodate their interests within a single committee, as may be the case for special interest groups such as tort claimants and equity holders, an insolvency law could provide for different committees to represent different interests. It is desirable, however, that this approach be adopted only in special cases, in order to avoid unnecessary costs and the mechanism for creditor representation becoming unwieldy.

104. The participation of equity holders 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 equity holders are involved with the management of the debtor. There will be cases, however, where these parties have no direct knowledge of, or involvement with, the management of the debtor, such as where they are investors in the debtor. In

such cases, there may be compelling reasons for allowing them to participate through their own committee. Other creditors who may have a conflict of interest (such as competitors of the debtor who have a personal interest that has 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 the committee is able to perform its functions on behalf of the creditor body impartially and independently.

105. 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. Purchases by third parties may give rise to concerns about access to sensitive, confidential information that may be of value in the secondary debt market (see below, para. 115). Purchases by a related party 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), especially where a creditor's ability to vote is directly related to the value its claim.

106. To address any potential problem, an insolvency law could adopt the approach of stipulating those parties which are not entitled to participate in a creditor committee.

*(b) Formation of a creditor committee*

107. Where the law provides for the formation of a creditor committee, details of the manner in which the committee is to be formed, the scope and extent of its duties, its governance and operation, including quorum and conduct of committee meetings, as well as replacement and substitution of members are often also addressed. It may be desirable to include provisions in an insolvency law to address some of these issues, in particular with respect to duties and replacement and substitution of members, not only to avoid disputes and ensure confidentiality, but also to provide transparent and predictable procedures. Other issues can be addressed in procedural rules adopted by the committee, including rules on meeting procedure, election of a chairperson and resolution of disputes.

108. 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, creditors are responsible for appointing 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 insolvency proceedings. Some jurisdictions allow the court to appoint a creditor committee, either at its own instigation or upon application by creditors or the insolvency representative. This approach may have a number of disadvantages, including that it has the potential for 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 simplify the procedure for establishing a creditor committee and reduce the scope for disputes between creditors that can lead to delay and cost. 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.

109. To facilitate administration 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 by reference to the list of creditors to be prepared by the debtor. To ensure that it fulfils its duty to fairly represent all creditors, however, oversight of the committee may be desirable where the insolvency law requires the committee to undertake a significant role and could be arranged by the insolvency representative or by the court.

*(c) Rights and functions of a creditor committee*

110. As a general proposition, a creditor committee will perform its functions on behalf of the creditors and those functions will therefore be related directly to the general functions given to creditors, as noted above. The rights of a creditor committee and the functions it is required to perform, however, should not impair the rights of creditors as a whole to continue to participate or otherwise act in the insolvency proceeding. With respect to decision-making, the creditor committee will generally play an advisory role, making recommendations to creditors at large on how key issues should be decided, but it will not usually have the authority to make major decisions on behalf of creditors. The creditor committee may also have a role with respect to receiving notice on behalf of creditors of certain issues of interest to the creditors it represents. For example, where the insolvency law provides that creditors should be consulted on the sale of assets outside the ordinary course of business, notice of any such proposed sale may be provided through the creditor committee to save time, minimize costs and facilitate consultation between the committee and the creditors it represents. While the creditor committee will interact with the insolvency representative or with the debtor in possession, where the insolvency law adopts that approach to reorganization, the committee should be able to act independently of those parties in representing the interests of creditors.

111. Insolvency laws provide for a creditor committee to undertake a range of functions, which may include advising the insolvency representative of the wishes of creditors with respect to issues such as the sale of assets outside the ordinary course of business and formulation of the reorganization plan; consulting with the insolvency representative and other principals in the

proceeding, such as the existing management of the debtor; participating in the development of a reorganization plan; or possibly supervising the insolvency representative. These functions may be established by the insolvency law, directed by the court or determined in cooperation with the insolvency representative.

112. As noted above with respect to creditors generally, the committee will need to be able to access up-to-date information on the debtor and its financial affairs and be able to express its views and those of creditors on matters falling within its functions or on matters that affect the interests of creditors (as to confidentiality, see below, para. 115). The committee may also require administrative and expert assistance, although the need for such assistance should be clearly linked to the functions to be performed by the committee. The committee may be required under the law to seek permission from the insolvency representative or the court to hire a secretary and, if circumstances warrant, consultants and professionals. Some insolvency laws provide that the insolvency estate will pay the costs of hiring assistants, including their remuneration, while other laws provide that these costs must be met by creditors as part of their costs of participation in the insolvency proceedings. Where these costs are to be paid by the estate, it is desirable that the court have some control not only over the decision to hire such professionals, but also over the associated costs and charges.

*(d) Liability of a creditor committee*

113. The committee's duty would be owed to the creditors generally. It would not have any liability or fiduciary duty to the owners of the insolvent business. It may be desirable, however, for an insolvency law to require committee members to act in good faith in carrying out committee functions 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 are found to have acted fraudulently or wilfully or to have breached a fiduciary duty to the creditors they represent. This might include, for example, deriving profit from the administration of the estate; acquiring assets forming part of the estate without prior approval of the court; or taking advantage of confidential information received as a committee member. The standard of liability applicable to members of the committee can be distinguished from that of the insolvency representative; committee members are not required to satisfy any requirements as to knowledge or expertise and are acting in a voluntary capacity without remuneration. 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 that will effectively discourage creditors from participating and too low a level that may lead to abuse and prevent the committee from functioning efficiently as a representative body.

*(e) Removal and replacement of members of a creditor committee*

114. 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. Those grounds might include gross negligence; lack of the necessary skills; incompetence; inefficiency; lack of independence; breach of confidence; or conflict of interest. The procedure for such removal and replacement will generally depend upon the procedure for appointment of a creditor committee, whether by the court or election by 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.

## 7. Confidentiality

115. As already noted (see above, paras. 28 and 52), it is desirable that an insolvency law impose obligations of confidentiality on both the debtor and the insolvency representative. For similar reasons, it may also be appropriate to consider the circumstances in which creditors should be required to observe confidentiality. In the course of the administration of insolvency proceedings, creditors will generally 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 and the creditor committee (and any professionals employed by it) 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. In cases where a creditor committee is appointed (and the committee hires professional advisors), the obligation may be given effect by requiring members of the committee (and the professional advisors) to sign confidentiality agreements.

### *Recommendations 126-136*

#### **Purpose of legislative provisions**

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

- (a) To facilitate participation of creditors in insolvency proceedings;
- (b) To provide a mechanism for the appointment of a creditor committee or other creditor representative where to do so would facilitate the participation of creditors in the insolvency proceedings;
- (c) To ensure the right of creditors to access information on the insolvency proceedings; and
- (d) To specify the functions and responsibilities of the creditor committee or other representative.



## **Contents of legislative provisions**

### *Right to be heard*

See recommendations 133 and 137.

### *Confidentiality*

See recommendation 111.

### *Participation by creditors (paras. 75-87)*

126. The insolvency law should specify that creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and identify what that participation may involve in terms of the functions that may be performed.

### *Voting by creditors (paras. 96-98)*

127. The insolvency law should specify the matters on which a vote of creditors is required and establish the relevant eligibility and voting requirements. In particular, the insolvency law should require creditors to vote on approval or rejection of a reorganization plan.

### *Convening meetings of creditors (paras. 91-94)*

128. The insolvency law may require a first meeting of creditors to be convened within a specified period of time after commencement to discuss matters specified in the insolvency law. The insolvency law may also permit the court, the insolvency representative or creditors holding a specific percentage of the total value of unsecured claims to request the convening of any other meeting of creditors and specify the circumstances in which such a meeting may be convened. The insolvency law should specify the party responsible for giving notice of such a meeting to creditors.

### *Creditor representation (paras. 88-90)*

129. The insolvency law should facilitate the active participation of creditors in insolvency proceedings such as through a creditor committee, a special representative or other mechanism for representation.<sup>11</sup> The insolvency law should specify whether a committee or other representation is required in all insolvency proceedings. Where the interests and categories of creditors involved in insolvency proceedings are diverse and participation will not be facilitated by the appointment of a single committee or representative, the insolvency law may provide for the appointment of different creditor committees or representatives.

<sup>11</sup>See above, paras. 2-21 and recommendations 112 and 113, on the continuing role of the debtor in reorganization. Where the debtor remains in possession of the business, a creditor committee or other creditor representative will have an important role to play in overseeing and, where necessary, reporting on the activities of the debtor.

***Recommendations 126-136 (continued)***

130. Where the insolvency law permits a creditor committee or representative to be appointed, the relationship between the creditors and the creditor committee or representative should be clearly specified.<sup>12</sup> The insolvency law should specify how the costs of the creditor committee would be paid.

***Creditors that may be appointed to a creditor committee (paras. 101-106)***

131. The insolvency law should specify the creditors that are eligible to be appointed to a committee. Creditors who may not be appointed to a creditor committee would include related persons and others who for any reason might not be impartial. The insolvency law should specify whether or not a creditor's claim must be admitted before the creditor is entitled to be appointed to a committee.

***Mechanism for appointment to a creditor committee (paras. 107-109)***

132. The insolvency law should establish a mechanism for appointment of a creditor committee. Different approaches may include selection of the creditor committee by creditors or appointment by the court or other administrative body.

***Rights and functions of a creditor committee (paras. 110-112)***

133. The insolvency law should specify the rights and functions of the creditor committee in insolvency proceedings, which may include:

- (a) Providing advice and assistance to the insolvency representative or the debtor-in-possession;
- (b) Participating in development of the reorganization plan;
- (c) Receiving notice of and being consulted on matters in which their class has an interest, including the sale of assets outside the ordinary course of business;
- (d) The right to hear the insolvency representative at any time; and
- (e) The right to be heard in the proceedings.

***Employment and remuneration of professionals by a creditor committee (para. 112)***

134. The insolvency law should permit a creditor committee, subject to approval by the court, to select, employ and remunerate professionals that may be needed to assist the creditor committee to perform its functions. The insolvency law should specify how the costs and remuneration of those professionals would be paid.

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<sup>12</sup>In particular, the insolvency law should specify the distribution of functions and powers between the creditors and the creditor committee and the mechanism for resolution of disputes between the creditors and the creditor committee.

*Liability of a creditor committee (para. 113)*

135. The insolvency law should specify that members of a creditor committee are exempt from liability for their actions in their capacity as members of the committee unless they are found to have acted fraudulently or to be guilty of wilful misconduct.

*Removal and replacement of members of a creditor committee (para. 114)*

136. The insolvency law should specify the grounds for removal of members of a creditor committee and provide for their replacement.<sup>13</sup>

## **D. Party in interest's right to be heard and to appeal**

### *1. Right to be heard*

116. Many insolvency laws provide creditors, as the primary beneficiaries of the estate, and other parties in interest with some ability to scrutinize both the administration of the estate and the conduct of the insolvency representative in performing its duties. The insolvency representative, the debtor, a creditor, a creditor committee or another party in interest may wish to request relief under the insolvency law or may oppose requests of others for such relief. Each of those parties should have a right to be heard when their rights, interests in assets or duties under the insolvency law are affected. Where decisions relating to administration of the estate are to be made by the courts, those decisions may generally be appealed to a higher court by a party whose interests are affected, although some insolvency laws do exempt certain decisions from appeal (e.g. the decision appointing the supervising judge or commencing the proceedings).

### *2. Review procedures*

117. Procedural approaches to the administration of an estate are determined to a large extent by the rules governing the duties of the insolvency representative, the rights and duties of the debtor under the insolvency law and the active role, if any, of creditors, either separately or through a creditor committee or other representative, 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 decision-making will normally preclude the need to permit creditors to seek court review of those acts, apart from in situations where the insolvency representative has misled creditors.

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<sup>13</sup>Exercise of the power to remove will depend on the method of appointment of the committee.

118. Where acts of the insolvency representative are not subject to the prior approval of creditors, it may be appropriate to permit creditors to request the court to review the insolvency representative's decision. Such a review procedure may be appropriate for other parties in interest when acts of the insolvency representative affect them.

119. Most insolvency laws require a party in interest to raise its requests for relief or objections through the court. 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 an action, or even require an action to be brought by the creditor committee or the creditors generally. Such requirements may depend upon the grounds of the objection raised. Other parties in interest may have legal standing to raise an objection or request relief when their rights, interests in assets or duties under the insolvency law are affected. As discussed above, the right to be heard must be balanced with the need for efficient administration of the insolvency proceedings.

### *3. Right of appeal*

120. A party in interest who has requested relief and been denied or who has unsuccessfully opposed a request or act of another party should have a right to appeal to a higher court if it believes that the court was in error. Most judicial systems establish a hierarchy of courts for appellate review and procedures to invoke that review. A similar structure should apply to the court that administers the insolvency law and to orders entered by that court.

#### ***Recommendations 137 and 138***

##### **Purpose of legislative provisions**

The purpose of legislative provisions on review and appeal is:

- (a) To ensure that parties in interest have a right to be heard and seek relief from the court when their rights, interests in assets or duties under the insolvency law are affected; and
- (b) To establish procedures for providing relief and for appellate review.

##### **Contents of legislative provisions**

*Right to be heard and to request review (paras. 116-119)*

137. The insolvency law should specify that a party in interest has a right to be heard on any issue in the insolvency proceedings that affects its rights, obligations or interests. For example, a party in interest should be entitled:

- (a) To object to any act that requires court approval;

- (b) To request review by the court of any act for which court approval was not required or not requested; and
- (c) To request any relief available to it in insolvency proceedings.

*Right of appeal*<sup>14</sup> (para. 120)

138. The insolvency law should specify that a party in interest may appeal from any order of the court in the insolvency proceedings that affects its rights, obligations or interests.

## E. Secured creditors

121. As already noted, under some insolvency laws the rights of secured creditors are unaffected by the commencement of proceedings and they may proceed to enforce those rights unimpeded by the insolvency proceedings. Under many insolvency laws, however, the rights of secured creditors are affected, for example, by the application of a stay against the right to enforce their security interest, by the reorganization and so on.

122. The rights of secured creditors are discussed throughout the *Legislative Guide* in the context of the provisions of an insolvency law that may affect those rights. With respect to some issues, the *Guide* makes specific reference to secured creditors and the manner in which they may be affected by the commencement of insolvency proceedings, for example, with respect to constitution of the insolvency estate, application of the stay and post-commencement finance. With respect to other issues, the commentary draws no distinction between types of creditor in terms of the application of the insolvency law and secured creditors will be affected in the same manner as other creditors.

123. A list of references to the sections of the *Guide* (to both paragraphs of the commentary and recommendations) addressing the treatment of secured creditors and their rights in insolvency is included in annex I. For a complete picture of how secured creditors are affected by commencement of insolvency proceedings, however, the *Guide* should be read as a whole.

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<sup>14</sup>In accordance with the key objectives, the insolvency law should provide that appeals in insolvency proceedings should not have suspensive effect unless otherwise determined by the court, in order to ensure that insolvency can be addressed and resolved in an orderly, quick and efficient manner without undue disruption. Time limits for appeal should be in accordance with generally applicable law, but in insolvency need to be shorter than otherwise to avoid interrupting insolvency proceedings.



## IV. Reorganization

### A. The reorganization plan

#### 1. Introduction

1. In the preceding chapters, the *Legislative Guide* discusses a number of matters relevant to reorganization proceedings. A central element of those proceedings is the reorganization plan and insolvency laws generally address a number of issues in relation to the plan. These include the nature or form of the plan; when it is to be prepared; who is permitted to prepare a plan; its content; how it is to be approved by creditors; whether court confirmation is required; the effect of the plan and how it is to be implemented.

2. Reorganization plans perform different functions in different types of proceeding. In some, the plan may be the tailpiece of the reorganization proceedings, dealing with the payout of a dividend in full and final settlement of all claims and the final structure of the business after the reorganization is complete. In others, the plan 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. Such a plan may address issues such as the timing and mechanics for interim distributions. The following discussion focuses upon the issues that would be relevant to a plan proposed at some time after the proceedings have commenced, addressing the conduct of the business in reorganization and the transformation of legal rights proposed to address the debtor's financial situation. These considerations will also be relevant, although not necessarily in their entirety, to other types of plan.

#### 2. Nature or form of a plan

3. 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 reorganization proceedings, each may have different views of how the various objectives can best be achieved. Some creditors, such as major customers or suppliers, may prefer continued business with the debtor to rapid repayment of their debt. Some creditors may favour taking 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. 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 be too constrictive. It is desirable that the law not restrict reorganization plans to those designed only to fully rehabilitate the debtor; prohibit debt from being written off; restrict the amount that must eventually be paid to creditors by specifying a minimum percentage; or prohibit exchange of debt for equity. A non-intrusive approach that does not prescribe such limitations is likely to provide sufficient flexibility to allow the most suitable of a range of possibilities to be chosen for a particular debtor.

4. Some insolvency laws adopt an illustrative approach, listing some of the possibilities that may be adopted, but it is not intended that the list be exhaustive or exclusive of other approaches. These possibilities could include a choice of a simple composition (an agreement to pay creditors a percentage of their claims, usually over time); 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 between the debtor, the insolvency representative, creditors and other parties in interest.

5. Even if it does not adopt a prescriptive approach to the form or nature of the plan, an insolvency law may establish some guiding principles, such as that the priorities afforded to creditors in liquidation should be maintained in reorganization, that creditors receive in reorganization as much as they would have received in liquidation, that the effect of the plan should not be such that the debtor remains insolvent and is returned to the marketplace in that condition and that the reorganization plan complies with limitations set forth in other laws (unless it is intended that the insolvency law amend those limitations), such as foreign exchange controls.

### *3. Proposal of a reorganization plan*

6. Two important issues to be considered in relation to the proposal of a reorganization plan are the stage of the proceedings at which it should be proposed and the party or parties that would be capable of proposing, or could be authorized to propose, a plan. A number of different approaches can be taken to each of these issues.

#### *(a) Timing of proposal*

7. As to the first issue, timing of proposal, 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 a reorganization plan should be filed with the application for reorganization proceedings (where the application may be called a



“proposal” for reorganization) where the debtor made the application for commencement of those proceedings.<sup>1</sup> This approach may delay the debtor’s ability to seek commencement of proceedings and obtain timely relief by way of the stay. It may also be difficult to know, at the time the application is made, exactly what the plan should accomplish. 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 would receive the approval of creditors and be successfully implemented. Many other laws provide for the plan to be negotiated and proposed after commencement of reorganization proceedings. This may be a more flexible option, allowing 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 proposing, or the ability to propose, a plan but are seeking to obtain only the benefits of the stay. Issues of timing of proposal of the plan may also arise where proceedings are converted from liquidation to reorganization (see below, paras. 72-75).

*(b) Parties permitted to propose a plan*

8. With regard to the second issue, participants in the reorganization proceedings may have different capabilities and responsibilities with regard to negotiation and proposal of a reorganization plan, depending upon the manner in which the insolvency law is designed and the respective roles assigned to the insolvency representative, debtor and creditors. For example, in some insolvency laws, these parties have a positive obligation to cooperate in negotiating and proposing a plan. In determining which party should be permitted to propose, or which parties are capable of proposing, a plan, a balance may be desirable between the freedom accorded to the different parties to propose a plan (e.g. should all parties be able to propose a plan, should they be able to do so at the same time or should proposal 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 negotiation and proposal, possible 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 proposed.

*(i) Proposal by the debtor*

9. Where the plan is to be proposed before commencement, it would generally be proposed by the debtor, but may involve negotiation with one or more classes of creditors, who may negotiate and agree on a plan, subject to its

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<sup>1</sup>This type of approach is not to be confused with an application for expedited proceedings, which would be accompanied by the plan approved by creditors, see recommendation 162.

acceptance by other creditors or its imposition on remaining classes. Where the plan is to be proposed after the commencement of proceedings, some insolvency laws provide that the debtor should propose a plan, sometimes specifying that it should do so in cooperation with other parties such as the insolvency representative, the creditors, an attorney, an accountant or other financial advisors. An approach involving the debtor may have the advantage of encouraging debtors to commence reorganization proceedings at an early stage and, where the plan envisages the ongoing operation of the debtor's business, of making the best use of the debtor's familiarity with its business and knowledge of the steps necessary to make the insolvent business viable. The freedom accorded to the debtor in this regard may need to be balanced against the need to ensure creditor confidence in the debtor and its proposal. The benefits of such an approach also may be clear where key management personnel of the debtor are necessary to the success of the business (e.g. because of its complexity) or will be difficult to replace in the short term.

10. Some insolvency laws give the debtor an exclusive opportunity to propose a plan. Other laws adopt a staged approach, limiting the debtor's exclusive opportunity to a specified period of time. The court may have the power to extend the period if the debtor can show that the extension is justified and there is a real prospect of a successful reorganization plan being proposed. Where the debtor's exclusive period expires without a plan being proposed, another party is able to propose a plan.

*(ii) Proposal by creditors*

11. 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 equity holders of a controlling equity interest in the business and the incumbent management of any management responsibilities. If the debtor has an exclusive opportunity to propose the plan and refuses to consider such arrangements, there is a danger that the reorganization will fail, to the detriment of the creditors, the employees and the debtor itself. To address such a situation, some insolvency laws provide that, in preparing its plan, the debtor should cooperate and negotiate with creditors and if it fails to propose 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). This option may provide the leverage necessary to reach a compromise between the participating parties.

*(iii) Proposal by the insolvency representative*

12. Another approach adopted by many insolvency laws is to give the insolvency representative an opportunity to propose a plan, either as an alternative to proposal 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 depends upon the design of the law and, in particular, requirements for approval of the plan by creditors or the court. Where approval by creditors is required, a plan that takes account of proposals that will be acceptable to creditors has a greater likelihood of being approved than one that does not. This consideration may not apply where creditor approval is not necessary. Where the plan is to be approved only by the court, substantial legal input may be required to ensure that the plan presented will be approved. Where the insolvency representative is not given the opportunity to negotiate and propose a plan or to participate in that process, it may be desirable to give the insolvency representative an opportunity to consider a proposed plan before it is submitted to creditors and others for approval.

*(iv) Proposal by multiple parties*

13. Some insolvency laws provide that a number of parties have the opportunity to propose a plan. These may include the debtor, the insolvency representative and creditors or the creditors committee. It may be desirable where such a provision is included that some procedure be adopted to ensure that a number of competing plans are not proposed simultaneously. Although in some cases this competitive approach may promote the proposal of a mutually acceptable plan, it may also have the potential to complicate the proceedings and lead to confusion, inefficiency and delay.

14. Some laws provide for the court to consider the opinions of third parties on the plan, such as governmental agencies and labour unions. Although including these parties in plan negotiation in particular cases may assist in the proposal of an acceptable plan, it also has the potential, if adopted as a general principle, to complicate and lengthen the duration of the proceedings. It may be desirable only if it is likely to be beneficial in a particular case where the interests of those parties are central to the reorganization plan and where the negotiation process is carefully monitored and time limits are specified.

*(c) Time limits for proposal of a plan*

15. Some insolvency laws specify a time period after commencement within which a plan is to be proposed. This limit may apply specifically to proposal of a plan by the debtor or generally. One law, for example, provides a 120-day limit for proposal of a plan by the debtor; once that has expired any other party may propose a plan without any time limit being imposed. Examples of time limits generally applicable to negotiation and proposal of a plan range 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 proceeds without delay, that advantage may need to be balanced against the risk that the deadline may be too inflexible and impose an arbitrary restraint, in particular in large cases where negotiation and proposal of a plan

may take significantly longer, such as more than 12 months; 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). One means of addressing the concern of inflexibility is to provide for the time period to be extended by the court, provided the extension is for a further limited period and that an unlimited number of extensions is not available. An advantage of that approach is that the party seeking an extension will be required to demonstrate to the court that the extension is warranted—that is, for example, that there are proper reasons for the delay (e.g. it is because of a need for further consultations with creditors or there has been a delay in receiving assessments or reports from professional advisors); that the delay will not be harmful to the interests of the other parties; and that, if the extension is granted, there is a real prospect for proposal of a plan that will be approved by creditors.

16. Where an insolvency law includes time periods for the negotiation and proposal of a plan, consideration will need to be given to those proceedings which are converted to reorganization from liquidation. The standard time periods that would be applicable by reference to the effective date of commencement of proceedings (i.e. the liquidation proceedings) may not easily be applied in cases that rely on the original application for commencement and treat the conversion as a continuation of those proceedings, as a significant period of time may have elapsed between commencement of the proceedings and their conversion.

#### 4. *The plan*

17. The outcome of the plan rests on what is feasible, that is, 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 and what it proposes. 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*

18. The question of what is to be included in the plan is closely related to the procedure for approval of the plan, that is, which creditors are required to approve the plan and the level of support required for approval, the effect of the plan once approved, that is, will it bind dissenting creditors and secured creditors and who will be responsible for implementation of the plan and for ongoing management of the debtor, and whether or not there is a requirement for court confirmation. 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 requirements that the reorganization plan should adequately and clearly disclose to all parties information regarding both the financial condition of the debtor 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. It should be noted that a plan need not modify or otherwise affect the rights of every class of creditor.

19. Other laws set out more specific requirements as to what information is required in relation to the debtor's financial situation and the proposals that can be included in a plan. Information on the financial situation of the debtor could include asset and liability statements; cash flow statements; and information relating to the causes or reasons for the financial situation of the debtor. Information relating to what is proposed by the plan could include, depending upon the objective of the plan and the circumstances of a particular debtor, details of classes of claims; claims modified or affected under the plan and the treatment to be accorded to each class under the plan; the continuation or rejection of contracts that are not fully executed; the treatment of unexpired leases; measures and arrangements for dealing with the debtor's assets (e.g. transfer, liquidation or retention); the sale or other treatment of encumbered assets; the disclosure and acceptance procedure; the rights of disputed claims to take part in the voting and provisions for disputed claims to be resolved; arrangements concerning personnel of the debtor; remuneration of management of the debtor; financing implementation of the plan; extension of the maturity date or a change in the interest rate or other term of outstanding security interests; 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; 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; distribution of all or any part of the assets of the estate among those having an interest in those assets; possible changes to the instrument or organic document constituting the debtor (e.g. changes to by-laws or articles of association) or the capital structure of the debtor or merger or consolidation of the debtor with one or more persons; the basis upon which the business will be able to keep trading and can be successfully reorganized; supervision of the implementation of the plan; and the period of implementation of the plan, including in some cases a statutory maximum period.

20. Rather than specifying a wide range of detailed information to be included in a plan, it may be desirable for the insolvency law to identify the minimum content of a plan, focusing upon the key objectives of the plan and procedures for implementation. For example, the insolvency law may require the plan to detail the classes of creditors and the treatment each is to be accorded in the plan; the terms and conditions of the plan (such as treatment of contracts and the ongoing role of the debtor); and what is required for implementation of the plan (such as sale of assets or parts of the business, extension of maturity dates, changes to capital structure of the business and supervision of implementation).

21. The content of the plan also raises issues related to other laws. For example, to the extent that national 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 law other than the insolvency law to providing only for debt forgiveness or the extension of maturity dates, it may be difficult to obtain creditor approval. 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.

22. Approaches to these issues vary. In some States, the insolvency law will be subject to the limitations contained in other laws, with the consequence that options for reorganization may be restricted. Other insolvency laws allow some of those limitations, 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. It is desirable that limitations in other laws that will affect the insolvency law be considered in designing the insolvency law and that, in order to ensure transparency and predictability, an insolvency law specifically address its relationship with other laws. Where possible, an insolvency law should note the impact of those other laws.

*(b) Information to accompany the plan*

23. Creditors and other relevant parties in interest (such as equity holders), who may be required to vote on the plan, 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 and other parties in interest need to be provided with information explaining what the plan proposes and the impact of those proposals on their rights and claims. For these purposes, the plan can be submitted to creditors and others together with a disclosure statement that provides a full disclosure of information that will enable all parties to properly evaluate the plan. That statement may be prepared by a qualified professional who can be expected to provide a credible and unbiased assessment of the measures proposed by the plan or by the party who proposes the plan, with or without professional advice. Where the insolvency representative is not involved in the proposal of a plan or preparation of the disclosure statement, it may be desirable to require it to comment on both instruments. Where creditors and other parties in interest do not agree with the professional evaluation or do not believe that the disclosed information is persuasive, their views could be taken into account in the course of approval by allowing the plan as proposed to be amended or in the course of the confirmation process (if confirmation is required by the insolvency law).

24. A number of insolvency laws include provisions specifying the information that is to be provided to creditors and other interested parties to enable them to properly assess the plan, whether it is to be included in the plan itself or in a separate statement. A requirement to provide this information, supported by appropriate mechanisms for obtaining it, satisfies the key objective of transparency and can assist in ensuring creditor confidence in insolvency proceedings. It may need to be balanced, however, against confidentiality concerns arising from 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. This concern can be addressed in the law by including obligations to observe confidentiality that will apply to the debtor, creditors, the insolvency representative and other parties in interest. The requirement to provide information should not be misused by supplying information that is irrelevant to evaluation of the plan; the focus should be upon the information required in a particular case to evaluate the specific proposals contained in the plan.

25. It is desirable that an insolvency law specify the minimum information to be provided in a disclosure statement. This could include information relating to the financial situation of the debtor, including asset and liability and cash flow statements; non-financial information that might have an impact on the future performance of the debtor (e.g. the availability of a new patent); a summary of the plan; a comparison of the treatment afforded to creditors by the proposed plan and what they could be expected to receive in liquidation; the basis upon which the debtor's business would be able to keep trading and be successfully reorganized; information on voting mechanisms applicable to approval of the plan; and information showing that, having regard to the effect of the plan, adequate provision has been made for satisfaction of all obligations provided for in the plan and that the debtor is expected to have the cash flow to pay its debts as provided for in the plan.

## 5. *Approval of a plan*

### *(a) Issues to be considered*

26. Designing the provisions of an insolvency law on approval of the plan requires a number of different issues to be considered, such as whether all creditors and equity holders are entitled to vote on the plan; whether voting on approval of the plan should be conducted in classes; and the manner in which creditors that do not approve a plan ("dissenting creditors") will be treated. Some underlying principles are that creditors whose rights are modified or affected by a plan, including secured creditors, can only be bound by the plan if they have been given the opportunity to vote on that plan; that secured creditors should vote separately from unsecured creditors; that creditors of the same class should each receive the same treatment under the plan; and that a dissenting class of creditors that is to be bound to the plan should receive at least as much as they would have received in liquidation proceedings.



(i) *Classification of claims*

27. The primary purpose of classifying claims is to satisfy the requirements to provide fair and equitable treatment to creditors, treating similarly situated claims in the same manner and ensuring that all creditors in a particular class are offered the same menu of terms by the reorganization plan. It is one way to ensure that priority claims are treated in accordance with the priority established under the insolvency law. It may also make it easier to treat the claims of major creditors who can be persuaded to receive different treatment from the general class of unsecured creditors, where that treatment may be necessary to make the plan feasible. Classification can, however, increase the complexity and costs of the insolvency proceedings, depending upon how many different classes are identified. An alternative, to ensure that creditors who should receive special treatment are not oppressed by the majority, may be to give those groups the opportunity to challenge the decision of the majority in court if they have not been treated in a fair and equitable manner. The fact that such a facility exists may operate to discourage majorities from making proposals that would unfairly disadvantage priority creditors.

(ii) *Treatment of dissenting creditors*

28. As to the treatment of dissenting creditors, it will be essential to provide a way of imposing a plan agreed by the majority of a class upon the dissenting minority 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 made binding upon dissenting classes of creditors and other affected parties.

29. To the extent that a plan can be approved and enforced upon dissenting parties, there will be a need to ensure that the content of the plan provides appropriate protection for those dissenting parties and, in particular, that their rights are not unfairly affected. The law might provide, for example, that dissenting creditors can not be bound unless assured of certain treatment. As a general principle, that treatment might be that the creditors will receive at least as much under the plan as they would have received in liquidation proceedings. If the creditors are secured, the treatment required may be that the creditor receives payment of the value of its security interest, while in the case of unsecured creditors it may be that any junior interests, including equity holders, receive nothing. To the extent that the approval procedure results in a significant impairment of the claims of creditors and other affected parties without their consent (in particular secured creditors), there is a risk that creditors will be unwilling to provide credit in the future. The mechanism for approval of the plan, and the availability of appropriate safeguards, is therefore of considerable importance to the protection of these interests.

(b) *Procedures for approval*

30. 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 applicable) be made available to those creditors and other parties in interest (including equity holders) who are entitled to vote at the meeting within a certain period of time before that meeting is called. Some laws require voting to occur in person at a meeting of creditors, while other laws also allow voting by mail or by proxy. To facilitate voting and recognize the increasing use of electronic means of communication, it may be desirable to permit voting to take place in person, by proxy and by electronic means.

31. Other issues to be considered with regard to approval of the plan include whether creditors and other parties in interest should vote in classes according to their respective rights; the types of claim (in terms of admission or provisional admission of those claims) that will be considered in determining whether the requisite voting majority has been reached; whether secured creditors are entitled to vote; whether the votes of priority claims will be considered in determining the requisite majority; which parties in interest, in addition creditors, are entitled to vote on the plan; and the manner in which abstaining or non-participating creditors will be treated. These issues are discussed in the paragraphs below.

*(i) Treatment of abstaining or non-participating creditors*

32. With respect to the last issue, some laws treat abstaining or non-participating voters as votes not to accept a plan. Such an approach may have the effect of disenfranchising those creditors who did participate and vote on approval of the plan and may in practice make it very difficult to obtain the requisite majority to approve a plan. As an alternative, many States adopt the approach of calculating the percentage of support on the basis of those parties actually participating in the voting on the basis that absentees and abstaining voters can be considered to have little interest in the proceedings. This approach may result in a potentially small and unrepresentative group of creditors affecting the course of the reorganization, in particular in view of the prevalence of creditor apathy. A balanced approach that facilitates approval of the plan and ensures a sufficient level of creditor support is required to enable implementation and avoid abuse. This can be facilitated, whichever of the approaches discussed above is adopted, by requiring provision of adequate notice to creditors and other parties in interest, especially where they are non-residents, as well as by adopting mechanisms to facilitate and encourage more widespread voting, such as the use of proxies and electronic means.

*(ii) Use of presumptions*

33. Some insolvency laws also make use of presumptions to simplify voting procedures. Where, for example, a plan cancels a creditor's claim or an owner's equity interest (and that party receives nothing under the plan), a vote by that party against the plan can be presumed. In contrast, where a plan does not modify or affect a claim or provides that it will be paid in full, a vote in favour of the plan can be presumed. The use of such presumptions may also reduce the need to provide notice and information to relevant creditors and other parties in interest.

(c) *Approval by secured and priority creditors*

(i) *The need for secured and priority creditors to vote*

34. In many cases of insolvency, secured claims will represent a significant portion of the value of the debt owed by the debtor. Different approaches can 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 entitled 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 security interest of the secured creditor and the extent to which the value of encumbered assets will satisfy the secured creditor's claim.

35. Under one approach, where the insolvency law does not affect secured creditors and, in particular, does not preclude them from enforcing their rights against the encumbered assets, there is no need to give these creditors the right to vote since their security interests will not be affected 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 before creditors without priority are paid. The limitation of this approach, however, is that it may reduce the chances for a successful reorganization where the encumbered assets or modification of the rights of such creditors are key to the success of the plan. If the secured creditor is not bound by the plan, the election by the secured creditor to enforce its rights, such as by repossessing and selling the encumbered asset, may make reorganization of the business impossible to implement. Similarly, there may be circumstances where ensuring a successful reorganization requires that priority creditors receive less than the full value of their claims upon approval of the plan. 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 secured debt are modified over time. If these creditors are not included in the plan and entitled to vote on proposals affecting their rights, modification of those rights cannot be achieved.

(ii) *Classes of secured and priority creditors*

36. Recognizing the need for secured and priority creditors to participate, a second approach provides for these creditors to vote as classes separate from unsecured creditors on a plan that would modify or affect the terms of their claims, or to otherwise consent to be bound by the plan. Adopting such an approach provides a minimum safeguard for the adequate protection of these creditors and recognizes that the respective rights and interests of secured and priority creditors differ from those of unsecured creditors. In many cases, however, the rights of secured and priority creditors will differ from each other and it may not be feasible to require all secured creditors or all priority creditors to vote in a single class. In such cases, some laws provide that each secured creditor with separate rights to encumbered assets forms a class of its own. Those laws also provide that, where secured creditors do vote as a class (e.g. where there are multiple holders of bonds that are secured by the same assets), the requisite majority of a class of secured creditors 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 to be affected by the plan (e.g. one law provides that a three-quarter majority is required where the maturity date is to be extended and a four-fifths majority where the rights are to be otherwise impaired). Similarly, each rank of priority claims would be a separate class under those laws.

37. Where secured creditors vote in classes, some insolvency laws provide that, to the extent the requisite majority of the class votes to approve the plan, dissenting members of the class will be bound by the terms of the plan, subject to certain protections. The insolvency law may provide, for example, that such creditors will only be bound by the plan where they receive at least as much as under the plan as they would have received in liquidation or, under some laws, if the plan makes provision for them to be paid in full to the extent of the value of their security interest within a certain period of time, together with interest at a market rate. Other insolvency laws provide that the plan cannot be imposed upon any secured creditors unless they consent to such imposition. A similar dichotomy exists with respect to priority claims. Some laws permit payment over time as long as the present value of the claim is preserved. Other laws permit modification of priority claims only with the consent of the priority creditors.

*(iii) Where secured creditors are not fully secured*

38. To the extent that the value of the encumbered asset will not satisfy the full amount of the secured creditor's claim, a number of insolvency laws provide that those secured creditors should vote with ordinary unsecured creditors in respect of the unsatisfied portion of the claim. This may raise difficult questions of valuation in order to determine whether, and to what extent, a secured creditor is in fact secured. For example, where three creditors hold security interests 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 therefore may have a right to vote only 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 determining the extent to which these secured creditors are secured and whether or not they are entitled to vote as unsecured creditors with respect to any portion of their claim.

39. 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 financing and to provide as much certainty and predictability as possible, balancing this against the objectives of insolvency law and the benefits to an economy of successful reorganization.

*(d) Approval by ordinary unsecured creditors*

40. Different mechanisms may be used to ensure that ordinary unsecured creditors can vote efficiently and effectively on approval of a plan. Whichever

mechanism is chosen it is desirable that it be as simple as possible and clearly set out in the insolvency law to ensure predictability and transparency.

*(i) Classes of unsecured creditors*

41. A number of insolvency laws do not provide for unsecured creditors to be divided into different classes and they vote together as a single group.

42. States 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 such 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 ensuring that all creditors in a class receive the same treatment; and a means for the court to utilize the requisite majority support of one class to make the plan binding on dissenting classes. 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 where there is a large number of creditors that lack a common economic interest and the treatment they are to be offered under the plan differs. Criteria that may be relevant in determining commonality of interest may include the nature of the debts giving rise to the claims; and the remedies available to the creditors in the absence of the reorganization plan, including the extent to which the creditors could recover their claims by exercising those remedies. Where there is a small number of unsecured creditors or where their interests are similar, there may be no need for voting on approval of the plan to be conducted in different classes, thus simplifying the procedure.

*(ii) Determination of classes*

43. 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 claims to be classified on the basis of common or substantial similarity of interest or on the basis of value. Where the test is commonality or similarity of interest, the party proposing the plan may have some flexibility in assigning claims to a particular group. Other approaches provide for the insolvency representative to make recommendations to the court before the creditors vote on approval or for the classes to be 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 dissatisfied with the composition of the class can seek to have the issue reviewed by the court.

*(e) Approval by equity holders*

44. Some insolvency laws provide for a reorganization plan to be approved by equity holders, at least where the corporate form, the capital structure or the

membership of the debtor will be affected by the plan. Equity holders may also be expected to vote in cases where they will receive a distribution under the plan. Where equity holders are entitled to vote, they should be provided with the same notice and information as creditors entitled to vote. Where the debtor's management proposes a plan, the terms of the plan may already have been approved by the equity holders (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 equity holders, such as through debt-for-equity conversions, either by transferring existing shares or issuing new shares.

45. 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 States allow the plan to be approved by creditors over the objection of equity holders, irrespective of the terms of the constitutive instrument of the debtor. Such plans may result in the interests of existing equity holders being entirely displaced in the new business without their consent.

*(f) Related persons*

46. 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 of related persons. In such cases, related persons generally vote in the same manner as other creditors. They will generally be subject, however, to the provisions of non-insolvency law in respect of their personal dealings with the debtor and its business.

*(g) Requirements for approval of the plan*

47. Many insolvency laws identify the minimum threshold of support required from creditors for a 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 and, as already discussed, whether the insolvency law requires a majority of creditors voting or of all creditors.

*(i) Where voting is not conducted in classes*

48. 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 a 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 those creditors actually voting on approval of the plan, there are laws that determine proportions by

reference to the total value of debt and total number of creditors, irrespective of whether or not they vote (see above, para. 32). Other combinations are also used.

*(ii) Where voting is conducted by class*

49. Where creditors vote in classes, a wide variety of different approaches are taken to determining when a plan is approved. These approaches can be somewhat complex, involving requirements both for approval by a particular class and for approval among all classes, with majorities determined by reference, in some cases, only to those creditors actually voting and in others to the total number of creditors, whether voting or not. Whichever approach is adopted, it is important that it be set forth clearly in the insolvency law to provide certainty and transparency for parties to reorganization proceedings.

*a. Majority within a particular class*

50. Some insolvency laws require a plan to be approved by a majority of creditors of a class, where the requisite majority is based upon a percentage or proportion of the value of claims or a number of creditors, or a combination of both. Although increasing the difficulty of achieving approval, a procedure that 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 give creditors holding more than a certain percentage of the total value of claims 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 that combines the value of claims with a number of creditors will also prevent a large number of creditors with small claims 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, if those creditors represent less than a certain percentage of value of the total claims (e.g. around 25 or 30 per cent), the court may not confirm the plan. This procedure may be justified on the basis that it helps to ensure that the support for the plan is sufficient to enable it to be successfully implemented.

*b. Majority of classes*

51. Some laws require that all classes of creditors must support the plan for it to be approved. A few laws, however, enable support by some classes to make the plan binding on other classes that do not support the plan. 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 classes that do not support the plan, provided the court

is satisfied that certain conditions are met. 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 amount 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 modified or affected under the plan, to ensure that the plan is not only supported by those creditors whose rights are not modified or affected. Other laws provide that support by classes of unsecured creditors cannot amount to approval of the plan if secured creditors oppose the plan. Requirements for binding dissenting classes are discussed further in paragraphs 54-63 below.

## 6. *Where a proposed plan cannot be approved*

### (a) *Modification of a proposed plan*

52. Whichever voting mechanism is chosen, it is desirable that the insolvency law be sufficiently flexible to allow a plan submitted for approval to be negotiated by creditors and other parties in interest in the course of the voting procedure with a view to achieving wide support. Where such negotiation is not possible and voting is restricted to the plan as proposed, the chances of achieving approval of that plan may be reduced. Flexibility may be achieved by allowing a majority of creditors to vote to adjourn the meeting convened to vote on the plan if it appears that further negotiation on the plan may produce a favourable result or that unresolved disputes and issues can be addressed. As with many other provisions of the insolvency law, however, it is desirable that any such an adjournment is 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) *Failure to approve a plan*

53. In cases where a reorganization plan is not approved and renegotiation 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 to obtain approval of the plan should be taken as an indication that creditors favour liquidation and the reorganization proceedings can be converted to liquidation (see below, paras. 72-75). This approach may encourage debtors to propose an acceptable plan, subject to safeguards to prevent abuse in cases where liquidation is not in the interests of all creditors. Other insolvency laws provide that the reorganization proceedings should be dismissed. In many circumstances, 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 (this approach is discussed further below, see para. 71).



### 7. *Binding dissenting classes of creditors*

54. As noted above, a few States that provide for voting on approval of a plan 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) that do not support the plan. This is sometimes referred to as a “cram-down” provision. Where such provisions are incorporated into the insolvency law, the law also generally includes conditions that are aimed at protecting the interests of those dissenting classes of creditors. These conditions include that the requisite approvals of the plan have been obtained and that the approval process was properly conducted; that creditors will receive at least as much under the plan as they would have received in liquidation proceedings; that the plan does not include provisions contrary to the insolvency law or to other relevant law; that administrative claims and expenses will be paid in full, except to the extent that the holder of such a claim or expense has agreed to different treatment; and that the claims of classes of creditors that do not support a plan are treated under the plan in accordance with the rank accorded to them under the insolvency law (in other words, that creditors in that class will be paid in full, whether in money or property, such as stock or other securities, before a junior rank is paid). Since it is generally the court that is required to consider whether these conditions have been satisfied, they are discussed in the following section.

55. Under some insolvency laws, the court has the power to order that secured creditors are bound by the plan, provided it is satisfied as to certain conditions. These conditions may include that enforcement of the security interest by the secured creditor will have a material adverse effect on achieving the purposes of the plan; 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 (e.g. payments of future interest will be made and the value of the encumbered asset securing the security interest will not be affected). Similar provisions permit the court to bind priority creditors to the plan if they are to be paid the full amount of their priority claim and interest that preserves the current value of the claim.

### 8. *Court confirmation of a plan*

56. Not all States 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 become effective and dissenting creditors will be bound by virtue of the operation of the insolvency law. In those systems, the court will still have a role to play with regard to review of the plan where dissenting creditors or other parties in interest, including the debtor, challenge the plan itself or the means by which approval was procured. Other States require court confirmation of the approval for the plan to become effective and binding.



(a) *Challenges to approval of the plan*

57. Many insolvency laws provide for the approval of the plan by creditors to be challenged in the court. The manner in which a challenge will be heard may depend upon the mechanism for making the plan effective. If court confirmation of the plan is not required, for example, dissenting creditors or other parties in interest, including the debtor, may raise their challenge with the court after the vote on approval. Where the insolvency law requires court confirmation of an approved plan, a challenge may be made at the confirmation hearing. The law will need to address the parties that may challenge approval of the plan, and the timing of any challenge, in particular where the basis of the challenge is fraud. In that case, any time limits to be established for challenging approval may need to refer to the time of discovery of the fraud. The law will also need to address the consequences of a successful challenge to the plan. It may permit, for example, further opportunities for consideration and approval of a plan if that approach is appropriate for remedying the ground on which the plan was challenged or provide for the proceedings to be converted to liquidation.

58. A number of insolvency laws establish the grounds for challenging approval of the plan. Examples of such grounds include that approval was obtained by fraud (e.g. false or misleading information was given to creditors and other parties in interest or material information was withheld with respect to the reorganization plan or the financial affairs of the debtor); 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 organization or conduct of the meeting at which the vote was taken (e.g. adequate notice of the meeting was not given); that the proposals contained in the plan were put forward for an improper purpose or that the plan contains provisions contrary to law; that the plan is not feasible (e.g. encumbered 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); that the proposals unfairly prejudice the interests of the objector; or that the treatment of claims in the plan does not conform to the ranking of claims under the insolvency law (unless there has been agreement to vary that ranking).

59. 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 to enable a creditor to successfully challenge approval on grounds of prejudice or unfairness. 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.

*(b) Steps required for court confirmation*

60. Where the insolvency law requires the court to confirm a plan, it would normally be expected to confirm the plan that has been approved by the requisite majority of creditors (whether voting in classes or otherwise). As noted above, some States enable the courts to play an active role in binding 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 creditors voted in support of the plan, but rather to ensure that the approval of the plan was properly obtained (i.e. there is no evidence of fraud in the approval process) and that certain conditions were satisfied.

61. As noted above (para. 54), these conditions may be similar to, or the same as, conditions relevant to challenges to approval of the plan: that those classes of creditor objecting to the plan will share in the economic benefits of the plan; that dissenting classes of creditors will receive as much under the plan as they would have received in liquidation; that no creditor will receive more than the full value of its claim; that normal ranking of claims under the insolvency law is observed by the plan; and that similarly ranked creditors are treated equally. Some insolvency laws permit classes of unsecured creditors that are not entitled to priority to consent, by vote of the requisite majority of the class, to ranking different from that applying to distribution in liquidation under the insolvency law. A class of ordinary unsecured creditors that will not be paid in full might consent, for example, to a distribution to a class of subordinated claims or equity holders. Claims and expenses that are administrative claims or are entitled to be paid in priority are generally required to be paid in full for a reorganization plan to be confirmed, except to the extent that the holder of the claim or expense agrees to different treatment. Some laws require the court to assess additional matters, such as whether the plan can be considered to be fair in respect of those classes whose interests are modified or affected by the plan but which nevertheless have voted to approve the plan.

62. 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 from a practical, rather than an economic, point of view. Such an approach may be justified, for example, where secured creditors are not bound by the plan, but the plan does not provide for full satisfaction of their secured claims. The court may reject the plan in such a case if it considers that secured creditors will enforce their rights against the encumbered assets, thus rendering the plan impossible to perform. The risk of this occurring should be addressed in provisions relating to preparation and approval of the plan.

63. The more complex the decisions the court is asked 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 approve or reject a plan. In particular, it is highly desirable that the law not require or permit the court

to review the economic and commercial basis of the decision of creditors (including issues of fairness that do not relate to the approval procedure, but rather to the substance of what has been agreed) nor that it be asked to review particular aspects of the plan in terms of their economic feasibility, unless the circumstances in which this power can be exercised are narrowly defined or the court has the competence and experience to exercise the necessary level of commercial and economic judgement. For these reasons, it is desirable that the requirements for approval of the plan by creditors and confirmation by the court be carefully designed to minimize potential problems of the kind discussed here.

### *9. Effect of an approved and, where required, confirmed plan*

64. Where the plan is approved by the requisite majority of creditors and equity holders and, where required, confirmed by the court, insolvency laws generally provide that it will bind all affected ordinary unsecured creditors, including creditors who voted in support of the plan, dissenting creditors, creditors who did not vote on the plan and equity holders. Some insolvency laws also provide that the plan will bind directors 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 in specific circumstances, such as where implementation fails or the debtor fails to perform its obligations 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, where required, confirmed by the court, the property of the insolvency estate returns to the control of the debtor for implementation of the plan (unless the plan provides otherwise) and the debtor may obtain a discharge from debts and claims pursuant to the plan.

### *10. Challenges to a plan after court confirmation*

65. Many of those insolvency laws that require confirmation by the court provide for the plan to be challenged in the court subsequent to the confirmation hearing (in some cases within a specified period of time). On the basis that the court is required to be satisfied as to a number of conditions before confirming a plan, the grounds for challenge after confirmation would generally be narrower than the grounds for challenge at the time of confirmation and be limited, for example, to fraud. Where an insolvency law permits such a challenge after confirmation, it may be desirable to specify a period of time after discovery of the fraud within which such a challenge can be brought and to specify who may bring such a challenge. Where a challenge to a plan that has already been confirmed is successful, an insolvency law may adopt different options. For example, the plan may be set aside and the proceedings converted to liquidation. Alternatively, the proceedings may be dismissed and the assets returned to the debtor's control. The latter approach does not resolve the debtor's financial difficulty and may simply delay commencement of liquidation proceedings, leading to further diminution of the value of the debtor's

assets before those proceedings are finally commenced. In determining the most appropriate action to be taken in those circumstances, consideration will need to be given to the extent to which the plan has already been implemented, how steps taken in the implementation, such as payments to creditors, are to be treated and the extent to which the grounds upon which the plan was successfully challenged can be addressed.

### *11. Amendment of a plan after approval by creditors*

66. An insolvency law may include limited provision for a plan to be modified after it has been approved by creditors (and both before and after confirmation) if its implementation breaks down or it is found to be incapable of performance, whether in whole or in part, and the specific problem can be remedied. Of those insolvency laws which allow modification, some provide for the plan to be modified only 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. Generally, any party in interest will be permitted to propose modification of a plan at any time. The only limitation that may apply in terms of timing relates to court approval of a modification. Such a requirement necessitates that the proceedings are still open and the court retains jurisdiction. If proceedings are concluded after approval (and confirmation) of a plan, approval of the proposed amendment by affected creditors may be sufficient, unless some other requirement is imposed.

67. Depending upon the nature of the modification it may not be necessary to obtain the approval of all classes of creditors, since in some cases obtaining that approval may prove difficult. Alternative approaches may include permitting small modifications to be approved by the court or by the creditors affected by the modification; or requiring creditors who supported the plan to be notified of proposed modifications and permitting them to object within a specified period of time or otherwise be deemed to have accepted the modification. The same approaches may be taken to creditors who did not approve the plan. Where the modification proposed is significant, the approval of all creditors may be required. Those insolvency laws which require court confirmation of the plan may also require modifications to satisfy the rules or conditions relating to confirmation. It is desirable that an insolvency law address the consequences of failure to obtain the requisite approval for the proposed modifications. These might be similar to those discussed above in respect of failure of creditors to approve the plan and successful challenges to the plan, taking into account the steps that may already have been taken in implementing the plan and the treatment to be afforded to payments made, contracts continued and so forth.

68. Whichever approach is adopted, it is desirable that the insolvency law require relevant creditors (whether all creditors or only affected creditors) to be notified of any proposed modification and specifies the party responsible for

giving that notice, as well as requiring information relevant to the failure of the plan and the proposed modification to be disclosed.

### 12. *Implementation of a plan*

69. Many plans can be executed by the debtor without the need for further intervention or supervision by the court or the insolvency representative, especially in the case of a debtor-in-possession reorganization. No further intervention or supervision would generally be possible where the insolvency law provides that the proceedings conclude once a plan becomes effective. Under other laws that provide for the proceedings to conclude when the plan has been fully implemented, it may sometimes be necessary for the implementation to be supervised or controlled by an independent person. Under several insolvency laws the court has an ongoing role in supervision of the debtor after approval of the plan, pending completion of its implementation. This may be important where issues of interpretation of the performance or obligations of the debtor or others arise. Some States provide for the court to authorize continued supervision of the affairs of the debtor, to varying degrees, by a supervisor or insolvency representative after approval of the plan. A further approach permits creditors to appoint a supervisor or representative to oversee implementation of the plan.

### 13. *Where implementation fails*

70. Where the debtor defaults in performing its obligations under the plan or implementation of the plan breaks down for some other reason, insolvency laws provide for a variety of consequences. Some insolvency laws provide that the court can terminate the plan and convert the proceedings to liquidation (see below). Other laws provide that the plan will only be terminated in respect of the specific obligation breached (it otherwise remains valid). The creditor whose obligation is breached will not be bound by the plan and will have its claim restored (in the event that it had agreed to receive a lesser amount under the plan) to the full amount. In some cases, this will only occur where the debtor has fallen significantly into arrears<sup>2</sup> in the performance of its obligations under the plan. In some States, the consequences of default may be set out in the plan itself.

71. A further approach may be to regard the insolvency proceedings as at an end and to allow creditors to pursue the remedies otherwise available under the law. As already discussed, this approach may not resolve the financial difficulties of the debtor, depending upon the stage reached in implementation of the plan when it fails, and could lead to a race for assets that the commencement of collective proceedings was intended to avoid. There may be situations, however, where the appropriate course of action is to permit the court to close proceedings and allow parties in interest to exercise their rights at law. An

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<sup>2</sup>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 two weeks.

example might be where the remaining assets are fully encumbered and there will be no distribution to unsecured creditors. In some circumstances, and depending upon the stage reached in implementation of the plan, 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 acceptable plan can be prepared within that deadline would liquidation follow. It must be recognized that a balance has to be achieved between different factors, including the time required to negotiate a plan; achieving the best outcome for creditors; ensuring that value is maximized; and the need for expeditious conduct of the proceedings.

#### 14. *Conversion to liquidation*

72. A number of circumstances may arise in the course of a reorganization proceeding when it will be desirable for an insolvency law to allow the proceedings to be converted to liquidation. The principal grounds for conversion would be failure to propose or approve a reorganization plan; failure to approve proposed modifications that are required for implementation of the plan; failure to obtain confirmation (where confirmation by the court is required); a successful challenge to an approved or confirmed plan; a majority vote by a meeting of creditors to terminate reorganization proceedings; a material or substantial default by the debtor of its obligations under the plan; or failure of implementation for some other reason. Some of these circumstances will only be relevant to those systems where the court supervises implementation of the plan and retains jurisdiction over the debtor after approval.

73. It may also 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 reorganization proceedings either by not cooperating with the insolvency representative or the court (e.g. withholding information) or otherwise acting in bad faith (e.g. making fraudulent transfers); where the business continues to incur losses during the reorganization period; or where administrative expenses are not paid. Some laws impose an obligation on the insolvency representative to terminate administration of the reorganization proceedings as soon as it is evident that reorganization will not be possible, in order to preserve value for creditors. Including provisions in an insolvency law for conversion to liquidation will provide predictability as to the ultimate resolution of the proceedings. If conversion to liquidation requires a new application for commencement to be made, rather than relying upon the original application as the basis for the converted proceedings, it may lead to further delay and diminution of value. Accordingly, consideration may need to be given to the procedural requirements for commencement and conduct of converted proceedings.

74. Where reorganization proceedings are converted to liquidation, an insolvency law will also need to consider the status of any actions taken by the insolvency representative prior to approval of the plan; the continued

application of the stay, in particular to secured creditors if the insolvency law contains a time limit calculated by reference to commencement; the treatment of payments made in the course of the implementation of the plan prior to a conversion; and the treatment of creditor claims that have been compromised in the reorganization. Payments made in the course of the reorganization may need to be protected from the operation of avoidance provisions. Claims that have been compromised in the reorganization may be reinstated to full value in any subsequent liquidation or may be enforceable only as compromised. The issue of failure of implementation may also be addressed in the reorganization plan, which may specify the rights of creditors in that event. Such an approach simplifies the question of treatment of those claims and avoids potentially difficult issues of applicable law.

75. Where the insolvency law permits conversion, a related question is how conversion can be triggered—whether it should be automatic once certain conditions are fulfilled or require application to the court by the insolvency representative or other parties in interest. Because it is the party that, after the debtor or its management, has the greatest knowledge of the debtor’s business, and often learns at an early stage of the proceedings whether or not the debtor’s business is viable, the insolvency representative can play a key role in initiating conversion. In addition, it may be reasonable to allow creditors or other parties in interest to request the court to convert the proceedings. The court could also be given the power to convert on its own motion where certain conditions are met.

### ***Recommendations 139-159***

#### **Purpose of legislative provisions**

The purpose of provisions relating to the reorganization plan is:

(a) To facilitate the rescue of businesses subject to the insolvency law, thereby preserving employment and, in appropriate cases, protecting investment;

(b) To identify those businesses which are capable of reorganization;

(c) To maximize the value of the estate;

(d) To facilitate the negotiation and approval of a reorganization plan and establish the effects of approval, including that the plan should bind the debtor, creditors and other parties in interest;

(e) To address the consequences of a failure to propose an acceptable reorganization plan or to secure approval of the plan, including conversion of the proceedings to liquidation in certain circumstances; and

(f) To provide for the implementation of the reorganization plan and the consequences of failure of implementation.



### ***Recommendations 139-159 (continued)***

#### **Contents of legislative provisions**

##### *Proposal of a reorganization plan (paras. 6-16)*

139. The insolvency law should specify that a plan may be proposed on or after the making of an application to commence insolvency proceedings or within a specified period of time after commencement of the insolvency proceedings:

- (a) The time period should be fixed by the insolvency law;
- (b) The court should be authorized to extend the time period in appropriate circumstances.

140. The insolvency law should specify that a plan may be proposed on or after the making of an application to commence insolvency proceedings or within a specified period of time after commencement of the insolvency proceedings: where liquidation proceedings are converted to reorganization proceedings, the insolvency law should also address the impact of conversion on time limits for proposal of a plan.

##### *Preparation of a disclosure statement (para. 23)*

141. The insolvency law should require a plan to be accompanied by a disclosure statement that will enable those entitled to vote on approval of the plan to make an informed decision about the plan. The party that prepares the plan should also prepare the disclosure statement.

##### *Submission of the plan and disclosure statement (para. 23)*

142. The insolvency law should provide a mechanism for submission of the plan and disclosure statement to creditors and equity holders.

##### *Contents of a disclosure statement (paras. 24 and 25)*

143. The insolvency law should specify that the disclosure statement include:<sup>3</sup>

- (a) A summary of the plan;
- (b) Information relating to the financial situation of the debtor, including assets, liabilities and cash flow;
- (c) Non-financial information that might have an impact on the future performance of the debtor;
- (d) A comparison of the treatment afforded to creditors by the plan and what they would otherwise receive in liquidation;
- (e) The basis upon which the business would be able to keep trading and could be successfully reorganized;

<sup>3</sup>Where the insolvency representative does not prepare, or is not involved in the preparation of, the plan and the statement, the insolvency representative should be required to comment on both instruments. Information included in the disclosure statement should be subject to the obligations of confidentiality, discussed in chapter III, recommendation 111 and paras. 28, 52 and 115.



(f) Information showing that, having regard to the effect of the plan, adequate provision has been made for satisfaction of all obligations included in the plan; and

(g) Information on the voting mechanisms applicable to approval of the plan.

*Content of a plan (paras. 18-22)*

144. The insolvency law should specify the minimum contents of a plan. The plan should:

(a) Identify each class of creditors and the treatment provided for each class by the plan (e.g. how much they will receive and the timing of payment, if any);

(b) Detail the treatment of equity holders;

(c) Detail the terms and conditions of the plan;

(d) Identify the debtor's role in implementation of the plan;

(e) Identify those responsible for future management of the debtor and supervision of the implementation of the plan and indicate their affiliation with the debtor and their remuneration; and

(f) Indicate how the plan will be implemented.

*Voting mechanisms (paras. 26-51)*

145. The insolvency law should establish a mechanism for voting on approval of the plan. The mechanism should address the creditors and equity holders who are entitled to vote on the plan; the manner in which the vote will be conducted, either at a meeting convened for that purpose or by mail or other means, including electronic means and the use of proxies; and whether or not creditors and equity holders should vote in classes according to their respective rights.

146. The insolvency law should specify that a creditor or equity holder whose rights are modified or affected by the plan should not be bound to the terms of the plan unless that creditor or equity holder has been given the opportunity to vote on approval of the plan.

147. The insolvency law should specify that where the plan provides that the rights of a creditor or equity holder or class of creditors or equity holders are not modified or affected by a plan, that creditor or equity holder or class of creditors or equity holders is not entitled to vote on approval of the plan.

148. The insolvency law should specify that creditors entitled to vote on approval of the plan should be separately classified according to their respective rights and that each class should vote separately.

149. The insolvency law should specify that all creditors and equity holders in a class should be offered the same treatment.

***Recommendations 139-159 (continued)******Approval by classes (paras. 49-51, 54 and 55)***

150. Where voting on approval of the plan is conducted by reference to classes, the insolvency law should specify how the vote achieved in each class would be treated for the purposes of approval of the plan. Different approaches may be taken, including requiring approval by all classes or approval by a specified majority of the classes, but at least one class of creditors whose rights are modified or affected by the plan must approve the plan.

151. Where the insolvency law does not require a plan to be approved by all classes, the insolvency law should address the treatment of those classes which do not vote to approve a plan that is otherwise approved by the requisite classes. That treatment should be consistent with the grounds set forth in recommendation 152.

***Confirmation of an approved plan (paras. 56 and 60-63)***

152. Where the insolvency law requires court confirmation of an approved plan, the insolvency law should require the court to confirm the plan if the following conditions are satisfied:

- (a) The requisite approvals have been obtained and the approval process was properly conducted;
- (b) Creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;
- (c) The plan does not contain provisions contrary to law;
- (d) Administrative claims and expenses will be paid in full, except to the extent that the holder of the claim or expense agrees to different treatment; and
- (e) Except to the extent that affected classes of creditors have agreed otherwise, if a class of creditors has voted against the plan, that class shall receive under the plan full recognition of its ranking under the insolvency law and the distribution to that class under the plan should conform to that ranking.

***Challenges to approval (where there is no requirement for confirmation) (paras. 57-59)***

153. Where a plan becomes binding on approval by creditors, without requiring confirmation by the court, the insolvency law should permit parties in interest, including the debtor, to challenge the approval of the plan. The insolvency law should specify criteria against which a challenge can be assessed, which should include:

- (a) Whether the grounds set forth in recommendation 152 are satisfied; and
- (b) Fraud, in which case the requirements of recommendation 154 should apply.

*Challenges to a confirmed plan (para. 65)*

154. The insolvency law should permit a confirmed plan to be challenged on the basis of fraud. The insolvency law should specify:

- (a) A time limit for bringing such a challenge calculated by reference to the time the fraud is discovered;
- (b) The party that may bring such a challenge; and
- (c) That the challenge should be heard by the court.

*Amendment of a plan (paras. 52 and 66)*

155. The insolvency law should permit amendment of a plan and specify the parties that may propose amendments and the time at which the plan may be amended, including between submission and approval, approval and confirmation, after confirmation and during implementation, where the proceedings remain open.

*Approval of amendments (paras. 67 and 68)*

156. The insolvency law should establish the mechanism for approval of amendments to a plan that has been approved by creditors. That mechanism should require notice to be given to the creditors and other parties affected by the proposed modification; specify the party required to give notice; require the approval of creditors and other parties affected by the modification; and require the rules for confirmation (where confirmation is required) to be satisfied. The insolvency law should also specify the consequences of failure to secure approval of proposed amendments.

*Supervision of implementation (para. 69)*

157. The law may establish a mechanism for supervising implementation of the plan, which may include supervision by the court, by a court-appointed supervisor, by the insolvency representative or by a creditor-appointed supervisor.<sup>4</sup>

*Conversion to liquidation (paras. 72-75)*

158. The insolvency law should provide that the court may convert reorganization proceedings to liquidation where:

- (a) A plan is not proposed within any time limit specified by the law and the court does not grant an extension of time;
- (b) A proposed plan is not approved;
- (c) An approved plan is not confirmed (where the insolvency law requires confirmation);
- (d) An approved or a confirmed plan is successfully challenged; or

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<sup>4</sup>Where the proceedings involve a debtor in possession, or where the proceedings conclude on approval of the plan, it may not be necessary to appoint a supervisor.

**Recommendations 139-159 (continued)**

(e) There is substantial breach by the debtor of the terms of the plan or an inability to implement the plan.<sup>5</sup>

*Failure of implementation of a plan (paras. 70 and 71)*

159. The insolvency law may specify that where there is a substantial breach by the debtor of the terms of the plan or an inability to implement the plan, the court may close the judicial proceedings and parties in interest may exercise their rights at law.

## B. Expedited reorganization proceedings<sup>6</sup>

### 1. Introduction

76. As discussed in part one of the *Legislative Guide*, reorganization can take one of several forms. These include informal (i.e. in the sense of being conducted out of court) voluntary restructuring negotiations, which require little or no court involvement and essentially depend upon the agreement of the parties involved and reorganization proceedings conducted in accordance with the insolvency law under the formal supervision of a court (referred to here as “full reorganization proceedings”). The latter proceedings generally involve all creditors of the debtor and a reorganization plan formulated and approved by creditors and other parties in interest after commencement of the proceedings. Reorganization may also include, however, proceedings commenced to give effect to a plan negotiated and agreed by affected creditors in voluntary restructuring negotiations that take place prior to commencement, where the insolvency law permits the court to expedite the conduct of those proceedings (referred to in this section as “expedited reorganization proceedings”).

77. Reaching agreement through voluntary restructuring negotiations 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 consent from all relevant parties. To provide a negotiating framework that can be agreed by all participants and facilitates the successful outcome of these negotiations, INSOL International published a *Statement of Principles for a Global Approach to Multi-Creditor Workouts*. The *Principles* are designed to expedite negotiation 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.

<sup>5</sup>This course of action is only available where the proceedings remain open during implementation: see chapter VI, paras. 18 and 19.

<sup>6</sup>Because these proceedings are based on the agreement achieved in voluntary restructuring negotiations, this section should be read in conjunction with part one, chapter II, paras. 2-18.

78. Voluntary restructuring negotiations can also be impeded by a minority of affected creditors who may refuse to agree to a solution 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 voluntary agreement can only be implemented if the contractual rights of these dissenting creditors can be modified without their consent. Under most existing legal systems, such a modification of contractual rights requires the commencement of full reorganization proceedings under the insolvency law, involving all creditors and requiring satisfaction of the provisions of the insolvency law governing the conduct of such proceedings. Typically, timing is critical in business restructuring and delay (usually inherent in full reorganization proceedings) can frequently be costly or even fatal to achieving an effective solution.

79. These difficulties, as well as some of the costs, delays and procedural and legal requirements often associated with full reorganization proceedings, can be avoided where voluntary restructuring negotiations and expedited reorganization proceedings are used. These proceedings can provide a cost efficient means of resolving a debtor’s financial difficulties, although their effectiveness may depend upon certain preconditions, discussed in part one of the *Legislative Guide* (see chap. II, paras. 2-18), being met. These conditions may include that a significant amount of debt is owed to a limited number of main banks or financial institution creditors; that creditors accept that it may be preferable to negotiate an arrangement, as between the debtor and the financiers and also between the financiers themselves, to resolve the financial difficulties of the debtor; that there is a prospect of 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); and that 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.

80. Notwithstanding the dependence upon such conditions, voluntary restructuring negotiations and expedited reorganization proceedings can be valuable tools in the range of insolvency solutions available to a country’s commercial and business sector. Encouraging the use of such solutions need not stem from the fact that a country’s formal insolvency system is poor, inefficient or unreliable, but rather from the advantages such solutions can offer as an adjunct to purely formal insolvency proceedings, which deliver fairness and certainty. Moreover, such solutions work best where there is the possibility that if the negotiation process cannot be started or breaks down, there can be swift and effective resort to the insolvency law.

## 2. *Creditors typically involved in voluntary restructuring negotiations*

81. As noted above (see part one, chap. II, paras. 14-16), it is not always possible, or even necessary, to involve all creditors in voluntary restructuring

negotiations. Typically these negotiations involve the debtor and one or more classes of creditors, such as lenders, bond holders and equity holders. They also frequently involve major non-institutional creditors, typically where these creditors' involvement in the debtor's business is so considerable that an effective restructuring is not possible without their participation. These types of creditor often find it advantageous to participate in the negotiations because there is a potential to reduce the loss that they would otherwise suffer under full reorganization proceedings.

82. The limited classes of creditors that would normally participate in voluntary restructuring negotiations make an agreement easier to accomplish than full reorganization because the latter proceedings typically affect all claims. Since it is usual in voluntary restructuring negotiations for certain types of non-institutional and other creditors, such as trade creditors, to continue to be paid in the ordinary course of business, these creditors are not likely to have any objection to the proposed restructuring and do not need to participate in the negotiations. Where, however, the rights of those creditors are to be modified by the plan, their agreement to the proposed modifications would be required.

### *3. Proceedings to implement a voluntary restructuring agreement*

83. An insolvency law can include, in provisions on commencement of reorganization proceedings under the insolvency law, provisions for the court to confirm a voluntary restructuring agreement and to expedite those proceedings. Where it does so, consideration will need to be given to defining the debtors to whom such provisions might apply and the parties that can be affected by such expedited proceedings.

#### *(a) Eligible debtors*

84. It is desirable that expedited reorganization proceedings be available on the application of any debtor that is not yet eligible to commence proceedings under the general reorganization provisions of an insolvency law, but is likely to be generally unable to pay its debts in the future as they mature. Including provisions in an insolvency law that permit such debtors to commence expedited proceedings recognizes the need to address financial difficulty at an early stage and allows advantage to be taken of a voluntary restructuring agreement that a majority of affected creditors has approved. Commencing expedited proceedings will ensure the protection of dissenting creditors under the insolvency law. The jurisdictional requirements generally applicable to commencement of insolvency proceedings would also apply (see part two, chap. I, paras. 12-18).

85. An insolvency law may also provide that expedited proceedings to confirm a voluntary restructuring agreement are available to a debtor that is already eligible to commence full proceedings under the insolvency law (see part two, chap. I, paras. 23-31 and recommendations 15 and 16). Where the insolvency law establishes an obligation to commence insolvency proceedings

if the debtor meets specified criteria concerning its financial position (e.g. that it is insolvent), it may be necessary to provide specifically that the commencement of expedited proceedings satisfies this obligation. Alternatively, the insolvency law may provide a temporary moratorium that will enable the debtor to avoid meeting those criteria (and thus avoid the sanctions for failure to meet the obligation to apply for commencement), while still taking action to resolve its financial difficulties.

*(b) Obligations affected*

86. As noted above, the types of obligation typically involved in voluntary restructuring negotiations relate to borrowed money indebtedness, both institutional and public, whether secured or unsecured, and other similar financial obligations. Secured debt could also be included in such negotiations with the agreement of the secured creditors. Indebtedness held by other creditors, such as trade creditors, priority creditors such as tax and social security authorities and employees, is generally not included because of the difficulty of obtaining the consent necessary to adjust their claims and they continue to be paid in the ordinary course of business. However, such creditors could be included where their rights are to be modified in the reorganization and the necessary majority approvals can be obtained, provided all the relevant safeguards applicable under the insolvency law are observed. The specific obligations to be affected in any given case would be those identified in the plan that is to be confirmed by the court in expedited proceedings.

*(c) Application of the insolvency law*

87. An insolvency law that permits expedited proceedings will need to identify those provisions of the insolvency law applicable to full reorganization proceedings that will apply, in particular if any changes are to be made in the manner in which they apply. So, for example, the provisions that would generally apply to expedited proceedings in the same manner as to full proceedings (unless specifically modified) might include provisions on application procedures; commencement of the proceedings; notification of commencement (which may be modified to limit notification to those creditors and equity holders affected by the plan) and the content of the notice (which may need to include information on claim verification, time and place for the court hearing on confirmation of the plan, objections to confirmation of the plan and impact of the plan on equity holders); application of the stay; requirements for preparation of a list of all creditors (in order to inform the court and to provide certainty as to who is affected by the plan and who is not); requirements for approval of the plan (including provision of the plan and supporting information to affected creditors, determination of classes of creditors, creditor committees, criteria and majorities required for approval); effect and confirmation of the plan, including standards of treatment that protect the interests of dissenting creditors; issues relating to implementation of the plan (including failure of implementation) and discharge of claims. Where implementation of a plan confirmed under expedited proceedings fails, the insolvency law will need to consider the consequences of that failure and, in particular, whether



they should be the same as for failure of plan approved in formal proceedings (see above, paras. 70-75) and whether special provision should be made in respect of payments already made in the course of implementation.

88. Provisions of the insolvency law that might not apply to expedited proceedings or might be modified to comply with the goal of expedited proceedings would include those relating to appointment of the insolvency representative, unless the plan specifically provides for that appointment; submission and verification of claims; requirements for notice to unaffected creditors; time periods for plan approval (where such provisions are included in the insolvency law); and voting on the plan (since this occurred before commencement). A further and important exception to the application of the insolvency law would be that, where it could be shown that confirmation of the plan was likely, the court could authorize creditors not affected by the plan to continue to be paid in the ordinary course of business.

*(i) Application requirements*

89. The application for commencement of expedited proceedings may need to be somewhat different to an application for full reorganization proceedings to take account of the different background considerations. The application could include the negotiated plan and disclosure statement; information concerning the negotiations that have already been conducted (including the members of any creditor committee that may have been formed to facilitate the negotiations), the pre-commencement solicitation of creditors and voting of affected classes of creditors (demonstrating that the majorities specified under the insolvency law for approval of a plan have been achieved in classes of affected creditors); evidence that unaffected creditors continue to be paid in the ordinary course of business and that the plan does not modify or affect their rights; as well as the protections afforded under the plan to dissenting creditors within accepting classes. An insolvency law would also need to address the question of whether the application functions to automatically commence 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, in particular because the application is based upon a negotiated agreement and delay will be detrimental not only to the debtor's business but also to implementation of the plan.

*(ii) Effects of commencement*

90. While commencement of full reorganization proceedings generally affects the debtor and all its creditors (unless certain classes are specifically excepted from application of the insolvency law), the effects of commencement of expedited proceedings will generally be limited to the debtor and individual or classes of creditors and equity holders whose rights are to be modified or affected by the negotiated plan. There may be circumstances, however, where the court may determine that additional creditors or classes of creditors should be included in those effects in order to ensure, for example, protection of the insolvency estate.



*(iii) Failure of implementation*

91. As already discussed (see above, paras. 70 and 71), insolvency laws adopt different approaches to the consequences of failure to implement a plan approved by creditors and, where required, confirmed by the court. While the consequences of failure of implementation of a plan confirmed by the court in expedited proceedings might generally be expected to be the same as in the case of full reorganization proceedings, the possibility of commencing expedited proceedings before a debtor can satisfy the commencement standard for full reorganization proceedings suggests that conversion to liquidation might not be appropriate; it may be preferable for the insolvency law to leave creditors free to pursue their rights at law.

*(d) Expedition of the proceedings*

92. In order to take full advantage of the negotiated plan and avoid the delays that may make that plan impossible to implement, an insolvency law may need to consider how, in addition to recognizing the steps that have been completed before commencement as noted above, expedited proceedings can be handled more quickly than full reorganization proceedings. For example, if a plan and other documentation that complies with the formal requirements of the insolvency law has been negotiated 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. It may also be possible for an exemption to be granted from part of the formal proceedings. For example, if a plan has been negotiated and agreed by a majority of creditors of a particular class—typically the institutional creditors—sufficient to satisfy the voting requirements of the insolvency law for approval of a reorganization plan and the rights of other creditors will not be modified or affected by the plan, it might be possible for the court to order a meeting or hearing of that particular approving class of creditors only. Similarly, if the solicitation of votes of affected classes of creditors has been conducted in compliance with applicable laws governing such solicitation (including the disclosure requirements of applicable securities laws), it should be possible for the court to dispense with any post-commencement solicitation procedures.

93. Even where the insolvency law provides for expeditious treatment of eligible cases, it is highly desirable that it not afford less protection for dissenting creditors and other parties than the insolvency law provides those same parties in full reorganization proceedings. The procedural requirements for such expedited reorganization proceedings would therefore include substantially the same safeguards and protections as provided in full reorganization proceedings.

94. Other laws may need to be modified to encourage or accommodate both voluntary restructuring negotiations and expedited reorganization proceedings. Examples of such laws might include those which expose directors to liability for trading during the conduct of voluntary restructuring negotiations; which do not recognize obligations for credit extended during such a period or subject those obligations to avoidance provisions; and which restrict conversion of debt to equity.

## ***Recommendations 160-168***

### **Purpose of legislative provisions**

The purpose of provisions relating to insolvency procedures that combine voluntary restructuring negotiations and acceptance of a plan with an expedited procedure conducted under the insolvency law for court confirmation of that plan is:

(a) To recognize that voluntary restructuring negotiations, which typically involve 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 creditor, is a cost-effective, efficient tool for the rescue of financially troubled businesses;

(b) To encourage and facilitate the use of informal negotiation;

(c) To develop a procedure under the insolvency law that will:

- (i) Preserve the benefits of voluntary restructuring negotiations where a majority of each affected class of creditors agree to a plan;
- (ii) Minimize time delays and expense and ensure that the plan negotiated and agreed in voluntary restructuring negotiations is not lost;
- (iii) Bind those minority members of each affected class of creditors and equity holders who do not accept the negotiated plan;
- (iv) Be based upon the same substantive requirements, but shortened time periods, as reorganization proceedings under the insolvency law, including essentially the same safeguards; and

(d) To suspend, with appropriate safeguards, requirements in other laws that may prevent or inhibit the use of processes that delay the invocation of the insolvency law.<sup>7</sup>

### **Contents of legislative provisions**

*Commencement of expedited reorganization proceedings (paras. 84 and 85 and chapter I, paras. 12-18 and recommendations 10-12 on jurisdiction)*

160. The insolvency law should specify that expedited proceedings can be commenced on the application of any debtor that:

(a) Is or is likely to be generally unable to pay its debts as they mature;

(b) Has negotiated a reorganization plan and had it accepted by each affected class of creditors; and

(c) Satisfies the jurisdictional requirements for commencement of full reorganization proceedings under the insolvency law.

<sup>7</sup>For example, 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 negotiations are being conducted, that do not recognize obligations for credit extended during such a period and that restrict conversion of debt to equity.

161. The insolvency law may additionally specify that an expedited proceeding can be commenced on the application of any debtor if:

- (a) The debtor's liabilities exceed or are likely to exceed its assets; and
- (b) The requirements of recommendation 160, subparagraphs (b) and (c), are satisfied.

*Application requirements (para. 89)*

162. The insolvency law should specify that the following additional materials should accompany an application for commencement of expedited reorganization proceedings:

- (a) The reorganization plan and disclosure statement;
- (b) A description of the voluntary restructuring negotiations that preceded the making of the application for commencement, including the information provided to affected creditors to enable them to make an informed decision about the plan;
- (c) Certification that unaffected creditors are being paid in the ordinary course of business and that the plan does not modify or affect the rights or claims of unaffected creditors without their agreement;
- (d) A report of the votes of affected classes of creditors demonstrating that those classes have accepted the plan by the majorities specified in the insolvency law;
- (e) A financial analysis or other evidence that demonstrates that the plan satisfies all applicable requirements for reorganization; and
- (f) A list of the members of any creditor committee formed during the course of the voluntary restructuring negotiations.

*Commencement*

163. The insolvency law should specify that the application for commencement will automatically commence the proceedings or that the court will be required to promptly determine whether the debtor satisfies the requirements of recommendations 160 or 161 and if so, commence proceedings.

*Effects of commencement (para. 90)*

164. The insolvency law should specify that:

- (a) Provisions of the insolvency law that apply to full reorganization proceedings will also apply to expedited proceedings unless specified as modified or not applicable;<sup>8</sup>

<sup>8</sup>Provisions of the insolvency law that generally would not be applicable or that could be modified would include full claim filing; notice and time periods for plan approval; the post-commencement mechanics of providing the plan and disclosure statement to creditors and other interested parties and for solicitation of votes and voting on the plan; appointment of an insolvency representative (who generally would not be appointed unless required by the plan); and provisions on amendment of the plan after confirmation. An exception to the provisions of the insolvency law applicable to full reorganization proceedings would be that creditors not affected by the plan would be paid in the ordinary course of business during the implementation of the plan.

**Recommendations 160-168 (continued)**

(b) Unless otherwise determined by the court, the effects of commencement should be limited to the debtor, individual creditors and classes of creditors and equity holders whose rights are modified or affected by the plan;

(c) Any creditor committee formed during the course of the voluntary restructuring negotiations should be treated as a creditor committee appointed under the insolvency law; and

(d) A hearing on the confirmation of the plan by the court should be held as expeditiously as possible.

**Notice of commencement (para. 87 and chapter I, paras. 64-71 and recommendations 22-25)**

165. The insolvency law should specify that notice of the commencement of expedited proceedings is to be given to affected creditors and affected equity holders. The notice should specify:

(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 the claim and the place where the claim can be submitted;

(c) The time and procedure for challenging claims submitted by other parties;

(d) The time and place for the hearing on confirmation of the plan and for the submission of any objection to confirmation; and

(e) The impact of the plan on equity holders.

**Confirmation of the plan (paras. 60-63 and 88 and recommendation 152)**

166. The insolvency law should specify that the court will confirm the plan if:

(a) The plan satisfies the substantive requirements for confirmation of a plan in full reorganization proceedings, in so far as those requirements apply to affected creditors and affected equity holders;

(b) The notice given and the information provided to affected creditors and affected equity holders during the voluntary restructuring negotiations 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 law;

(c) Unaffected creditors are being paid in the ordinary course of business and the plan does not modify or affect the rights or claims of unaffected creditors without their agreement; and

(d) The financial analysis submitted with the application demonstrates that the plan satisfies all applicable requirements for reorganization.

*Effect of a confirmed plan (para. 64)*

167. The insolvency law should specify that the effect of a plan confirmed by the court should be limited to the debtor and those creditors and equity holders affected by the plan.

*Failure of implementation of a confirmed plan (paras. 70, 71 and 91)*

168. The insolvency law may specify that where there is a substantial breach by the debtor of the terms of the plan or an inability to implement the plan, the court may close the judicial proceedings and parties in interest may exercise their rights at law.



## V. Management of proceedings

### A. Treatment of creditor claims

#### 1. Introduction

1. 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 into which they fall and the value of their claim, where that is a relevant factor) and, secondly, for purposes of distribution. The procedure for submission of claims and their admission is therefore a key part of the insolvency proceedings. Consideration should be given to determining which creditors should be required to submit claims and the types of claim that should be submitted. Those claims might include, for example, all rights to payment that arise from acts of omissions of the debtor prior to commencement of the insolvency proceedings, whether or not they are mature, liquidated or unliquidated, fixed or contingent. Consideration should also be given to the procedures applicable to the submission, verification and admission of claims, the consequences of failure to submit a claim and review of decisions concerning the 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 a 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

2. 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 an alternative mechanism for verification and admission of claims that does not require all creditors to submit claims—discussed below).

3. Under those insolvency laws which do not include encumbered assets in the insolvency estate and allow secured creditors to freely enforce their security interest against the encumbered assets, secured creditors may be excepted from the requirements to submit a claim, to the extent that their claim will be met from the value of the sale of the encumbered asset. To the extent that the value of the encumbered asset is less than the amount of the secured creditor's claim, the creditor may be required to submit a claim for the unsecured portion

as an ordinary unsecured creditor. The value of the unsecured claim thus depends upon the value of the encumbered asset and how it is determined, as well as the time at which it is determined. Unless clear rules apply to valuation, there is the potential for some uncertainty, in particular in terms of deciding voting rights where they are calculated by reference to the value of claims.<sup>1</sup>

4. Another approach requires secured creditors to submit a claim for the total value of their security interest irrespective of whether any part of the claim is unsecured. That requirement is limited in some laws to the holders of certain types of security interest, such as floating charges, bills of sale, or security over chattels. Some of those jurisdictions which require all secured creditors to submit a claim include serious consequences for those failing to do so (discussed below). Some insolvency laws also permit secured creditors to surrender their security interest to the insolvency representative and submit a claim for its total value.<sup>2</sup>

5. The rationale of requiring secured creditors to submit claims is to provide information to the insolvency representative as to existence of all claims, the extent of the secured debt and the assets that might be subject to a security interest, as well as the total amount of the outstanding debt. Whichever approach is chosen, it is desirable that an insolvency law include clear rules on the treatment of secured creditors for the purposes of submission of claims. It is also important, in particular where an insolvency law provides that the claims procedure can affect the security rights of a secured creditor, that notification of the commencement of proceedings include information regarding the submission, or failure to submit, secured claims. It is desirable, where secured creditors are required to submit a claim, that the procedures for submission and verification be generally the same as for unsecured creditors.

*(b) Limitations on claims that can be submitted*

6. It has not been unusual in the past for insolvency laws to limit the types of claim that could be submitted, excluding, for example, unliquidated tort claims. More recently, however, there has been a trend towards widening the definition of claims that can be submitted to include those unliquidated tort and contract claims, as well as contingent claims. An insolvency law may also need to address the treatment of claims of a non-monetary nature, such as a right to performance of an obligation (e.g. delivery of specific property) or a non-recourse loan.

7. Insolvency laws adopt different approaches to excluded claims. Under some laws, the creditors holding those claims cannot participate in the proceedings and have no recourse for collecting their debt from the debtor; their claim

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<sup>1</sup>On the valuation of encumbered assets, see chap. II, paras. 66-68.

<sup>2</sup>The UNCITRAL Model Law on Cross-Border Insolvency (art. 14, para. 3) and the Guide to Enactment (para. 111) note that under some laws a secured creditor who files a claim is deemed to have waived the security interest or some of the privileges attached to the credit, while under other laws failure to submit a claim has that result (see annex III).



is effectively extinguished. Under other laws, however, alternative courses of recovery are preserved and the claim can be can be pursued outside the insolvency proceedings. It is desirable that an insolvency law adopt a broad definition of claims that can be submitted and addressed in the context of the insolvency proceedings. It should be noted, however, that expanding that definition has the potential to make the insolvency proceedings more complicated, in particular when those claims have to be valued to enable submission and admission, even on a provisional basis.

(i) *Post-commencement debt*

8. As a general principle, claims can only be submitted in respect of debt incurred prior to commencement. The treatment of debt incurred after commencement will depend on the nature of the proceedings and the provisions of the insolvency law—many laws provide that such debts are payable in full as costs of the proceedings.

(ii) *Types of excluded claim*

9. For a variety of public policy reasons, an insolvency law may seek to exclude certain types of claim from the insolvency proceedings. Examples include foreign tax claims, fines and penalties, claims relating to personal injury, claims relating to negligence and gambling debts. Some insolvency laws provide that these claims can be submitted, but that they may be subject to special treatment, such as subordination to other unsecured claims. It is highly desirable that an insolvency law identify those claims which are to be excluded from the insolvency proceedings or subjected to special treatment (see below, paras. 45-49).

a. *Foreign tax claims*

10. Foreign tax claims are currently excluded by many States and it is generally recognized that such 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 State 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, paragraph 2, of the UNCITRAL Model Law on Cross-Border Insolvency (see annex III) recognizes these different approaches and provides that the principle 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 claims without priority or lower, if equivalent local claims have that lower ranking.

b. *Claims arising from illegal activity*

11. 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 focusing upon specific examples of claims that may be excluded as illegal, an

insolvency law may exclude, as a general category, those claims which arise from illegal activity and therefore are unenforceable.

*c. Fines and penalties*

12. 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 of fines and penalties 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, in particular 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.

*(c) Procedure for submission of claims*

*(i) Timing of submission of claims*

13. To ensure that claims are submitted in a timely fashion and that the insolvency proceedings are not unnecessarily prolonged, a flexible approach to the submission of claims is desirable, allowing creditors to make their claims not only by mail, but also e-mail and other appropriate means. Deadlines for submission of claims also can be specified. There are generally three types of approach to specifying deadlines. In the first, the insolvency law specifies that claims must be submitted within a certain period of time after the effective date of commencement of proceedings or by reference to some other specified event in the proceedings. In other laws, the deadline is to be determined by the court or insolvency representative, but within a range specified in the insolvency law, with examples ranging from 10 days to three months after a specified event, such as commencement of proceedings. The third approach is reflected in insolvency laws that do not establish any deadlines for submission and leave it up to the insolvency representative to determine the timing of submission of claims or also provide for claims to be submitted at any time up until some specified point in the proceedings, such as the final report and accounting by the insolvency representative. Some insolvency laws also establish 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.

14. A key factor in determining any deadline for submission will be the procedure for verification and admission of claims. If that process is required to take place at a court hearing or a meeting of creditors convened for that purpose, there is likely to be less flexibility with respect to the timing of the

submission of claims and claims not submitted by the specified date before that meeting or hearing will require a special hearing or meeting to be convened. Where verification and admission is conducted by the insolvency representative, greater flexibility will be possible since there will not be the same need to satisfy procedural requirements associated with convening meetings of creditors or court hearings.

15. While deadlines may assist in ensuring that the claims process does not impose unnecessary delay on the proceedings, they 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 some other specified event in the proceedings or sets a time limit that 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.

16. Where a deadline is established (whether by the insolvency law, the court or insolvency representative) and the claim is submitted late, causing costs to be incurred, those costs could be borne by the creditor. Where claims can be submitted at an advanced stage of the proceedings, an associated question to be addressed is whether interim distributions can be made before all claims have been submitted and, if so, whether creditors submitting their claims after a distribution has been made can nevertheless participate in that distribution. Some insolvency laws provide that such a creditor can only participate in distributions occurring after submission of its claim, while others require the insolvency representative to make provision at the time of the distribution for creditors that have not yet submitted their claims.

*(ii) Burden of submitting and proving claims*

17. Many insolvency laws place the burden of submitting and proving a claim upon creditors. Generally they will be required to produce evidence, in some cases by way of a standard claim form accompanied by supporting documentation, as to the amount of the claim, the basis of the debt and any priority or security interest claimed. Many laws also permit the insolvency representative to request the creditor to provide additional information or documentation to prove their claim; some laws also permit rejection of claims that have not been properly proved. While admission may be assisted in some jurisdictions 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, the formalities associated with such declarations in some jurisdictions have led to that practice being abandoned.

18. As a means of shortening the claims procedure, a number of insolvency laws permit claims to be admitted in specified circumstances without a requirement for formal submission of proof by the creditor. Appropriate

circumstances may include those where the insolvency representative is able to ascertain from the debtor's books and records the creditors that are entitled to payment and the amount of the debt. Although in many insolvency cases the books and records of the debtor may not be completely reliable, this method of admission has the advantage of reducing the formalities associated with verification and admission of claims and may be appropriate where the claims are not disputed either by the debtor or other creditors (discussed further below).

19. This approach may be facilitated by the preparation of a list of creditors and claims at an early stage of the proceedings. Preparation of such a list by the debtor takes advantage of the debtor's knowledge about its creditors and their claims and can give the insolvency representative an early indication of the financial state of the business. An alternative approach could require the insolvency representative to assist the debtor to prepare that list or the insolvency representative to prepare the list. While the latter approach may serve to reduce the formalities associated with the process of verification of claims, it may add to costs and delay, since it relies upon the insolvency representative being able to obtain accurate and relevant information from the debtor. Once the list is prepared, it could be used to assess which creditors claims could be admitted without formal proof and which creditors should be invited to make their claims to the insolvency representative for purposes of verification, as well as for the purposes of ensuring that all relevant creditors have been considered in the claims process. The list could also be revised and updated over time to provide not only an accurate indication of the level of the debtor's indebtedness, but also the status of verification and admission of claims.

20. It is desirable that an insolvency law address the question of false claims and provide appropriate sanctions for creditors and others who lodge claims that prove to be false.

*(iii) Formalities for submission of foreign claims*

21. 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. To facilitate the access of foreign creditors, it is desirable that consideration 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 annex III).<sup>3</sup> In other respects, it is desirable that foreign claims be subject to the same procedures for verification and admission as domestic claims.

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<sup>3</sup>See also EC Regulation 1346/2000, articles 40 and 41, concerning information to be provided to creditors.

(iv) *Conversion of foreign currency claims*

22. Where the debtor has business activities in different countries, creditors may have debt denominated 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, although circumstances may exist in which conversion is not required. The date of conversion may have been agreed in the contract between the debtor and creditor or it may be set in the insolvency law by reference to a fixed time, such as the effective date of commencement or any other point in the proceedings. Where there is a time difference between the date of conversion and the date of distribution (which could occur significantly later), any appreciation or depreciation of the currency will affect the amount of the claim. Where the currency is relatively stable, this fluctuation may not be significant. In times of severe currency instability or fluctuation, however, the fluctuation could result in a creditor being significantly disadvantaged in favour of other creditors or advantaged at the expense of other creditors. In such circumstances, an insolvency law might provide that a provisional conversion could be made at the effective date of commencement for the purposes of voting and, where the exchange rate fluctuates more than a given percentage (which is stipulated in the insolvency law) in the period before distribution, the conversion will be made at the time of distribution or an appropriate adjustment made to the earlier calculation.

(v) *Party authorized to receive claims*

23. Insolvency laws generally adopt one of two approaches to the question of to whom claims should be submitted. Some laws require the claim to be submitted to the court, while others provide for claims to be submitted to the insolvency representative. The basis for the difference generally relates to the process of verification and the respective roles of the court and the insolvency representative. Where the insolvency representative is responsible for verification and admission of claims, creditors generally have a right of recourse to the court to dispute issues relating to the value or priority accorded to the admitted claim or to the denial of the claim.

(d) *Failure to submit claims required to be submitted*

(i) *Failure to submit within a stipulated time period*

24. Insolvency laws adopt different approaches to claims required to be submitted under the insolvency law where any time limit specified for submission is not met. Some laws adopt a flexible approach, providing that, notwithstanding the application of a deadline, claims still can be submitted at any time up to, for example, the insolvency representative's final report and accounting in liquidation, but the creditor must bear any additional costs associated with late submission. One consequence of late submission may be that the creditor cannot participate in interim distributions occurring before submission (or admission) of the claim, although as noted above there are examples of laws that permit 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, where submission of a claim is a prerequisite to that participation.

25. Another approach to submission of claims adheres strictly to submission deadlines and some laws provide that failure to submit a claim may result in the debt being extinguished or security rights being waived or forfeited, provided the creditor received the prescribed notification of commencement and the requirements for claim submission. Other laws require a creditor who has failed to submit its claim by the deadline to petition the court for admission. Where the court admits the claim, the creditor may be limited to sharing only in future dividends.

26. While creditors should be given the widest possible opportunity to submit their claim in insolvency proceedings and must therefore receive timely and appropriate notice of commencement and the requirements for claim submission, the proceedings should not be delayed by creditors who are aware of the need to submit and of the applicable deadlines, but nevertheless fail to do so in a timely manner. This has the potential to increase the costs of the proceedings and disadvantages other creditors. The consequences of failure to submit should therefore be clearly specified and creditors made aware of them at the time they are notified of the deadlines for submission.

*(ii) Failure to submit a claim before conclusion of the proceedings*

27. 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 an insolvency law. For example, some of the insolvency laws that provide for a discharge of the debtor upon conclusion of the insolvency proceedings also provide that claims not submitted in the insolvency proceedings are forfeited.

### *3. Verification and admission of claims*

*(a) List of submitted claims*

28. 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 or the deadline occurs later in the proceedings. Where the insolvency law requires preparation of a list of creditors as discussed above (see chap. III, paras. 23 and 49), the list of claims would update that earlier list of creditors and form the basis of verification and admission of claims, as well as notification of the receipt, admission or denial of claims, depending upon the applicable admission procedure. Many insolvency laws provide that all identified and identifiable creditors are entitled to receive notice of all claims that have been made, whether personally, by publication of notices in appropriate commercial publications or by filing a list with the court. That notice will enable creditors, the debtor and interested

parties to see what claims have been submitted and to object to any claims listed (where this is permitted under the insolvency law).

*(b) Procedures for verification and admission*

29. 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, priority claims and so on).

*(i) Deadline for verification and admission*

30. In addition to establishing deadlines for the submission of claims, 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, for example 30 days after the deadline for submission expires. Other laws make no provision for time limits. A key factor in deciding whether an insolvency law should impose time limits in this case is the procedure for verification and whether admission requires a court hearing or a meeting of creditors to be held or is conducted by the insolvency representative. Where a court hearing or meeting of creditors is held, admission usually occurs at that hearing or meeting, subject to resolution by the court of disputes arising from challenges to claims. For reasons of transparency and certainty and to ensure the efficient conduct of the proceedings without undue delay, it is desirable that the decision on admission or denial be made in a timely manner, in particular where admission will determine participation in the proceedings and voting rights. However, as is generally the case with any consideration of the need for a time limit and irrespective of the approach adopted for verification and admission, the advantages of establishing a limit must be weighed against the potential disadvantages of inflexibility and the need to ensure that the time limit is properly observed.

*(ii) Admission procedure*

31. Insolvency laws adopt a variety of approaches to the admission procedure, involving differing degrees of complexity and levels of involvement by the court, the insolvency representative and creditors, in some cases requiring input from all of these at various times. When coupled with rights of appeal and the difficulties associated with processing types of claim requiring valuation, the complexity of the process has the potential to significantly interrupt the conduct of the proceedings and cause delay that will affect other steps in the proceedings. For these reasons, it is highly desirable that formalities be minimized and that decision-making be as streamlined as possible.

*a. Admission by the insolvency representative*

32. As noted above (para. 23), insolvency laws generally require claims to be submitted to the insolvency representative or to the court. Many insolvency laws provide that where the claim is to be submitted to the insolvency



representative, the insolvency representative will verify the claims and decide whether or not they should be admitted, whether in whole or in part, or require special treatment, such as where they are claims by related persons. The creditor will be notified of the insolvency representative's decision and where the claim is denied, or admitted only in part or subjected to special treatment, the insolvency representative is generally required to provide reasons for that decision (often required to be given in writing). A requirement to provide written reasons will enhance the transparency of the procedure, as well as, potentially, its predictability for creditors and facilitate review by the court where an insolvency representative's decision is contested. Some insolvency laws also require, as already noted, the insolvency representative's decisions on admission of claims to be regularly 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 that it proposes to admit, a number of insolvency laws provide that the claim is deemed to be admitted.

33. Under other insolvency laws the insolvency representative is required to convene a meeting of creditors to consider submitted claims on the basis of the list it has prepared and provided to creditors. 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 laws adopting this approach typically provide that the insolvency representative's recommendations are deemed under the insolvency law to be approved or the claims are deemed to be admitted.

*b. Admission by the court*

34. Where claims are to be submitted to the court, the court will generally convene the meeting or hearing at which claims are examined and a decision made as to admission. A number of laws require claims to be submitted within a certain number of days before the date fixed for the meeting and a provisional list of admissions, prepared either by the court or by the insolvency representative, to be provided to all creditors before the hearing or meeting. Where no objections to admission of the listed claims are made at that meeting, these claims are typically deemed under the insolvency law to be admitted.

*c. Requirements for personal appearance of creditors*

35. One issue that may be of concern to creditors, and in particular to foreign creditors, is the requirement in some insolvency laws for them to attend in person creditor meetings called for the purpose of considering claims 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 to cause delay. While there may be cases where appearance will be important, as a general rule claims can be admitted on the basis of documentary evidence. It is therefore desirable that an insolvency law not require that in all cases creditors must



appear in person for their claim to be admitted, but rather that, as a general rule, they can be admitted on the basis of documentary evidence.

(iii) *Automatic admission of claims*

36. With a view to minimizing 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, value and priority of claims. While not necessarily sufficient in all cases for reasons of reliability and completeness, it may be appropriate to rely, in the first instance, upon the books and records of the debtor and the list of creditors to be prepared in the proceedings to identify all outstanding claims and their notional value. Where those claims are not disputed, the claim might be admitted without the creditor having to submit formal proof. Automatic admission of claims in this manner may avoid many of the difficulties associated with the need for 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.

(iv) *Provisional admission of claims*

37. Creditor claims may be of two types: liquidated claims and unliquidated claims where the amount owed by the debtor has not been determined at the time the claim is to be submitted or cannot at present be determined (e.g. because it is the subject of a court action that has not been finalized at the time of commencement and may be subject to the stay). 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).

38. 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 allow a claim to be admitted provisionally, subject to giving it a notional value. Determining a value for such claims raises a number of issues such as the time at which the value is to be determined and whether it must be liquidated (in which case it will need to be considered by a court) or estimated (which might be undertaken by the insolvency representative, the court or some other appointed person). Where a court is required to determine the issue, an associated question relates to the court that will be appropriate (i.e. the insolvency court or some other court) and how any delay in reaching a determination can be addressed in terms of its effect on the conduct of the insolvency proceedings. The question of valuation of unliquidated claims can have a significant impact on insolvency proceedings where, for example, mass tort claims are involved. As to timing of the valuation, many insolvency laws require it to refer to the effective date of commencement of proceedings. Special rules may be required where proceedings are converted from one form of proceedings to another.

39. An important reason for permitting provisional admission is to allow creditors holding those claims to participate in the proceedings and, in particular, to vote on key issues, such as on approval of the reorganization plan or on other issues requiring a decision by creditors.

40. Where an insolvency law permits 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. Other issues requiring consideration include whether, when creditors with provisionally admitted claims do vote on a reorganization plan they can be bound, as minority creditors, by a plan to which they have not agreed; whether creditors with provisionally admitted claims are entitled to participate in distributions occurring before the claim has been fully admitted; and, if a provisionally admitted claim is subsequently denied or admitted only in part, what effect that will have on decisions in which that creditor has participated. 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 ultimately not fully admitted, any previous votes by the creditor in the proceedings may be discounted in proportion to the admitted claim.

(c) *Disputed claims*

41. Where an insolvency law allows a claim submitted in the insolvency proceedings to be disputed, whether as to its value, priority or basis, it is desirable that it also specify the parties that are entitled to initiate such a challenge. Some laws allow claims to be disputed only by the insolvency representative, while other laws permit parties in interest, including other 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 disputed in the insolvency proceedings a mechanism for quick resolution of the dispute is essential to ensure efficient and orderly progress of the proceedings. Provisional admission of such a claim, pending resolution of the dispute, may minimize disruption to the proceedings and the claims procedure. 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.

42. Where claims submitted in the proceedings 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, and pending resolution of that dispute (subject to application of the stay—see chap. II, paras. 30-34 and 60-62).

*(d) Effects of admission of a claim*

43. Admission of a creditor's claim will establish the right of that creditor to attend meetings of creditors and the amount for which the creditor is entitled to vote at such meetings, whether on the election of an insolvency representative or approval of a reorganization plan or some other matter specified in the insolvency law. It will also fix the amount and priority of the claim that the insolvency representative must take into account in making a distribution to creditors.

*(e) Set-off of mutual claims*

44. As noted above (chap. II, paras. 204-207), a number of insolvency laws make provision for mutual money obligations between the debtor and creditors to be set-off 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 effective date 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 set-off to the insolvency representative; and that the claims were related. A very few insolvency laws provide for mandatory set-off in insolvency, while a number of other laws do not permit set-off on the basis that it violates the *pari passu* principle. Where set-off is permitted, it will usually be taken into account by the insolvency representative or the court when verifying and admitting claims.

*(f) Claims requiring special treatment*

*(i) Administrative claims*

45. As noted above (chap. III, paras. 31, 66 and 112), 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, for the purposes of operating the business of the debtor, including many or all post-commencement debts, such as claims of employees, lease costs and similar claims, and in otherwise carrying out the proceedings.

46. Notwithstanding the importance of providing appropriate remuneration to those involved in the conduct of the insolvency proceedings, administrative expenses have the potential to make 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 minimized may be desirable. An insolvency law can provide, for example, precise but flexible criteria relating to the allowance of such expenses. Those criteria may include allowing expenses on the basis of the utility of the expense to increasing the value of the estate for the general benefit of all constituents or on the basis that they are 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.

47. 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. Another approach may be to require creditors to make the assessment, in order to facilitate the transparency of the proceedings, subject to recourse to the court in the event that the assessment of the creditors is disputed. As noted above with respect to the remuneration of the insolvency representative (see chap. III, para. 53), any mechanism adopted for assessment of expenses should avoid a situation where a party or the parties assessing the expenses can unduly influence the conduct of proceedings.

*(ii) Claims by related persons*

48. 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 chap. II, para. 183, and below, para. 77). Special treatment of the claims of these persons is often justified on the basis that they are more likely than other creditors to have been favoured and to have had early knowledge of the financial difficulties of the debtor. 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 situation in which claims will deserve additional attention, such as where the debtor is severely undercapitalized (e.g. where an office holder of the debtor has advanced funds to the company in the form of a loan when the company is undercapitalized and continues to trade without sufficient funds to pay creditors) or where there is evidence of self-dealing (i.e. that the related persons have taken advantage of their position to obtain a benefit, e.g. where six months before liquidation the principal agrees to a compensation package that the company cannot pay and files a claim for it in the liquidation). In those cases, the amount of the claim that is admitted may be reduced, the claim can be subordinated to the

claims of other classes of creditors (see below, paras. 55-61) or the voting rights of the related creditor can be restricted with respect to certain issues (such as in selection of the insolvency representative, where the insolvency law allows creditors that choice).

(iii) *Claims for interest*

49. 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. Other insolvency laws provide that interest may accrue, but payment will be given a low priority, such as after the payment of all unsecured creditors.

4. *Claims not admitted*

50. Many insolvency laws provide that where a claim is denied, the creditor concerned will have a right to seek review of that decision, whether it was made by the court or the insolvency representative, within a specified period of time after notification of the decision. Examples include time periods of between 10 and 45 days.

***Recommendations 169-184***

**Purpose of legislative provisions**

The purpose of provisions on creditor claims is:

- (a) To define the claims that can or are required to be submitted and the treatment to be accorded to those claims;
- (b) To enable persons who have a claim against a debtor to submit claims against the estate;
- (c) To establish a mechanism for verification and admission of claims;
- (d) To provide for review of disputed claims; and
- (e) To ensure that similarly ranked creditors are treated equally.

**Contents of legislative provisions**

*Requirement to submit (paras. 1 and 13)*

169. The insolvency law should require creditors who wish to participate in the proceedings to submit a claim, which should specify the basis and amount of the claim. The law should minimize the formalities associated with submission of claims. The insolvency law should permit claims to be submitted using different means, including mail and electronic means.

***Recommendations 169-184 (continued)******Undisputed claims (paras. 17-19, 35 and 36)***

170. The insolvency law may permit claims that are undisputed to be admitted by reference to the list of creditors and claims prepared by the debtor in cooperation with the insolvency representative<sup>4</sup> or the court or the insolvency representative may require a creditor to provide evidence of its claim. The insolvency law should not require that in all cases a creditor must appear in person to prove its claim.

***Claims that may be submitted (para. 1)***

171. The insolvency law should specify that claims that may be submitted include all rights to payment that arise from acts or omissions of the debtor<sup>5</sup> prior to commencement of the insolvency proceedings, whether mature or not, whether liquidated or unliquidated, whether fixed or contingent. The law should identify claims that will not be affected by the insolvency proceedings.<sup>6</sup>

***Secured claims (paras. 2-5)***

172. The insolvency law should specify whether secured creditors are required to submit claims.

***Equal treatment of similarly ranked creditors (paras. 10 and 21)***

173. The insolvency law should specify that all similarly ranked creditors, regardless of whether they are domestic or foreign creditors, are to be treated equally with respect to the submission and processing of their claims.

***Timing of submission of claims (paras. 13-16)***

174. The insolvency law should specify the period of time after the effective date of commencement of proceedings within which claims may be submitted. That time period should be adequate to allow creditors to submit their claims.<sup>7</sup>

***Consequences of failure to submit a claim (paras. 24-27)***

175. Where the insolvency law requires a creditor to submit a claim, the insolvency law should specify the consequences of failure to submit a claim within any period of time specified for submission.

<sup>4</sup>See recommendation 110.

<sup>5</sup>This would include claims by third parties or a guarantor for payment arising from acts or omission of the debtor.

<sup>6</sup>Some insolvency laws provide, for example, that claims such as fines and penalties and taxes will not be affected by the insolvency proceedings. Where a claim is to be unaffected by the insolvency proceedings it would continue to exist and would not be included in any discharge.

<sup>7</sup>Where proceedings involve foreign creditors, longer time periods may be required to facilitate submission of claims. Also, it is desirable that claims be submitted at an early stage of the proceedings so that the insolvency representative will be aware of the claims involved, of the encumbered assets affected and of the value of those assets and claims.

*Foreign currency claims (para. 22)*

176. Where claims are denoted in foreign currency, the insolvency law should specify the circumstances in which those claims must be converted and the reasons for conversion. Where conversion is required, the insolvency law should specify that the claim will be converted into local currency by reference to a specified date, such as the effective date of commencement of insolvency proceedings.

*Admission or denial of claims (paras. 29-40)*

177. The insolvency law should permit the insolvency representative to admit or deny any claim, in full or in part.<sup>8</sup> Where the claim is to be denied or subjected to treatment under recommendation 184 as a claim by a related person, whether in full or in part, notice of the reasons for the decision should be given to the creditor.

*Unliquidated claims (para. 38)*

178. The insolvency law should permit unliquidated claims to be admitted provisionally, pending determination of the amount of the claim by the insolvency representative.

*Valuation of secured claims (para. 38)*

179. The insolvency law should provide that the insolvency representative may determine the portion of a secured creditor's claim that is secured and the portion that is unsecured by valuing the encumbered asset.

*Disputing a claim (para. 41)*

180. The insolvency law should permit a party in interest to dispute any submitted claim, either before or after admission, and to request review of that claim by the court.

*Review of claims denied or subjected to special treatment (paras. 32, 33 and 48)*

181. The insolvency law should permit creditors whose claims have been denied or subjected to treatment under recommendation 184 as a claim by a related person, whether in full or in part, to request the court to review their claim. The insolvency law may specify a period of time after notification of the decision within which that request may be made.

*Provisional admission of disputed claims (para. 41)*

182. The insolvency law should specify that, claims disputed in the insolvency proceedings could be admitted provisionally by the insolvency representative pending resolution of the dispute by the court.

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<sup>8</sup>In some jurisdictions, the court may be required to ratify the decision of the insolvency representative.

### ***Recommendations 169-184 (continued)***

#### *Effects of admission (para. 43)*

183. The insolvency law should specify the effects of admission, including provisional admission, of a claim. These effects may include:

- (a) Entitling the creditor to participate in the proceedings and to be heard;
- (b) Permitting the creditor to vote at a meeting of creditors, including on approval of a plan;
- (c) Determining the priority to which the creditor's claim is entitled;
- (d) Determining the amount for which the creditor is entitled to vote;
- (e) Except in the case of provisional admission of a claim, permitting the creditor to participate in a distribution.<sup>9</sup>

#### *Claims by related persons (para. 48)*

184. The insolvency law should specify that claims by related persons should be subject to scrutiny and, where justified:<sup>10</sup>

- (a) The voting rights of the related person may be restricted;
- (b) The amount of the claim of the related person may be reduced; or
- (c) The claim may be subordinated.<sup>11</sup>

## **B. Priorities and distribution of proceeds**

### *1. Priorities*

#### *(a) Introduction*

51. There are many diverse and competing interests in insolvency proceedings. 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 generally will be less common). Accordingly, the rights of creditors will be governed by a number of different laws.

<sup>9</sup>However, when making a distribution, the insolvency representative may be required to take account of claims that have been provisionally admitted, or submitted but not yet admitted.

<sup>10</sup>Sufficient justification may involve situations where the debtor is undercapitalized or there has been self-dealing, as noted above, para. 48.

<sup>11</sup>On subordination, see below, paras. 55-61.



52. While many creditors will be similarly situated with respect to the kinds of claims they hold based on similar legal or contractual rights, others will have superior claims or hold superior rights. For these reasons, insolvency laws generally rank creditors for the purposes of distribution of the proceeds of the estate in liquidation by reference to their claims, an approach not inconsistent with the objective of equitable treatment. To the extent that different creditors have struck different commercial bargains with the debtor, the ranking of creditors may be justified by the desirability for the insolvency system to recognize and respect the different bargains, preserve legitimate commercial expectations, foster predictability in commercial relationships and promote 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.

53. There is, however, a limit on the extent to which these goals can be achieved. In addition to rankings 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). To the extent that these broader public interests compete with private interests, they may lead to a distortion of normal commercial incentives. Where public interests are given priority and equality of treatment based upon the ranking 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, distribution and the establishment of creditor classes under a reorganization plan.

54. Insolvency laws adopt a wide variety of different approaches to the ranking of creditors, both in terms of priorities between different ranks and in terms of the treatment of creditors within a particular rank, for example those creditors broadly defined as “unsecured”, where different sub-ranks may be employed.

*(b) Subordination of claims*

55. When a natural person or organization owes debts to more than one creditor, the priority scheme established in the applicable law (which may provide for subordination of certain types of claim, for example, those of related persons) or by agreement between the parties will determine the order in which those debts should be paid. Even where a priority scheme is in place, however, a creditor with a higher priority may be paid after one with a lower priority because of subordination.

56. Subordination refers to a rearranging of the creditors' priorities and does not relate to the validity or legality of a claim. A subordinated claim may be valid and enforceable, but, because of an agreement or a court decision, it will be paid later in the distribution scheme than it would otherwise be paid. Subordination by agreement and by operation of law are discussed below.

(i) *Contractual subordination*

57. Contractual subordination occurs when two or more creditors of a single debtor enter into an agreement (referred to as a "subordination" or "distribution agreement") that provides that one creditor agrees to receive payment on its claim against the debtor after the payment of the other creditor or creditors. These agreements may be between secured creditors or between unsecured creditors. If between secured creditors, the agreement usually provides that one creditor receives priority over the holder of an otherwise senior security interest. Agreements between unsecured creditors typically provide that one creditor will receive payment in full on its claim before the subordinated creditor receives any distribution.

58. Subordination agreements can arise in different contexts. For example, debenture holders typically agree to subordinate their claims to the debtor's working capital lender. Also, when a business is in financial distress, certain creditors may agree to subordinate their claims in order to aid the business's reorganization efforts. Some creditors may agree to subordinate themselves to a lender injecting new money into the business in the hope that the new money will help the business recover and, thus, improve the prospects of the subordinated creditors being paid in full (see chap. II, paras. 94-107, on post-commencement finance).

59. The laws that determine contract validity and enforceability also apply to subordination agreements, as do the normal contract defences such as lack of consideration, fraud and unconscionability. The general principle in insolvency of recognizing pre-commencement priorities should be interpreted to include priorities based upon a subordination agreement, provided that the agreement is not to provide a ranking higher than would otherwise be accorded to the particular creditor under the applicable law.

(ii) *Subordination by the court (referred to as "equitable subordination")*

60. This type of subordination occurs where a court has the power to change the priority of payment of claims to prevent, for example, a creditor who has committed fraud or some other illegal activity or acted inappropriately to gain an advantage over other creditors from benefiting from that act. The doctrine originally arose to prevent related persons from using legal mechanisms to obtain advantages in priority.

61. Where this type of subordination is used, it will generally apply only if the conduct under consideration actually results in some harm to other

creditors, such as altering the normal distribution scheme and giving a creditor an unfair priority position. The court could then use subordination to restore the priority scheme so that a fair distribution occurs. If the conduct occurs, but does not result in an unfair advantage, this type of subordination generally cannot be used.

(c) *Ranking of claims*

(i) *Secured creditors*

62. 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 encumbered assets or from general funds, depending on the manner in which encumbered assets are treated. The method of distribution to secured creditors depends on the method used to protect the secured creditor during the proceedings (see chap. II, paras. 63-69). If the security interest was protected by preserving the value of the encumbered asset, the secured creditor will generally have a priority claim on the proceeds of the sale of that asset to the extent of the value of its secured claim. Alternatively, if the security interest was 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 encumbered 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.

63. Some insolvency laws do not afford secured creditors a first priority. Payment of secured creditors may be ranked, for example, after costs of administration and other claims, such as unpaid wage claims, tax claims, environmental claims and personal injury claims, which are afforded the protection of priority under the insolvency law. Another approach is reflected in laws that 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. In some of the laws that adopt that approach, a distinction is made between security interests over essentially all of the assets of a business (sometimes referred to as an enterprise mortgage or floating charge) and other types of security interest, where only the former are subject to this exception.

64. 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 suggested that, unless some portion of the debtor's assets are reserved for payment of those other claims, it is unlikely that they will share in a distribution. The adoption of these

types of exception to the rule of first priority of secured creditors has the potential to create uncertainty with respect to the recovery of secured credit, thus discouraging the provision of secured credit and raising the associated costs. It is highly desirable that the use of such exceptions in an insolvency law be limited.

65. Where the secured claim is satisfied directly from the net realization proceeds of the asset concerned, the secured creditor, unlike unsecured creditors, will generally 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 to contribute to other costs directly related to its interests. If the insolvency representative has expended resources in maintaining the value of the encumbered 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, in particular since it may have been approved by the secured creditors.

*(ii) Administrative costs and expenses*

66. The administrative expenses of the insolvency proceeding often have priority over unsecured claims and are generally 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 or in some cases the debtor; debts arising from the proper exercise of the insolvency representative's (or in some cases the debtor's) functions and powers; 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.

*(iii) Priority or privileged claims*

67. 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 creditors by reducing the value of the assets available for distribution to them. The provision of priority rights has the potential to foster unproductive debate on the assessment of which 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 and availability of credit, which will increase as the amount of funds available for distribution to other creditors decreases.

68. Some priorities are based on social concerns that may be addressed more readily by law other than the insolvency law, such as social welfare legislation, than by designing an insolvency law to achieve social objectives that 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 insolvency proceedings less effective. Where priorities are to be included in an insolvency law or where priorities that exist in law other than insolvency law will be recognized and have effect in insolvency proceedings, 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 transparent and predictable as to its impact on creditors and will enable lenders to assess more accurately the risks associated with lending.

69. In some recent insolvency laws there has been a significant reduction in the number of these types of priority right, reflecting a change in the public acceptability of such treatment. A few States, for example, have recently removed the priority traditionally provided to tax claims. In others, 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 claim has the potential to complicate the basic goals of insolvency and to make efficient and effective proceedings difficult to achieve. 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 does not increase the total amount of funds available for creditors. Rather, 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.

70. 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 treaty obligations, such as those applicable to employee claims (discussed further below); 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 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.

71. Many different approaches are taken to the types of claim that will be afforded priority and what that priority will be. The types of priority afforded by States vary, but two categories are particularly prevalent. The first is a priority for employee salaries and benefits (social security and pension claims) and the 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 States that do not recognize foreign tax and social security claims can continue to discriminate against them.<sup>12</sup>

*a. Employee claims*<sup>13</sup>

72. In a majority of States, workers' claims (including claims for wages, leave or holiday pay, allowances for other paid absence and severance pay) constitute a class of priority claims in insolvency. In a number of cases those claims rank higher than most other priority claims, specifically tax and social security claims, and in a few cases, as noted above, above secured claims (see paras. 63 and 64). The approach of providing priority for workers' claims is generally consistent with the special protection that is afforded to employees in other areas of insolvency law (see chap. II, para. 145), as well as with the approach of international treaties on protection of workers.<sup>14</sup> In some insolvency laws, the importance of maintaining continuity of employment in priority to other objectives of insolvency proceedings, 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 employment obligations), as opposed to liquidation or reorganization where these obligations may be altered or terminated.

73. In some States, 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 others, 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 (e.g. wages and remuneration arising within three months before commencement of insolvency proceedings) may be guaranteed by the State through a wage guarantee fund or insurance scheme providing a separate source of funds to ensure the settlement of employees' claims. 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

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<sup>12</sup>See the UNCITRAL Model Law on Cross-Border Insolvency, article 13, paragraph 2, and footnote 2 (see annex III); EC Regulation 1346/2000, article 4.2, subparagraph (i), provides that the ranking of claims is determined by the law of the State of the opening of the proceedings (whether main or secondary).

<sup>13</sup>For an analysis of national laws on the protection of employees' service-related claims, see the 2003 General Survey on the Application of the Protection of Wages Convention of 1949 (No. 95) prepared by the International Labour Organization (ILO) Committee of Experts on the Application of Conventions and Recommendations, paras. 298-353.

<sup>14</sup>For example, the ILO Protection of Workers' Claims (Employer's Insolvency) Convention of 1992 (No. 173). Article 8, paragraph 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.

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. Usual practice would be for the fund to enjoy the same rights as the employee, at least in respect of a certain specified amount that may be denoted in terms of an amount of wages or a number of weeks of pay.

*b. Tax claims*

74. Priority is often accorded to government tax claims to protect public revenue, but has also been justified on a number of other grounds. These grounds include that it can be beneficial to reorganization because tax authorities will be encouraged to delay the collection of taxes from a troubled business 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 that undermines the discipline that an effective insolvency regime is designed to support. It may encourage tax authorities to be complacent about monitoring debtors and collecting debts in a commercial manner that otherwise would assist to prevent insolvency and the depletion of assets (on treatment of foreign tax claims, see above, para. 10).

*(iv) Ordinary unsecured creditors*

75. Once the claims of all secured and priority creditors have been satisfied, the balance of the insolvency estate would generally 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 of the types of claim that are generally subordinated are discussed below.

*(v) Owners and equity holders*

76. Owners and equity holders 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 equity holders of the business are not entitled to a distribution of the proceeds of assets until all other claims that are senior in priority have been fully repaid (including claims of interest accruing after commencement). As such, these parties will rarely receive any distribution in respect of their 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.



(vi) *Related persons*

77. A category of creditors that may require special consideration is that of persons related to the debtor, whether in a familial or business capacity (see chap. II, para. 183, and above, para. 48). 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 or percentage of the claim that will be admitted in the proceedings.

(vii) *Fines, penalties and post-commencement interest*

78. Some States treat claims such as gratuities and fines and penalties (whether administrative, criminal or of some other type) as ordinary unsecured claims and subordinate them to other unsecured claims. In some insolvency laws these types of claim are treated as excluded claims.

79. 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*

(a) *Liquidation*

80. Where there are a number of different categories of claims with different priorities, each level of priority will generally 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 that do not establish different levels of priority, all the creditors share pro rata if there are insufficient funds to pay them all in full.

(b) *Reorganization*

81. A plan of reorganization may propose distribution priorities that are different to those provided by an insolvency law in liquidation, provided that creditors voting on the plan approve such a modification. In reorganization proceedings it may be desirable to provide that priority claims must be paid in full as a predicate to confirmation of a plan, unless the affected priority creditors agree otherwise.



### ***Recommendations 185-193***

#### **Purpose of legislative provisions**

The purpose of provisions on priority and distribution is:

- (a) To establish the order in which claims should be satisfied from the estate;
- (b) To ensure that similarly ranked creditors are satisfied proportionately out of the assets of the estate; and
- (c) To specify limited circumstances in which priority in distribution is permitted.

#### **Contents of legislative provisions**

##### *Classes and treatment of creditors affected by commencement of insolvency proceedings*

185. The insolvency law should specify the classes of creditors that will be affected by the commencement of insolvency proceedings and the treatment of those classes in terms of priority and distribution.

##### *Establishing an order for satisfaction of claims (paras. 5 and 52)*

186. The insolvency law should establish the order in which claims are to be satisfied from the estate.

##### *Priority claims (paras. 53 and 67-71)*

187. The insolvency law should minimize the priorities accorded to unsecured claims. The law should set out clearly the classes of claims, if any, that will be entitled to be satisfied in priority in insolvency proceedings.

##### *Secured claims (paras. 62-65)*

188. The insolvency law should specify that a secured claim should be satisfied from the encumbered asset in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the insolvency law. To the extent that the value of the encumbered asset is insufficient to satisfy the secured creditor's claim, the secured creditor may participate as an ordinary unsecured creditor.

##### *Ranking of claims other than secured claims (paras. 66-79)*

189. The insolvency law should specify that claims other than secured claims, are ranked in the following order:<sup>15</sup>

- (a) Administrative costs and expenses;

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<sup>15</sup>The insolvency law may provide for further ranking of claims within each of the ranks set forth in subparagraphs (a), (b) and (d). Where all creditors within a rank cannot be paid in full, the order of payment should reflect any further ranking specified in the insolvency law for claims of the same rank.

**Recommendations 185-193 (continued)**

- (b) Claims with priority;
- (c) Ordinary unsecured claims;
- (d) Deferred claims or claims subordinated under the law.

190. The insolvency law should specify that in the event there is a surplus after all claims have been satisfied in full, the surplus is to be returned to the debtor.

**Distribution in liquidation (paras. 40 and 80)**

191. The insolvency law should provide, as a general principle, that similarly ranked claims are paid *pari passu*. All similarly ranked claims in a particular class should be paid in full before the next rank is paid.

192. The insolvency law should specify that in making a distribution the insolvency representative is to be required to make provision for submitted claims that are not yet finally admitted.

193. The insolvency law should specify that, in liquidation proceedings, distributions are to be made promptly and that interim distributions may be made.

**C. Treatment of corporate groups in insolvency****1. Introduction**

82. 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 that 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.

83. Three issues of specific concern in insolvency proceedings involving one of a group of companies are:

(a) The responsibility of any other company in the group 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”);

(b) The treatment of intra-group debts (claims against the debtor company by related group companies); and

(c) Commencement of insolvency proceedings by a group company against a related group company.

84. Reflecting the complexity of this topic, the discussion that follows is intended only as a brief introduction to some of these issues. Insolvency laws provide different responses to these and other issues, which may be distinguished by the extent to which a law allows the veil of incorporation to be lifted. Some laws adopt a prescriptive approach, which strictly limits the circumstances in which group companies can be treated as other than separate legal personalities and the corporate veil lifted or, in other words, the circumstances in which a related company can be responsible for the debts of an insolvency 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 on the basis of 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, in particular when the decision about responsibility for group debts is made by a court after the event of insolvency; and involve accounting complexities concerning the manner in which liabilities are treated within the group.

85. Although a variety of approaches are taken to these very complex issues, it is important that an insolvency regime address matters concerning corporate groups in sufficient procedural detail to provide certainty for all parties concerned in commercial transactions with corporate groups. Alternatives to direct regulation of corporate groups in insolvency would include providing sufficient definition in other parts of the insolvency law to allow application of these provisions to corporate groups, such as the use of avoidance or subordination provisions with respect to related parties.

## 2. *Group responsibility for external debts*

86. 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.

87. It is common in 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.

88. 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 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,<sup>16</sup> in particular 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.

89. 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

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<sup>16</sup>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.

into account whether withholding a consolidation decision, ensuring separate insolvency proceedings, would increase the cost and length of proceedings and deplete funds that would otherwise be available for creditors and result in benefiting the equity holders of some corporate group companies who receive a return at the expense of creditors in other group companies.<sup>17</sup>

90. 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 those 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 States where they are available.

91. 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*

92. Intra-group debts may be dealt with in a number of ways. Under some insolvency laws, intra-group transactions may be subject to avoidance proceedings. 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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<sup>17</sup>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.



## VI. Conclusion of proceedings

### A. Discharge

1. There is an increasing awareness in some circles of the need to recognize business failure as a natural feature of an 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 States 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 an 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. 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.

2. Following distribution in the liquidation of the insolvency estate, it is likely that a number of creditors will not have been paid in full. An insolvency law will need to consider whether those creditors will still have an outstanding claim against the debtor or, alternatively, whether the debtor will be released or “discharged” from those residual claims.

#### *1. Discharge of the debtor in liquidation*

*(a) Where the debtor is a legal entity*

3. When the debtor is a limited liability company, the question of discharge following liquidation does not arise; generally 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 equity holders 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 a sole proprietorship, a group of individuals (a partnership) or an entity whose owners have unlimited liability, the question arises as to whether those debtors as individuals will still be personally liable for unsatisfied claims following liquidation.

*(b) Where the debtor is a natural person*

4. Insolvency laws adopt a variety of different approaches to the question of discharge of a natural person debtor. Under some laws an insolvent debtor cannot be discharged until all its debts are paid. Under other laws, the debtor remains liable for unsatisfied claims, subject to a limitation period (which in some cases might be quite long, for example, 10 years), after which a discharge might be given. Some of those laws may also impose on the debtor a number of conditions and restrictions relating to professional, commercial and personal activities, for example, acting as the director of a corporation. 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 and deter debtors from applying for commencement of insolvency proceedings.

5. Other insolvency laws provide for a complete discharge of an honest, non-fraudulent debtor immediately following distribution in 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 recognition that over-indebtedness is a current economic reality and should be addressed by an insolvency law. A third approach attempts to strike a compromise: discharge is granted after a period following distribution, during which period the debtor is expected to make a good faith effort to satisfy its outstanding obligations.

6. Irrespective of the approach adopted, in some circumstances all laws restrict the availability of a discharge. These circumstances vary from law to law but may include where 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 cooperate with the insolvency representative; failed to provide or actively withheld or 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.

7. Certain types of debt may be excluded from the discharge, such as those arising from tort claims; maintenance agreements (payments to a divorced spouse or to support children of the debtor); fraud; penalties, where the alternative is a term of imprisonment; and taxes.

8. In addition to imposing conditions as part of a discharge, conditions may also be imposed upon the debtor and its activities during the proceedings and as a precondition for a discharge. These restrictions may be recommended by the insolvency representative or by the court. These conditions may include restrictions on the debtor's ability to obtain new credit; leave the country; carry on business for a certain period of time; or practise its profession for a period



of time. A discharge may also be provided on the condition that the debtor does not subsequently acquire a substantial new fortune from which previous debts could be paid. The length of the application of these restrictions varies, depending upon the situation of the debtor. Other limitations adopted by insolvency laws 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 that 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 the payments made in those previous proceedings were less than a fixed percentage.

9. The choice between these different alternatives involves weighing the underlying rationale of an insolvency law and the provision of a discharge against the need to sanction certain behaviour. A distinction might be drawn between behaviour that is inappropriate and perhaps negligent and behaviour that would amount to criminal misconduct. If the underlying purpose of the insolvency law is to resolve the financial difficulties of the debtor and provide for a fresh start to encourage entrepreneurial activity and risk-taking, an honest and cooperative debtor that has performed its obligations under the insolvency law can be discharged after liquidation with minimal restrictions. An approach that imposes severe restrictions upon such debtors and allows a discharge only after long periods of time and the fulfilment of many conditions suggests that the underlying purpose is to punish, rather than rehabilitate the debtor. Imposing conditions and restrictions might be more appropriate in cases where the debtor has not been honest, has not cooperated with the insolvency representative or performed its obligations under the insolvency law or, in more extreme cases, has been guilty of criminal misconduct.

10. An additional consideration in framing the conditions for discharge is the connection between those conditions and the basic rationale of discharge. The imposition of certain broad conditions, such as prohibiting the debtor generally from engaging in business activities, may operate as a sanction and be inconsistent with the basic notion of providing a fresh start. More specific conditions, such as limiting the debtor's ability to serve on a board of directors might be more appropriate, especially where the debtor was a director of the business that became insolvent. Where an insolvency law adopts the approach of imposing conditions and exempting certain debts from discharge, it is desirable that those conditions and exemptions be kept to a minimum. To the extent possible, types of debt to be exempted should be set forth in an insolvency law to ensure transparency and predictability.

11. Some insolvency laws provide that a discharge can be given at an early stage of the proceedings (prior to conclusion). However, it can be suspended if, for example, the debtor fails to comply with an obligation or revoked if, for example, the discharge was obtained by fraud or the debtor fraudulently withheld information concerning property that should be part of the estate or failed to comply with orders of the court.

12. One issue that may need to be taken into account in considering discharge of natural persons 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 States a natural person cannot be declared bankrupt at all, while in others there is a requirement for the person to have acted in the capacity of a “merchant”) and that many States do not have a developed consumer insolvency system, a number of States 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 is often 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 both consumer and business debt, it may not be feasible to have rules on the business debts of natural persons that differ from the rules applicable to consumer debts.

13. It should be noted that discharge of a natural person debtor does not generally affect the liability of a third party that has guaranteed the obligations of that debtor.

## *2. Discharge of debts and claims in reorganization*

14. 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 provisions of the plan will be complied with by creditors that rejected the plan and by creditors that did not participate in the proceedings. 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.

15. Discharge in reorganization might be effective from the time the plan becomes effective under the insolvency law or from the time it is fully implemented. In the event that the plan is not fully implemented or implementation fails, many insolvency laws provide that the discharge can be set aside.

### ***Recommendations 194-196***

#### **Purpose of legislative provisions**

The purpose of provisions on discharge is:

(a) To enable a natural person debtor to be finally discharged from liabilities for pre-commencement debts, thus providing a fresh start;

(b) To establish the circumstances under which discharge will be granted and the terms of that discharge.

### **Contents of legislative provisions**

#### *Discharge of a natural person debtor in liquidation (paras. 1, 2 and 4-13)*

194. Where natural persons are eligible as debtors under the insolvency law, the issue of discharge of those debtors from liability for pre-commencement debts should be addressed. The insolvency law may specify that the discharge may not apply until after the expiration of a specified period of time following commencement, during which period the debtor is expected to cooperate with the insolvency representative. Upon the expiration of such time period, the debtor may be discharged where the debtor has not acted fraudulently and has cooperated with the insolvency representative in performing its obligations under the insolvency law. The insolvency law may specify that the discharge is to be revoked where it was obtained fraudulently.

195. Where the insolvency law provides that certain debts are excluded from a discharge, those debts should be kept to a minimum in order to facilitate the debtor's fresh start and be clearly set forth in the insolvency law.

196. Where the insolvency law provides that conditions may be attached to a debtor's discharge, those conditions should be kept to a minimum in order to facilitate the debtor's fresh start and should be clearly set forth in the insolvency law.

## **B. Closure of proceedings**

16. Insolvency laws adopt different approaches to the manner in which a proceeding is to be concluded or closed, the prerequisites for closure and the procedures to be followed. It is desirable that an insolvency law specify the party that can apply to close proceedings; whether the application and the decision to close should be publicized; and whether creditors could be heard on the application.

### *1. Liquidation*

17. A number of insolvency laws adopt an approach that generally requires, following realization 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. Other laws require a formal application to the court for an order for dissolution. Some variations on this general approach include slightly different procedures, depending upon whether the application for commencement was made by the debtor and or by creditors.

## 2. Reorganization

18. In general, insolvency laws adopt one of two or three approaches to closing reorganization proceedings. They may be treated as closed when the reorganization plan is approved (and confirmed where this is required); 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 be discharged from its duties by a formal order of the court); or if the court dismisses the proceedings because they constituted an improper use of the insolvency law or the debtor did not meet the commencement criteria at the time of commencement.

19. Proceedings may also be closed in accordance with the terms of the plan or some other contractual agreement with creditors. Where the reorganization plan is not fully implemented, the insolvency law may provide that where there is a substantial breach of the plan by the debtor or the plan cannot be implemented, the court may convert the proceedings to liquidation in order to avoid the debtor being left in an insolvent state with its financial situation unresolved. Alternatively, an insolvency law may provide for proceedings to be dismissed in appropriate circumstances, such as that the remaining assets are fully encumbered and there will be no distribution to unsecured creditors. Whether conversion constitutes formal closing of the reorganization proceedings and commencement of liquidation proceedings depends upon the approach of the jurisdiction in question (see above, chap. IV, paras. 72-75). Where the reorganization proceedings close once the plan has been approved (and confirmed, where this is required), rights and obligations included in the plan will be enforced under non-insolvency law.

### *Recommendations 197 and 198*

#### **Purpose of legislative provisions**

The purpose of provisions on conclusion of insolvency proceedings is to determine a procedure for closing the proceedings once their goal has been achieved.

#### **Contents of legislative provisions**

##### *Reorganization (paras. 18 and 19)*

197. The law should specify the procedures by which reorganization proceedings should be closed.

##### *Liquidation (para. 16)*

198. The law should specify the procedures by which liquidation proceedings should be closed following final distribution or a determination that no distribution can be made.

## Annex I

### Treatment of secured creditors in insolvency proceedings

The *UNCITRAL Legislative Guide on Insolvency Law* does not include a separate chapter addressing the treatment of secured creditors throughout insolvency proceedings, but rather deals with treatment of secured creditors in the context of each topic. In respect of some issues, the *Guide* makes specific reference to secured creditors and the manner in which they may be affected by the commencement of insolvency proceedings, for example, constitution of the insolvency estate, application of the stay and post-commencement finance. In respect of other issues, secured creditors will be treated in the same manner as all other creditors, for example, with respect to treatment of contracts, avoidance provisions and claims procedures. The references (to both paragraphs of the commentary and recommendations) set forth below list certain sections specifically relating to secured creditors. For a complete picture of how secured creditors are affected by commencement of insolvency proceedings, however, the *Guide* should be read as a whole.

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## Annex II

### Decision of the United Nations Commission on International Trade Law and General Assembly resolution 59/40

#### A. Decision of the Commission

1. At its 792nd meeting, on 25 June 2004, the United Nations Commission on International Trade Law adopted the following decision:<sup>a</sup>

*The United Nations Commission on International Trade Law,*

*Recognizing* the importance to all countries of strong insolvency regimes,

*Recognizing also* that it is demonstrably in the public interest to have an effective and efficient insolvency regime as a means of encouraging economic development and investment,

*Noting* the growing realization that reorganization regimes are critical to corporate and economic recovery, the development of entrepreneurial activity, the preservation of employment and the availability of venture capital,

*Noting also* that the effectiveness of reorganization regimes affects the availability of finance in the capital market, with comparative analysis of such systems becoming both common and essential for lending purposes, which affects countries at all levels of economic development,

*Noting further* the importance of social policy issues, including the interests of stakeholders in an insolvent debtor, to the design of an insolvency regime,

*Recognizing* that solutions to the key economic, legal and legislative issues raised by insolvency that are negotiated internationally through a process involving a broad range of constituents will be useful both to States that do not have an effective and efficient insolvency regime and to States that are undertaking a process of review and modernization of their insolvency regimes,

*Noting* that the UNCITRAL legislative guide on insolvency law (to which the UNCITRAL Model Law on Cross-Border Insolvency<sup>b</sup> and Guide to Enactment<sup>c</sup> are annexed) and an UNCITRAL legislative guide on secured transactions, which is

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<sup>a</sup>Official Records of the General Assembly, Fifty-ninth Session, Supplement No. 17 (A/59/17), para. 55.

<sup>b</sup>Ibid., Fifty-second Session, Supplement No. 17 (A/59/17), annex I.

<sup>c</sup>A/CN.9/442, annex.

currently under preparation in Working Group VI (Security Interests), together will form key elements of a modern commercial law framework,

*Recalling* the mandate given to Working Group V (Insolvency Law) to prepare a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features, including a discussion of the alternative approaches possible and the benefits and detriments of such approaches and recommendations,

*Appreciating* the participation in and support for the development of the legislative guide of international intergovernmental and non-governmental organizations active in the field of insolvency law reform,

*Noting with approval* the collaboration and commitment to consistent resolution of common issues between Working Group V (Insolvency Law) and Working Group VI (Security Interests) on the treatment of secured creditors and security interests in insolvency,

*Confirming* its intention to continue coordination and cooperation with the World Bank and the International Monetary Fund to facilitate the development of a unified international standard in the area of insolvency law,

*Expressing its appreciation* to Working Group V (Insolvency Law) for its work in developing the draft UNCITRAL legislative guide on insolvency law,

1. *Adopts* the *UNCITRAL Legislative Guide on Insolvency Law*, consisting of the text contained in the working paper of Working Group V (Insolvency),<sup>d</sup> as amended in the note by the Secretariat of 30 April 2004,<sup>e</sup> with the amendments adopted by the Commission at its thirty-seventh session,<sup>f</sup> and of the UNCITRAL Model Law on Cross-Border Insolvency<sup>b</sup> and Guide to Enactment<sup>c</sup> annexed thereto, and authorizes the Secretariat to edit and finalize the text of the *Legislative Guide* in the light of the deliberations of the Commission;

2. *Requests* the Secretary-General to transmit the text of the *Legislative Guide* to Governments and other interested bodies;

3. *Recommends* that all States utilize the *Legislative Guide* to assess the economic efficiency of their insolvency law regimes and give favourable consideration to the *Legislative Guide* when revising or adopting legislation relevant to insolvency, and invites States that have used the *Legislative Guide* to advise the Commission accordingly;

4. *Recommends also* that all States continue to consider implementation of the UNCITRAL Model Law on Cross-Border Insolvency.

<sup>d</sup>A/CN.9/WG.V/WP.70 (Parts I and II).

<sup>e</sup>A/CN.9/559 and Add.1-3.

<sup>f</sup>*Official Records of the General Assembly, Fifty-ninth Session, Supplement No. 17 (A/59/17), paras. 12-53.*



## B. General Assembly resolution 59/40

2. On 2 December 2004, the General Assembly adopted the following resolution:

### **Legislative Guide on Insolvency Law of the United Nations Commission on International Trade Law**

*The General Assembly,*

*Recognizing* the importance to all countries of strong, effective and efficient insolvency regimes as a means of encouraging economic development and investment,

*Noting* the growing realization that reorganization regimes are critical to corporate and economic recovery, the development of entrepreneurial activity, the preservation of employment and the availability of finance in the capital market,

*Noting also* the importance of social policy issues to the design of an insolvency regime,

*Noting with satisfaction* the completion and adoption of the Legislative Guide on Insolvency Law of the United Nations Commission on International Trade Law by the Commission at its thirty-seventh session, on 25 June 2004,<sup>8</sup>

*Believing* that the Legislative Guide, which includes the text of the Model Law on Cross-Border Insolvency and Guide to Enactment recommended by the General Assembly in its resolution 52/158 of 15 December 1997, contributes significantly to the establishment of a harmonized legal framework for insolvency and will be useful both to States that do not have an effective and efficient insolvency regime and to States that are undertaking a process of review and modernization of their insolvency regimes,

*Recognizing* the need for cooperation and coordination between international organizations active in the field of insolvency law reform to ensure consistency and alignment of that work and to facilitate the development of international standards,

*Noting* that the preparation of the Legislative Guide was the subject of due deliberations and extensive consultations with Governments and international inter-governmental and non-governmental organizations active in the field of insolvency law reform,

1. *Expresses its appreciation* to the United Nations Commission on International Trade Law for the completion and adoption of its Legislative Guide on Insolvency Law;<sup>8</sup>

2. *Requests* the Secretary-General to publish the Legislative Guide and to make all efforts to ensure that it becomes generally known and available;

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<sup>8</sup>Official Records of the General Assembly, Fifty-ninth Session, Supplement No. 17 (A/59/17), chap. III.

3. *Recommends* that all States give due consideration to the Legislative Guide when assessing the economic efficiency of their insolvency regimes and when revising or adopting legislation relevant to insolvency;

4. *Recommends also* that all States continue to consider implementation of the Model Law on Cross-Border Insolvency of the United Nations Commission on International Trade Law.

## Annex III

# UNCITRAL Model Law on Cross-Border Insolvency and Guide to Enactment

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# Part one. UNCITRAL Model Law on Cross-Border Insolvency

## Preamble

The purpose of this Law is to provide effective mechanisms for dealing with cases of cross-border insolvency so as to promote the objectives of:

- (a) Cooperation between the courts and other competent authorities of this State and foreign States involved in cases of cross-border insolvency;
- (b) Greater legal certainty for trade and investment;
- (c) Fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested persons, including the debtor;
- (d) Protection and maximization of the value of the debtor's assets; and
- (e) Facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

## Chapter I. General provisions

### Article 1. Scope of application

1. This Law applies where:

- (a) Assistance is sought in this State by a foreign court or a foreign representative in connection with a foreign proceeding; or
- (b) Assistance is sought in a foreign State in connection with a proceeding under [*identify laws of the enacting State relating to insolvency*]; or
- (c) A foreign proceeding and a proceeding under [*identify laws of the enacting State relating to insolvency*] in respect of the same debtor are taking place concurrently; or
- (d) Creditors or other interested persons in a foreign State have an interest in requesting the commencement of, or participating in, a proceeding under [*identify laws of the enacting State relating to insolvency*].

2. This Law does not apply to a proceeding concerning [*designate any types of entities, such as banks or insurance companies, that are subject to a special insolvency regime in this State and that this State wishes to exclude from this Law*].

### Article 2. Definitions

For the purposes of this Law:

- (a) "Foreign proceeding" means a collective judicial or administrative proceeding in a foreign State, including an interim proceeding, pursuant to a law relating to

insolvency in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation;

(b) “Foreign main proceeding” means a foreign proceeding taking place in the State where the debtor has the centre of its main interests;

(c) “Foreign non-main proceeding” means a foreign proceeding, other than a foreign main proceeding, taking place in a State where the debtor has an establishment within the meaning of subparagraph (f) of this article;

(d) “Foreign representative” means a person or body, including one appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor’s assets or affairs or to act as a representative of the foreign proceeding;

(e) “Foreign court” means a judicial or other authority competent to control or supervise a foreign proceeding;

(f) “Establishment” means any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services.

### *Article 3. International obligations of this State*

To the extent that this Law conflicts with an obligation of this State arising out of any treaty or other form of agreement to which it is a party with one or more other States, the requirements of the treaty or agreement prevail.

### *Article 4. [Competent court or authority]<sup>a</sup>*

The functions referred to in this Law relating to recognition of foreign proceedings and cooperation with foreign courts shall be performed by [*specify the court, courts, authority or authorities competent to perform those functions in the enacting State*].

### *Article 5. Authorization of [insert the title of the person or body administering reorganization or liquidation under the law of the enacting State] to act in a foreign State*

A [*insert the title of the person or body administering a reorganization or liquidation under the law of the enacting State*] is authorized to act in a foreign State on behalf of a proceeding under [*identify laws of the enacting State relating to insolvency*], as permitted by the applicable foreign law.

### *Article 6. Public policy exception*

Nothing in this Law prevents the court from refusing to take an action governed by this Law if the action would be manifestly contrary to the public policy of this State.

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<sup>a</sup>A State where certain functions relating to insolvency proceedings have been conferred upon government-appointed officials or bodies might wish to include in article 4 or elsewhere in chapter I the following provision:

Nothing in this Law affects the provisions in force in this State governing the authority of [*insert the title of the government-appointed person or body*].



*Article 7. Additional assistance under other laws*

Nothing in this Law limits the power of a court or a [insert the title of the person or body administering a reorganization or liquidation under the law of the enacting State] to provide additional assistance to a foreign representative under other laws of this State.

*Article 8. Interpretation*

In the interpretation of this Law, regard is to be had to its international origin and to the need to promote uniformity in its application and the observance of good faith.

**Chapter II. Access of foreign representatives and creditors to courts in this State**

*Article 9. Right of direct access*

A foreign representative is entitled to apply directly to a court in this State.

*Article 10. Limited jurisdiction*

The sole fact that an application pursuant to this Law is made to a court in this State by a foreign representative does not subject the foreign representative or the foreign assets and affairs of the debtor to the jurisdiction of the courts of this State for any purpose other than the application.

*Article 11. Application by a foreign representative to commence a proceeding under [identify laws of the enacting State relating to insolvency]*

A foreign representative is entitled to apply to commence a proceeding under [identify laws of the enacting State relating to insolvency] if the conditions for commencing such a proceeding are otherwise met.

*Article 12. Participation of a foreign representative in a proceeding under [identify laws of the enacting State relating to insolvency]*

Upon recognition of a foreign proceeding, the foreign representative is entitled to participate in a proceeding regarding the debtor under [identify laws of the enacting State relating to insolvency].

*Article 13. Access of foreign creditors to a proceeding under [identify laws of the enacting State relating to insolvency]*

1. Subject to paragraph 2 of this article, foreign creditors have the same rights regarding the commencement of, and participation in, a proceeding under [identify laws of the enacting State relating to insolvency] as creditors in this State.

2. Paragraph 1 of this article does not affect the ranking of claims in a proceeding under [*identify laws of the enacting State relating to insolvency*], except that the claims of foreign creditors shall not be ranked lower than [*identify the class of general non-preference claims, while providing that a foreign claim is to be ranked lower than the general non-preference claims if an equivalent local claim (e.g. claim for a penalty or deferred-payment claim) has a rank lower than the general non-preference claims*].<sup>b</sup>

*Article 14. Notification to foreign creditors of a proceeding under*  
[*identify laws of the enacting State relating to insolvency*]

1. Whenever under [*identify laws of the enacting State relating to insolvency*] notification is to be given to creditors in this State, such notification shall also be given to the known creditors that do not have addresses in this State. The court may order that appropriate steps be taken with a view to notifying any creditor whose address is not yet known.

2. Such notification shall be made to the foreign creditors individually, unless the court considers that, under the circumstances, some other form of notification would be more appropriate. No letters rogatory or other, similar formality is required.

3. When a notification of commencement of a proceeding is to be given to foreign creditors, the notification shall:

- (a) Indicate a reasonable time period for filing claims and specify the place for their filing;
- (b) Indicate whether secured creditors need to file their secured claims; and
- (c) Contain any other information required to be included in such a notification to creditors pursuant to the law of this State and the orders of the court.

### **Chapter III. Recognition of a foreign proceeding and relief**

*Article 15. Application for recognition of a foreign proceeding*

1. A foreign representative may apply to the court for recognition of the foreign proceeding in which the foreign representative has been appointed.

2. An application for recognition shall be accompanied by:

- (a) A certified copy of the decision commencing the foreign proceeding and appointing the foreign representative; or

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<sup>b</sup>The enacting State may wish to consider the following alternative wording to replace paragraph 2 of article 13:

“2. Paragraph 1 of this article does not affect the ranking of claims in a proceeding under [*identify laws of the enacting State relating to insolvency*] or the exclusion of foreign tax and social security claims from such a proceeding. Nevertheless, the claims of foreign creditors other than those concerning tax and social security obligations shall not be ranked lower than [*identify the class of general non-preference claims, while providing that a foreign claim is to be ranked lower than the general non-preference claims if an equivalent local claim (e.g. claim for a penalty or deferred-payment claim) has a rank lower than the general non-preference claims*].”

(b) A certificate from the foreign court affirming the existence of the foreign proceeding and of the appointment of the foreign representative; or

(c) In the absence of evidence referred to in subparagraphs (a) and (b), any other evidence acceptable to the court of the existence of the foreign proceeding and of the appointment of the foreign representative.

3. An application for recognition shall also be accompanied by a statement identifying all foreign proceedings in respect of the debtor that are known to the foreign representative.

4. The court may require a translation of documents supplied in support of the application for recognition into an official language of this State.

#### *Article 16. Presumptions concerning recognition*

1. If the decision or certificate referred to in paragraph 2 of article 15 indicates that the foreign proceeding is a proceeding within the meaning of subparagraph (a) of article 2 and that the foreign representative is a person or body within the meaning of subparagraph (d) of article 2, the court is entitled to so presume.

2. The court is entitled to presume that documents submitted in support of the application for recognition are authentic, whether or not they have been legalized.

3. In the absence of proof to the contrary, the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the centre of the debtor's main interests.

#### *Article 17. Decision to recognize a foreign proceeding*

1. Subject to article 6, a foreign proceeding shall be recognized if:

(a) The foreign proceeding is a proceeding within the meaning of subparagraph (a) of article 2;

(b) The foreign representative applying for recognition is a person or body within the meaning of subparagraph (d) of article 2;

(c) The application meets the requirements of paragraph 2 of article 15; and

(d) The application has been submitted to the court referred to in article 4.

2. The foreign proceeding shall be recognized:

(a) As a foreign main proceeding if it is taking place in the State where the debtor has the centre of its main interests; or

(b) As a foreign non-main proceeding if the debtor has an establishment within the meaning of subparagraph (f) of article 2 in the foreign State.

3. An application for recognition of a foreign proceeding shall be decided upon at the earliest possible time.

4. The provisions of articles 15, 16, 17 and 18 do not prevent modification or termination of recognition if it is shown that the grounds for granting it were fully or partially lacking or have ceased to exist.

### Article 18. *Subsequent information*

From the time of filing the application for recognition of the foreign proceeding, the foreign representative shall inform the court promptly of:

- (a) Any substantial change in the status of the recognized foreign proceeding or the status of the foreign representative's appointment; and
- (b) Any other foreign proceeding regarding the same debtor that becomes known to the foreign representative.

### Article 19. *Relief that may be granted upon application for recognition of a foreign proceeding*

1. From the time of filing an application for recognition until the application is decided upon, the court may, at the request of the foreign representative, where relief is urgently needed to protect the assets of the debtor or the interests of the creditors, grant relief of a provisional nature, including:

- (a) Staying execution against the debtor's assets;
- (b) Entrusting the administration or realization of all or part of the debtor's assets located in this State to the foreign representative or another 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;
- (c) Any relief mentioned in paragraph 1 (c), (d) and (g) of article 21.

2. *[Insert provisions (or refer to provisions in force in the enacting State) relating to notice.]*

3. Unless extended under paragraph 1 (f) of article 21, the relief granted under this article terminates when the application for recognition is decided upon.

4. The court may refuse to grant relief under this article if such relief would interfere with the administration of a foreign main proceeding.

### Article 20. *Effects of recognition of a foreign main proceeding*

1. Upon recognition of a foreign proceeding that is a foreign main proceeding:

- (a) Commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities is stayed;
- (b) Execution against the debtor's assets is stayed; and
- (c) The right to transfer, encumber or otherwise dispose of any assets of the debtor is suspended.

2. The scope, and the modification or termination, of the stay and suspension referred to in paragraph 1 of this article are subject to *[refer to any provisions of law of the enacting State relating to insolvency that apply to exceptions, limitations, modifications or termination in respect of the stay and suspension referred to in paragraph 1 of this article]*.

3. Paragraph 1 (a) of this article does not affect the right to commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor.

4. Paragraph 1 of this article does not affect the right to request the commencement of a proceeding under [*identify laws of the enacting State relating to insolvency*] or the right to file claims in such a proceeding.

*Article 21. Relief that may be granted upon  
recognition of a foreign proceeding*

1. Upon recognition of a foreign proceeding, whether main or non-main, where necessary to protect the assets of the debtor or the interests of the creditors, the court may, at the request of the foreign representative, grant any appropriate relief, including:

(a) Staying the commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities, to the extent they have not been stayed under paragraph 1 (a) of article 20;

(b) Staying execution against the debtor's assets to the extent it has not been stayed under paragraph 1 (b) of article 20;

(c) Suspending the right to transfer, encumber or otherwise dispose of any assets of the debtor to the extent this right has not been suspended under paragraph 1 (c) of article 20;

(d) Providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor's assets, affairs, rights, obligations or liabilities;

(e) Entrusting the administration or realization of all or part of the debtor's assets located in this State to the foreign representative or another person designated by the court;

(f) Extending relief granted under paragraph 1 of article 19;

(g) Granting any additional relief that may be available to [*insert the title of a person or body administering a reorganization or liquidation under the law of the enacting State*] under the laws of this State.

2. Upon recognition of a foreign proceeding, whether main or non-main, the court may, at the request of the foreign representative, entrust the distribution of all or part of the debtor's assets located in this State to the foreign representative or another person designated by the court, provided that the court is satisfied that the interests of creditors in this State are adequately protected.

3. In granting relief under this article to a representative of a foreign non-main proceeding, the court must be satisfied that the relief relates to assets that, under the law of this State, should be administered in the foreign non-main proceeding or concerns information required in that proceeding.

*Article 22. Protection of creditors and other interested persons*

1. In granting or denying relief under article 19 or 21, or in modifying or terminating relief under paragraph 3 of this article, the court must be satisfied that the interests of the creditors and other interested persons, including the debtor, are adequately protected.

2. The court may subject relief granted under article 19 or 21 to conditions it considers appropriate.

3. The court may, at the request of the foreign representative or a person affected by relief granted under article 19 or 21, or at its own motion, modify or terminate such relief.

*Article 23. Actions to avoid acts detrimental to creditors*

1. Upon recognition of a foreign proceeding, the foreign representative has standing to initiate [*refer to the types of actions to avoid or otherwise render ineffective acts detrimental to creditors that are available in this State to a person or body administering a reorganization or liquidation*].

2. When the foreign proceeding is a foreign non-main proceeding, the court must be satisfied that the action relates to assets that, under the law of this State, should be administered in the foreign non-main proceeding.

*Article 24. Intervention by a foreign representative in proceedings in this State*

Upon recognition of a foreign proceeding, the foreign representative may, provided the requirements of the law of this State are met, intervene in any proceedings in which the debtor is a party.

**Chapter IV. Cooperation with foreign courts and foreign representatives**

*Article 25. Cooperation and direct communication between a court of this State and foreign courts or foreign representatives*

1. In matters referred to in article 1, the court shall cooperate to the maximum extent possible with foreign courts or foreign representatives, either directly or through a [*insert the title of a person or body administering a reorganization or liquidation under the law of the enacting State*].

2. The court is entitled to communicate directly with, or to request information or assistance directly from, foreign courts or foreign representatives.

*Article 26. Cooperation and direct communication between the*  
[*insert the title of a person or body administering a reorganization or liquidation under the law of the enacting State*]  
*and foreign courts or foreign representatives*

1. In matters referred to in article 1, a [*insert the title of a person or body administering a reorganization or liquidation under the law of the enacting State*] shall, in the exercise of its functions and subject to the supervision of the court, cooperate to the maximum extent possible with foreign courts or foreign representatives.

2. The [*insert the title of a person or body administering a reorganization or liquidation under the law of the enacting State*] is entitled, in the exercise of its

functions and subject to the supervision of the court, to communicate directly with foreign courts or foreign representatives.

### *Article 27. Forms of cooperation*

Cooperation referred to in articles 25 and 26 may be implemented by any appropriate means, including:

- (a) Appointment of a person or body to act at the direction of the court;
- (b) Communication of information by any means considered appropriate by the court;
- (c) Coordination of the administration and supervision of the debtor's assets and affairs;
- (d) Approval or implementation by courts of agreements concerning the coordination of proceedings;
- (e) Coordination of concurrent proceedings regarding the same debtor;
- (f) [*The enacting State may wish to list additional forms or examples of cooperation*].

## **Chapter V. Concurrent proceedings**

### *Article 28. Commencement of a proceeding under [identify laws of the enacting State relating to insolvency] after recognition of a foreign main proceeding*

After recognition of a foreign main proceeding, a proceeding under [*identify laws of the enacting State relating to insolvency*] may be commenced only if the debtor has assets in this State; the effects of that proceeding shall be restricted to the assets of the debtor that are located in this State and, to the extent necessary to implement cooperation and coordination under articles 25, 26 and 27, to other assets of the debtor that, under the law of this State, should be administered in that proceeding.

### *Article 29. Coordination of a proceeding under [identify laws of the enacting State relating to insolvency] and a foreign proceeding*

Where a foreign proceeding and a proceeding under [*identify laws of the enacting State relating to insolvency*] are taking place concurrently regarding the same debtor, the court shall seek cooperation and coordination under articles 25, 26 and 27, and the following shall apply:

- (a) When the proceeding in this State is taking place at the time the application for recognition of the foreign proceeding is filed,
  - (i) Any relief granted under article 19 or 21 must be consistent with the proceeding in this State; and
  - (ii) If the foreign proceeding is recognized in this State as a foreign main proceeding, article 20 does not apply;
- (b) When the proceeding in this State commences after recognition, or after the filing of the application for recognition, of the foreign proceeding,

- (i) Any relief in effect under article 19 or 21 shall be reviewed by the court and shall be modified or terminated if inconsistent with the proceeding in this State; and
- (ii) If the foreign proceeding is a foreign main proceeding, the stay and suspension referred to in paragraph 1 of article 20 shall be modified or terminated pursuant to paragraph 2 of article 20 if inconsistent with the proceeding in this State;

(c) In granting, extending or modifying relief granted to a representative of a foreign non-main proceeding, the court must be satisfied that the relief relates to assets that, under the law of this State, should be administered in the foreign non-main proceeding or concerns information required in that proceeding.

### *Article 30. Coordination of more than one foreign proceeding*

In matters referred to in article 1, in respect of more than one foreign proceeding regarding the same debtor, the court shall seek cooperation and coordination under articles 25, 26 and 27, and the following shall apply:

(a) Any relief granted under article 19 or 21 to a representative of a foreign non-main proceeding after recognition of a foreign main proceeding must be consistent with the foreign main proceeding;

(b) If a foreign main proceeding is recognized after recognition, or after the filing of an application for recognition, of a foreign non-main proceeding, any relief in effect under article 19 or 21 shall be reviewed by the court and shall be modified or terminated if inconsistent with the foreign main proceeding;

(c) If, after recognition of a foreign non-main proceeding, another foreign non-main proceeding is recognized, the court shall grant, modify or terminate relief for the purpose of facilitating coordination of the proceedings.

### *Article 31. Presumption of insolvency based on recognition of a foreign main proceeding*

In the absence of evidence to the contrary, recognition of a foreign main proceeding is, for the purpose of commencing a proceeding under [*identify laws of the enacting State relating to insolvency*], proof that the debtor is insolvent.

### *Article 32. Rule of payment in concurrent proceedings*

Without prejudice to secured claims or rights *in rem*, a creditor who has received part payment in respect of its claim in a proceeding pursuant to a law relating to insolvency in a foreign State may not receive a payment for the same claim in a proceeding under [*identify laws of the enacting State relating to insolvency*] regarding the same debtor, so long as the payment to the other creditors of the same class is proportionately less than the payment the creditor has already received.



## **Part two. Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency**

### **I. Purpose and origin of the Model Law**

#### *A. Purpose of the Model Law*

1. The UNCITRAL Model Law on Cross-Border Insolvency, adopted in 1997, is designed to assist States to equip their insolvency laws with a modern, harmonized and fair framework to address more effectively instances of cross-border insolvency. Those instances include cases where the insolvent debtor has assets in more than one State or where some of the creditors of the debtor are not from the State where the insolvency proceeding is taking place.

2. The Model Law reflects practices in cross-border insolvency matters that are characteristic of modern, efficient insolvency systems. Thus, the States enacting the Model Law (“enacting States”) would be introducing useful additions and improvements in national insolvency regimes designed to resolve problems arising in cross-border insolvency cases. Both jurisdictions that currently have to deal with numerous cases of cross-border insolvency and jurisdictions that wish to be well prepared for the increasing likelihood of cases of cross-border insolvency will find the Model Law useful.

3. The Model Law respects the differences among national procedural laws and does not attempt a substantive unification of insolvency law. It offers solutions that help in several modest but significant ways. These include the following:

(a) Providing the person administering a foreign insolvency proceeding (“foreign representative”) with access to the courts of the enacting State, thereby permitting the foreign representative to seek a temporary “breathing space”, and allowing the courts in the enacting State to determine what coordination among the jurisdictions or other relief is warranted for optimal disposition of the insolvency;

(b) Determining when a foreign insolvency proceeding should be accorded “recognition” and what the consequences of recognition may be;

(c) Providing a transparent regime for the right of foreign creditors to commence, or participate in, an insolvency proceeding in the enacting State;

(d) Permitting courts in the enacting State to cooperate more effectively with foreign courts and foreign representatives involved in an insolvency matter;

(e) Authorizing courts in the enacting State and persons administering insolvency proceedings in the enacting State to seek assistance abroad;

(f) Providing for court jurisdiction and establishing rules for coordination where an insolvency proceeding in the enacting State is taking place concurrently with an insolvency proceeding in a foreign State;

(g) Establishing rules for coordination of relief granted in the enacting State in favour of two or more insolvency proceedings that may take place in foreign States regarding the same debtor.

## B. Preparatory work and adoption

4. The project was initiated by the United Nations Commission on International Trade Law (UNCITRAL), in close cooperation with INSOL.<sup>c</sup> The project benefited from the expert advice of INSOL during all stages of the preparatory work. In addition, assistance during the formulation of the Law, consultative assistance was provided by Committee J (Insolvency) of the Section on Business Law of the International Bar Association.
5. Prior to the decision by UNCITRAL to undertake work on cross-border insolvency, the Commission and INSOL held two international colloquiums for insolvency practitioners, judges, government officials and representatives of other interested sectors.<sup>d</sup> The suggestion arising from those colloquiums was that work by UNCITRAL should have the limited but useful goal of facilitating judicial cooperation, court access for foreign insolvency administrators and recognition of foreign insolvency proceedings.
6. When UNCITRAL decided in 1995 to develop a legal instrument relating to cross-border insolvency, it entrusted the work to the Working Group on Insolvency Law, one of the three subsidiary bodies of UNCITRAL.<sup>e</sup> The Working Group devoted four two-week sessions to the work on the project.<sup>f</sup>
7. In March 1997, another international meeting of practitioners was held to discuss the draft text as prepared by the Working Group. The participants (mostly judges, judicial administrators and government officials) generally considered that the model legislation, when enacted, would constitute a major improvement in dealing with cross-border insolvency cases.<sup>g</sup>

<sup>c</sup>Now known as INSOL International.

<sup>d</sup>The first was the UNCITRAL/INSOL Colloquium on Cross-Border Insolvency, held in Vienna from 17 to 19 April 1994 (for the report on the Colloquium, see *United Nations Commission on International Trade Law Yearbook, Volume XXV: 1994* (United Nations publication, Sales No. E.95.V.20), document A/CN.9/398; for the proceedings of the Colloquium, see *International Insolvency Review*, Special Conference Issue, vol. 4, 1995; and for the considerations of UNCITRAL relating to the Colloquium, see *Official Records of the General Assembly, Forty-ninth Session, Supplement No. 17 (A/49/17)*, paras. 215-222). The second, organized to elicit the views of judges, was the UNCITRAL/INSOL Judicial Colloquium on Cross-Border Insolvency, held in Toronto on 22 and 23 March 1995 (for the report on the Judicial Colloquium, see *United Nations Commission on International Trade Law Yearbook, Volume XXVI: 1995* (United Nations publication, Sales No. E.96.V.8), document A/CN.9/413; and for the considerations of UNCITRAL relating to the Judicial Colloquium, see *Official Records of the General Assembly, Fiftieth Session, Supplement No. 17 (A/50/17)*, paras. 382-393).

<sup>e</sup>*Official Records of the General Assembly, Fiftieth Session, Supplement No. 17 (A/50/17)*, paras. 392 and 393.

<sup>f</sup>For the report of the Working Group on its eighteenth session, held at Vienna from 30 October to 10 November 1995, see *United Nations Commission on International Trade Law Yearbook, Volume XXVII: 1996* (United Nations publication, Sales No. E.98.V.7), document A/CN.9/419 and Corr.1; for the report on its nineteenth session, held in New York from 1 to 12 April 1996, see *United Nations Commission on International Trade Law Yearbook, Volume XXVII: 1996* (United Nations publication, Sales No. E.98.V.7), document A/CN.9/422; and for the report on its twentieth session, held at Vienna from 7 to 18 October 1996, see *United Nations Commission on International Trade Law Yearbook, Volume XXVIII: 1997*, document A/CN.9/433 to be issued as a United Nations sales publication; and for the report on its twentieth session, held in New York from 20 to 31 January 1997, see *United Nations Commission on International Trade Law Yearbook, Volume XXVIII: 1997*, document A/CN.9/435, to be issued as a United Nations sales publication.

<sup>g</sup>The Second UNCITRAL/INSOL Multinational Judicial Colloquium on Cross-Border Insolvency was held in New Orleans on 22 and 23 March 1997 in conjunction with the 5th World Congress of INSOL, held in the same city from 23 to 26 March 1997. A brief account of the Colloquium appears in the report of UNCITRAL on the work of its thirtieth session, held in Vienna from 12 to 30 May 1997 (*Official Records of the General Assembly, Fifty-second Session, Supplement No. 17 (A/52/17)*, paras. 17-22).

8. The final negotiations on the draft text took place during the thirtieth session of UNCITRAL, held in Vienna from 12 to 30 May 1997. UNCITRAL adopted the Model Law by consensus on 30 May 1997.<sup>h</sup> In addition to the 36 States members of UNCITRAL, representatives of 40 observer States and 13 international organizations participated in the deliberations of the Commission and the Working Group. Subsequently, the General Assembly adopted resolution 52/158 of 15 December 1997 (see appendix), in which it expressed its appreciation to UNCITRAL for completing and adopting the Model Law.

## II. Purpose of the Guide to Enactment

9. UNCITRAL considered that the Model Law would be a more effective tool for legislators if it were accompanied by background and explanatory information. While such information would be directed primarily to executive branches of Governments and legislators preparing the necessary legislative revisions, it would also provide useful insight to other users of the text such as judges, practitioners and academics. Such information might also assist States in considering which, if any, of the provisions should be varied in order to be adapted to the particular national circumstances.

10. The present Guide to Enactment has been prepared by the Secretariat pursuant to the request of UNCITRAL made at the close of its thirtieth session, in 1997. It is based on the deliberations and decisions of the Commission at that session,<sup>i</sup> when the Model Law was adopted, as well as on considerations of the Working Group on Insolvency Law, which conducted the preparatory work.

## III. Model Law as a vehicle for the harmonization of laws

11. A model law is a legislative text that is recommended to States for incorporation into their national law. Unlike an international convention, a model law does not require the State enacting it to notify the United Nations or other States that may have also enacted it.

12. In incorporating the text of the model law into its system, a State may modify or leave out some of its provisions. In the case of a convention, the possibility of changes being made to the uniform text by the States parties (normally referred to as “reservations”) is much more restricted; in particular trade law conventions usually either totally prohibit reservations or allow only specified ones. The flexibility inherent in a model law is particularly desirable in those cases where it is likely that the State would wish to make various modifications to the uniform text before it would be ready to enact it as a national law. Some modifications may be expected in particular when the uniform text is closely related to the national court and procedural system (which is the case with the UNCITRAL Model Law on Cross-Border Insolvency). This, however, also means that the degree of, and certainty about, harmonization achieved through a model law is likely to be lower than in the case of a convention. Therefore, in order to achieve a satisfactory degree of harmonization and certainty, it is recommended that States make as few changes as possible in incorporating the UNCITRAL Model Law into their legal systems.

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<sup>h</sup>For the discussion, see *Official Records of the General Assembly, Fifty-second Session, Supplement No. 17 (A/52/17)*, paras. 12-225.

<sup>i</sup>*Official Records of the General Assembly, Fifty-second Session, Supplement No. 17 (A/52/17)*, para. 220.

## IV. Main features of the Model Law

### A. Background

13. The increasing incidence of cross-border insolvencies reflects the continuing global expansion of trade and investment. However, national insolvency laws have by and large not kept pace with the trend, and they are often ill-equipped to deal with cases of a cross-border nature. This frequently results in inadequate and inharmonious legal approaches, which hamper the rescue of financially troubled businesses, are not conducive to a fair and efficient administration of cross-border insolvencies, impede the protection of the assets of the insolvent debtor against dissipation and hinder maximization of the value of those assets. Moreover, the absence of predictability in the handling of cross-border insolvency cases impedes capital flow and is a disincentive to cross-border investment.

14. Fraud by insolvent debtors, in particular by concealing assets or transferring them to foreign jurisdictions, is an increasing problem, in terms of both its frequency and its magnitude. The modern, interconnected world makes such fraud easier to conceive and carry out. The cross-border cooperation mechanisms established by the Model Law are designed to confront such international fraud.

15. Only a limited number of States have a legislative framework for dealing with cross-border insolvency that is well suited to the needs of international trade and investment. Various techniques and notions are employed in the absence of a specific legislative or treaty framework for dealing with cross-border insolvency. These include the following: application of the doctrine of comity by courts in common-law jurisdictions; issuance for equivalent purposes of enabling orders (*exequatur*) in civil-law jurisdictions; enforcement of foreign insolvency orders relying on legislation for enforcement of foreign judgements; and techniques such as letters rogatory for transmitting requests for judicial assistance.

16. Approaches based purely on the doctrine of comity or on *exequatur* do not provide the same degree of predictability and reliability as can be provided by specific legislation, such as the one contained in the Model Law, on judicial cooperation, recognition of foreign insolvency proceedings and access for foreign representatives to courts. For example, in a given legal system general legislation on reciprocal recognition of judgements, including *exequatur*, might be confined to enforcement of specific money judgements or injunctive orders in two-party disputes, thus excluding decisions opening collective insolvency proceedings. Furthermore, recognition of foreign insolvency proceedings might not be considered as a matter of recognizing a foreign “judgement”, for example, if the foreign bankruptcy order is considered to be merely a declaration of status of the debtor or if the order is considered not to be final.

17. To the extent that there is a lack of communication and coordination among courts and administrators from concerned jurisdictions, it is more likely that assets would be dissipated, fraudulently concealed, or possibly liquidated without reference to other more advantageous solutions. As a result, not only is the ability of creditors to receive payment diminished, but so is the possibility of rescuing financially viable businesses and saving jobs. By contrast, mechanisms in national legislation for coordinated administration of cases of cross-border insolvency make it possible to adopt solutions that are sensible and in the best interest of the creditors and the debtor; the presence of such mechanisms in the law of a State is therefore perceived as advantageous for foreign investment and trade in that State.

18. The Model Law takes into account the results of other international efforts, including the European Council (EC) Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings (the “EC Regulation”), the European Convention on Certain International Aspects of Bankruptcy of 1990,<sup>j</sup> the Montevideo treaties on international commercial law of 1889 and 1940, the Convention regarding Bankruptcy between Nordic States of 1933 and the Convention on Private International Law (Bustamante Code) of 1928.<sup>k</sup> Proposals from non-governmental organizations that have been taken into account include the Model International Insolvency Cooperation Act and the Cross-Border Insolvency Concordat, both developed by Committee J of the Section on Business Law of the International Bar Association.

19. The EC Regulation establishes a cross-border insolvency regime within the European Union for cases where the debtor has the centre of its main interests in a State member of the Union. The Regulation does not deal with cross-border insolvency matters extending beyond a State member of the European Union into a non-member State. Thus, the Model Law offers to States members of the European Union a complementary regime of considerable practical value that addresses the many cases of cross-border cooperation not covered by the EC Regulation.

### *B. Fitting the Model Law into existing national law*

20. With its scope limited to some procedural aspects of cross-border insolvency cases, the Model Law is intended to operate as an integral part of the existing insolvency law in the enacting State. This is manifested in several ways:

(a) The amount of possibly new legal terminology added to existing law by the Model Law is limited. New legal terms are those specific to the cross-border context, such as “foreign proceeding” and “foreign representative”. The terms used in the Model Law are unlikely to be in conflict with terminology in existing law. Moreover, where the expression is likely to vary from country to country, the Model Law, instead of using a particular term, indicates the meaning of the term in italics within square brackets and calls upon the drafters of the national law to use the appropriate term;

(b) The Model Law presents to enacting States the possibility of aligning the relief resulting from recognition of a foreign proceeding with the relief available in a comparable proceeding in the national law;

(c) Recognition of foreign proceedings does not prevent local creditors from initiating or maintaining collective insolvency proceedings in the enacting State (art. 28);

(d) Relief available to the foreign representative is subject to the protection of local creditors and other interested persons, including the debtor, against undue prejudice; relief is also subject to compliance with the procedural requirements of the enacting State and to applicable notification requirements (art. 22 and art. 19, para. 2);

(e) The Model Law preserves the possibility of excluding or limiting any action in favour of the foreign proceeding, including recognition of the proceeding, on the basis of overriding public policy considerations, although it is expected that the public policy exception will be rarely used (art. 6);

(f) The Model Law is in the flexible form of model legislation that takes into account differing approaches in national insolvency laws and the varying propensities of States to cooperate and coordinate in insolvency matters (arts. 25-27).

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<sup>j</sup>European Treaty Series, No. 136.

<sup>k</sup>League of Nations, *Treaty Series*, vol. LXXXVI, No. 1950.

21. The flexibility to adapt the Model Law to the legal system of the enacting State should be utilized with due consideration for the need for uniformity in its interpretation and for the benefits to the enacting State in adopting modern, generally acceptable international practices in insolvency matters. Thus it is advisable to limit deviations from the uniform text to a minimum. One advantage of uniformity is that it will make it easier for the enacting States to obtain cooperation from other States in insolvency matters.

### *C. Scope of application of the Model Law*

22. The Model Law may be applied in a number of cross-border insolvency situations, including the following: (a) the case of an inward-bound request for recognition of a foreign proceeding; (b) an outward-bound request from a court or administrator in the enacting State for recognition of an insolvency proceeding commenced under the laws of the enacting State; (c) coordination of concurrent proceedings in two or more States; and (d) participation of foreign creditors in insolvency proceedings taking place in the enacting State (see art. 1).

### *D. Types of foreign proceeding covered*

23. To fall within the scope of the Model Law, a foreign insolvency proceeding needs to possess certain attributes. These include the following: basis in insolvency-related law of the originating State; involvement of creditors collectively; control or supervision of the assets and affairs of the debtor by a court or another official body; and reorganization or liquidation of the debtor as the purpose of the proceeding (see art. 2, subpara. (a)).

24. Within those parameters, a variety of collective proceedings would be eligible for recognition, be they compulsory or voluntary, corporate or individual, winding-up or reorganization. It also includes those in which the debtor retains some measure of control over its assets, albeit under court supervision (e.g. suspension of payments, “debtor in possession”).

25. An inclusive approach is used also as regards the possible types of debtor covered by the Model Law. Nevertheless, the Model Law refers to the possibility of excluding from its scope of application certain types of entity, such as banks or insurance companies specially regulated with regard to insolvency under the laws of the enacting State (art. 1, para. 2).

### *E. Foreign assistance for an insolvency proceeding taking place in the enacting State*

26. In addition to equipping the courts of the enacting State to deal with incoming requests for recognition, the Model Law authorizes the courts of the enacting State to seek assistance abroad on behalf of a proceeding taking place in the enacting State (art. 25). Addition of the authorization for the courts of the enacting State to seek cooperation abroad may help to fill a gap in legislation in some States. Without such legislative authorization, the courts, in some legal systems, feel constrained from seeking such assistance abroad, which creates potential obstacles to a coordinated international response in case of cross-border insolvency.

27. The Model Law may similarly help an enacting State to fill a gap in its legislation as to the “outward” powers of persons appointed to administer insolvency proceedings under the local insolvency law. Article 5 authorizes those persons to seek recognition of, and assistance for, those proceedings from foreign courts.

#### *F. Foreign representative’s access to courts of the enacting State*

28. An important objective of the Model Law is to provide expedited and direct access for foreign representatives to the courts of the enacting State. The Model Law avoids the need to rely on cumbersome and time-consuming letters rogatory or other forms of diplomatic or consular communications that might otherwise have to be used. This facilitates a coordinated, cooperative approach to cross-border insolvency and makes fast action possible.

29. In addition to establishing the principle of direct court access for the foreign representative, the Model Law:

(a) Establishes simplified proof requirements for seeking recognition and relief for foreign proceedings, which avoid time-consuming “legalization” requirements involving notarial or consular procedures (art. 15);

(b) Provides that the foreign representative has procedural standing for commencing an insolvency proceeding in the enacting State (under the conditions applicable in the enacting State) and that the foreign representative may participate in an insolvency proceeding in the enacting State (arts. 11 and 12);

(c) Confirms, subject to other requirements of the enacting State, access of foreign creditors to the courts of the enacting State for the purpose of commencing in the enacting State an insolvency proceeding or participating in such a proceeding (art. 13);

(d) Gives the foreign representative the right to intervene in proceedings concerning individual actions in the enacting State affecting the debtor or its assets (art. 24);

(e) Provides that the mere fact of a petition for recognition in the enacting State does not mean that the courts in that State have jurisdiction over all the assets and affairs of the debtor (art. 10).

#### *G. Recognition of foreign proceedings*

##### *Decision whether to recognize a foreign proceeding*

30. The Model Law establishes criteria for determining whether a foreign proceeding is to be recognized (arts. 15-17) and provides that, in appropriate cases, the court may grant interim relief pending a decision on recognition (art. 19). The decision includes a determination whether the jurisdictional basis on which the foreign proceeding was commenced was such that it should be recognized as a “main” or a “non-main” foreign insolvency proceeding. Procedural matters related to notice of the filing of an application for recognition or of the decision to grant recognition are not dealt with in the Model Law; they remain to be governed by other provisions of law of the enacting State.

31. A foreign proceeding is deemed to be the “main” proceeding if it has been commenced in the State where “the debtor has the centre of its main interests”. This corresponds to the formulation in article 3 of the EC Regulation, thus building on the emerging harmonization as regards the notion of a “main” proceeding. The determination that a foreign proceeding is a “main” proceeding may affect the nature of the relief accorded to the foreign representative.



*Effects of recognition and discretionary relief available to a foreign representative*

32. Key elements of the relief accorded upon recognition of the representative of a foreign “main” proceeding include a stay of actions of individual creditors against the debtor or a stay of enforcement proceedings concerning the assets of the debtor, and a suspension of the debtor’s right to transfer or encumber its assets (art. 20, para. 1). Such stay and suspension are “mandatory” (or “automatic”) in the sense that either they flow automatically from the recognition of a foreign main proceeding or, in the States where a court order is needed for the stay or suspension, the court is bound to issue the appropriate order. The stay of actions or of enforcement proceedings is necessary to provide “breathing space” until appropriate measures are taken for reorganization or fair liquidation of the assets of the debtor. The suspension of transfers is necessary because in a modern, globalized economic system it is possible for multinational debtors to move money and property across boundaries quickly. The mandatory moratorium triggered by the recognition of the foreign main proceeding provides a rapid “freeze” essential to prevent fraud and to protect the legitimate interests of the parties involved until the court has an opportunity to notify all concerned and to assess the situation.

33. Exceptions and limitations to the scope of the stay and suspension (e.g. exceptions for secured claims, payments by the debtor made in the ordinary course of business, set-off, execution of rights *in rem*) and the possibility of modifying or terminating the stay or suspension are determined by provisions governing comparable stays and suspensions in insolvency proceedings under the laws of the enacting State (art. 20, para. 2).

34. In addition to the mandatory stay and suspension, the Model Law authorizes the court to grant “discretionary” relief for the benefit of any foreign proceeding, whether it is a “main” proceeding or not (art. 21). Such discretionary relief may consist of, for example, staying proceedings or suspending the right to encumber assets (to the extent such stay and suspension have not taken effect automatically under art. 20), facilitating access to information concerning the assets of the debtor and its liabilities, appointing a person to administer all or part of those assets, and any other relief that may be available under the laws of the enacting State. Urgently needed relief may be granted already upon filing an application for recognition (art. 21).

*Protection of creditors and other interested persons*

35. The Model Law contains provisions such as the following to protect the interests of the creditors (in particular local creditors), the debtor and other affected persons: the availability of temporary relief upon application for recognition of a foreign proceeding or upon recognition is subject to the discretion of the court; it is expressly stated that in granting such relief the court must be satisfied that the interests of the creditors and other interested persons, including the debtor, are adequately protected (art. 22, para. 1); the court may subject the relief it grants to conditions it considers appropriate; and the court may modify or terminate the relief granted, if so requested by a person affected thereby (art. 22, paras. 2 and 3).

36. In addition to those specific provisions, the Model Law in a general way provides that the court may refuse to take an action governed by the Model Law if the action would be manifestly contrary to the public policy of the enacting State (art. 6).

37. Questions of notice to interested persons, while closely related to the protection of their interests, are in general not regulated in the Model Law. Thus, such questions are governed by the procedural rules of the enacting State, some of which may be of a public-order character. For example, the law of the enacting State will determine



whether any notice is to be given to the debtor or another person of an application for recognition of a foreign proceeding and the time period for giving the notice.

### *H. Cross-border cooperation*

38. A widespread limitation on cooperation and coordination between judges from different jurisdictions in cases of cross-border insolvency is derived from the lack of a legislative framework, or from uncertainty regarding the scope of the existing legislative authority, for pursuing cooperation with foreign courts.

39. Experience has shown that, irrespective of the discretion courts may traditionally enjoy in a State, the passage of a specific legislative framework is useful for promoting international cooperation in cross-border cases. Accordingly, the Model Law fills the gap found in many national laws by expressly empowering courts to extend cooperation in the areas covered by the Model Law (arts. 25-27).

40. For similar reasons, provisions are included authorizing cooperation between a court in the enacting State and a foreign representative and between a person administering the insolvency proceeding in the enacting State and a foreign court or a foreign representative (art. 26).

41. The Model Law lists possible forms of cooperation and leaves the legislator an opportunity to list others (art. 27). It is advisable to keep the list, when enacted, illustrative rather than exhaustive so as not to stymie the ability of courts to fashion remedies in keeping with specific circumstances.

### *I. Coordination of concurrent proceedings*

#### *Jurisdiction to commence a local proceeding*

42. The Model Law imposes virtually no limitations on the jurisdiction of the courts in the enacting State to commence or continue insolvency proceedings. Pursuant to article 28, even after recognition of a foreign “main” proceeding, jurisdiction remains with the courts of the enacting State to institute an insolvency proceeding if the debtor has assets in the enacting State. If the enacting State wished to restrict its jurisdiction to cases where the debtor had not only assets but also an establishment in the enacting State, the adoption of such a restriction would not be contrary to the policy underlying the Model Law.

43. In addition, the Model Law deems the recognized foreign main proceeding to constitute proof that the debtor is insolvent for the purposes of commencing local proceedings (art. 31). This rule would be helpful in those legal systems in which commencement of an insolvency proceeding requires proof that the debtor is in fact insolvent. Avoidance of the need for repeated proof of financial failure reduces the likelihood that a debtor may delay the commencement of the proceeding long enough to conceal or carry away assets.

#### *Coordination of relief when proceedings take place concurrently*

44. The Model Law deals with coordination between a local proceeding and a foreign proceeding concerning the same debtor (art. 29) and facilitates coordination between two or more foreign proceedings concerning the same debtor (art. 30). The objective of the provisions is to foster coordinated decisions that would best achieve the objectives

of both proceedings (e.g. maximization of the value of the debtor's assets or the most advantageous restructuring of the enterprise). In order to achieve satisfactory coordination and to be able to adapt relief to changing circumstances, the court is in all situations covered by the Model Law, including those which limit the effects of foreign proceedings in the face of local proceedings, directed to cooperate to the maximum extent possible with foreign courts and the foreign representatives (arts. 25 and 30).

45. When the local insolvency proceeding is already under way at the time that recognition of a foreign proceeding is requested, the Model Law requires that any relief granted for the benefit of the foreign proceeding must be consistent with the local proceeding. Furthermore, the existence of the local proceeding at the time the foreign main proceeding is recognized prevents the operation of article 20. When there is no local proceeding pending, article 20 mandates the stay of individual actions or enforcement proceedings against the debtor and a suspension of the debtor's right to transfer or encumber its assets.

46. When the local proceeding begins subsequent to recognition or application for recognition of the foreign proceeding, the relief that has been granted for the benefit of the foreign proceeding must be reviewed and modified or terminated if inconsistent with the local proceeding. If the foreign proceeding is a main proceeding, the stay and a suspension, as mandated by article 20, must also be modified or terminated if inconsistent with the local proceeding.

47. When the court is faced with more than one foreign proceeding, article 30 calls for tailoring relief in such a way that will facilitate coordination of the foreign proceedings; if one of the foreign proceedings is a main proceeding, any relief must be consistent with that main proceeding.

48. Another rule designed to enhance coordination of concurrent proceedings is the one on rate of payment of creditors (art. 32). It provides that a creditor, by claiming in more than one proceeding, does not receive more than the proportion of payment that is obtained by other creditors of the same class.

## V. Article-by-article remarks

### A. Title

#### *"Model Law"*

49. If the enacting State decides to incorporate the provisions of the Model Law into an existing national insolvency statute, the title of the enacted provisions would have to be adjusted accordingly and the word "Law", which appears at various places in the title and in the text of the Model Law, would have to be replaced by the appropriate expression.

50. In enacting the Model Law, it is advisable to adhere as much as possible to the uniform text in order to make the national law as transparent as possible for foreign users of the national law (see also paras. 11, 12 and 21 above).

#### *"Insolvency"*

51. The word "insolvency", as used in the title of the Model Law, refers to various types of collective proceedings against insolvent debtors. The reason is that the Model

Law (as pointed out above in paras. 23 and 24) covers proceedings concerning different types of debtors and, among those proceedings, deals with proceedings aimed at reorganizing the debtor and proceedings leading to a liquidation of the debtor as a commercial entity.

52. It should be noted that in some jurisdictions the expression “insolvency proceedings” has a narrow technical meaning in that it may refer, for example, only to collective proceedings involving a company or a similar legal person or only to collective proceedings against a natural person. No such distinction is intended to be drawn by the use of the term “insolvency” in the title of the Model Law, since the Model Law is designed to be applicable to proceedings regardless of whether they involve a natural person or a legal person as the debtor. If in the enacting State the word “insolvency” may be misunderstood as referring to one particular type of collective proceeding, another term should be used to refer to the proceedings covered by the Law.

53. However, when referring to foreign insolvency proceedings, it is desirable to utilize the wording of article 2, subparagraph (a), so as not to exclude recognition of foreign proceedings that, according to article 2, subparagraph (a), should be covered.

### *B. Preamble*

The purpose of this Law is to provide effective mechanisms for dealing with cases of cross-border insolvency so as to promote the objectives of:

- (a) Cooperation between the courts and other competent authorities of this State and foreign States involved in cases of cross-border insolvency;
- (b) Greater legal certainty for trade and investment;
- (c) Fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested persons, including the debtor;
- (d) Protection and maximization of the value of the debtor’s assets; and
- (e) Facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

54. The preamble gives a succinct statement of the basic policy objectives of the Model Law. It is not intended to create substantive rights, but rather to give a general orientation for users of the Model Law and to assist in the interpretation of the Model Law.

55. In States where it is not customary to set out preambular statements of policy in legislation, consideration might be given to including the statement of objectives either in the body of the statute or in a separate document, in order to preserve a useful tool for the interpretation of the law.

“*State*”

56. The word “State”, as used in the preamble and throughout the Model Law, refers to the entity that enacts the Law (the “enacting State”). The term should not be understood as referring, for example, to a state in a country with a federal system.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 136-139.*

A/CN.9/422, paras. 19-23.

A/CN.9/433, paras. 22-28.

A/CN.9/435, para. 100.

*C. Chapter I. General provisions*

*Article 1. Scope of application*

1. This Law applies where:

(a) Assistance is sought in this State by a foreign court or a foreign representative in connection with a foreign proceeding; or

(b) Assistance is sought in a foreign State in connection with a proceeding under [*identify laws of the enacting State relating to insolvency*]; or

(c) A foreign proceeding and a proceeding under [*identify laws of the enacting State relating to insolvency*] in respect of the same debtor are taking place concurrently; or

(d) Creditors or other interested persons in a foreign State have an interest in requesting the commencement of, or participating in, a proceeding under [*identify laws of the enacting State relating to insolvency*].

2. This Law does not apply to a proceeding concerning [*designate any types of entity, such as banks or insurance companies, that are subject to a special insolvency regime in this State and that this State wishes to exclude from this Law*].

*Paragraph 1*

57. Article 1, paragraph 1, outlines the types of issue that may arise in cases of cross-border insolvency and for which the Model Law provides solutions: (a) inward-bound requests for recognition of a foreign proceeding; (b) outward-bound requests from a court or administrator in the enacting State for recognition of an insolvency proceeding commenced under the laws of the enacting State; (c) coordination of proceedings taking place concurrently in two or more States; and (d) participation of foreign creditors in insolvency proceedings taking place in the enacting State.

58. The words “this State” are used in the preamble and throughout the Model Law to refer to the State that is enacting the text. The national statute may use another expression that is customarily used for this purpose.

59. “Assistance” in paragraph 1, subparagraphs (a) and (b), is meant to cover various situations, dealt with in the Model Law, in which a court or an insolvency administrator in one State may make a request directed to a court or an insolvency administrator in

another State for taking a measure encompassed in the Model Law. Some of those measures the Law specifies (e.g. art. 19, subparas. 1 (a) and (b); art. 21, subparas. 1 (a)-(f) and para. 2; and art. 27, subparas. (a)-(e)), while other possible measures are covered by a broader formulation (such as the one in art. 21, subpara. 1 (g)).

*Paragraph 2 (Specially regulated insolvency proceedings)*

60. In principle, the Model Law was formulated to apply to any proceeding that meets the requirements of article 2, subparagraph (a), independently of the nature of the debtor or its particular status under national law. The only possible exceptions contemplated in the text of the Model Law itself are indicated in paragraph 2 (see, however, para. 66 below, for considerations regarding “consumers”).

61. Banks or insurance companies are mentioned as examples of entities that the enacting State might decide to exclude from the scope of the Model Law. The reason for the exclusion would typically be that the insolvency of such entities gives rise to the particular need to protect vital interests of a large number of individuals or that the insolvency of those entities usually requires particularly prompt and circumspect action (for instance to avoid massive withdrawals of deposits). For those reasons, the insolvency of such types of entity is in many States administered under a special regulatory regime.

62. Paragraph 2 indicates that the enacting State might decide to exclude the insolvency of entities other than banks and insurance companies; the State might do so where the policy considerations underlying the special insolvency regime for those other types of entity (e.g. public utility companies) call for special solutions in cross-border insolvency cases.

63. It is not advisable to exclude all cases of insolvency of the entities mentioned in paragraph 2. In particular, the enacting State might wish to treat, for recognition purposes, a foreign insolvency proceeding relating to a bank or an insurance company as an ordinary insolvency proceeding if the insolvency of the branch or of the assets of the foreign entity in the enacting State do not fall under the national regulatory scheme. The enacting State might also wish not to exclude the possibility of recognition of a foreign proceeding involving one of those entities if the law of the State of origin does not make that proceeding subject to special regulation.

64. In enacting paragraph 2, a State may wish to make sure that it would not inadvertently and undesirably limit the right of the insolvency administrator or court to seek assistance or recognition abroad of an insolvency proceeding conducted in the territory of the enacting State, merely because that insolvency is subject to a special regulatory regime. Moreover, even if the particular insolvency is governed by special regulation, it is advisable, before generally excluding those cases from the Model Law, to consider whether it would be useful to leave certain features of the Model Law (e.g. on co-operation and coordination and possibly on certain types of discretionary relief) applicable also to the specially regulated insolvency proceedings.

65. In any case, with a view to making the national insolvency law more transparent (for the benefit of foreign users of the law based on the Model Law), it is advisable that exclusions from the scope of the law be expressly mentioned by the enacting State in paragraph 2.

*Non-traders or natural persons*

66. In jurisdictions that have not made provision for the insolvency of consumers or whose insolvency law provides special treatment for the insolvency of non-traders, the enacting State might wish to exclude from the scope of application of the Model Law insolvencies that relate to natural persons residing in the enacting State whose debts have been incurred predominantly for personal or household purposes, rather than for commercial or business purposes, or insolvencies that relate to non-traders. The enacting State might also wish to provide that such exclusion would not apply in cases where the total debts exceed a certain monetary ceiling.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 141-150.*

A/CN.9/422, paras. 24-33.

A/CN.9/433, paras. 29-32.

A/CN.9/435, paras. 102-106 and 179.

*Article 2. Definitions*

For the purposes of this Law:

(a) “Foreign proceeding” means a collective judicial or administrative proceeding in a foreign State, including an interim proceeding, pursuant to a law relating to insolvency in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation;

(b) “Foreign main proceeding” means a foreign proceeding taking place in the State where the debtor has the centre of its main interests;

(c) “Foreign non-main proceeding” means a foreign proceeding, other than a foreign main proceeding, taking place in a State where the debtor has an establishment within the meaning of subparagraph (f) of this article;

(d) “Foreign representative” means a person or body, including one appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor’s assets or affairs or to act as a representative of the foreign proceeding;

(e) “Foreign court” means a judicial or other authority competent to control or supervise a foreign proceeding;

(f) “Establishment” means any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services.

*Subparagraphs (a)-(d)*

67. Since the Model Law will be embedded in the national insolvency law, article 2 only needs to define the terms specific to cross-border scenarios. Thus, the Model Law

contains definitions of the terms “foreign proceeding” (subpara. (a)) and “foreign representative” (subpara. (d)), but not of the person or body that may be entrusted with the administration of the assets of the debtor in an insolvency proceeding in the enacting State. To the extent that it would be useful to define in the national statute the term used for such a person or body (rather than just using the term commonly employed to refer to such persons), this may be added to the definitions in the law enacting the Model Law.

68. By specifying required characteristics of the “foreign proceeding” and “foreign representative”, the definitions limit the scope of application of the Model Law. For a proceeding to be susceptible to recognition or cooperation under the Model Law and for a foreign representative to be accorded access to local courts under the Model Law, the foreign proceeding and the foreign representative must have the attributes of subparagraphs (a) and (d).

69. The definitions in subparagraphs (a) and (d) cover also an “interim proceeding” and a representative “appointed on an interim basis”. In a State where interim proceedings are either not known or do not meet the requisites of the definition, the question may arise whether recognition of a foreign “interim proceeding” creates a risk of allowing potentially disruptive consequences under the Model Law that the situation does not warrant. It is advisable that, irrespective of the way interim proceedings are treated in the enacting State, the reference to “interim proceeding” in subparagraph (a) and to a foreign representative appointed “on an interim basis” in subparagraph (d) be maintained. The reason is that in the practice of many States insolvency proceedings are often, or even usually, commenced on an “interim” or “provisional” basis. Except for being labelled as interim, those proceedings meet all the other requisites of the definition in article 2, subparagraph (a). Such proceedings are often conducted for weeks or months as “interim” proceedings under the administration of persons appointed on an “interim” basis and only some time later would the court issue an order confirming the continuation of the proceedings on a non-interim basis. The objectives of the Model Law apply fully to such “interim proceedings” (provided the requisites of subparagraphs (a) and (d) are met); these proceedings should therefore not be distinguished from other insolvency proceedings merely because they are of an interim nature. The point that an interim proceeding and the foreign representative must meet all the requirements of article 2 is emphasized in article 17, paragraph 1, according to which a foreign proceeding may only be recognized if “the foreign proceeding is a proceeding within the meaning of subparagraph (a) of article 2” and “the foreign representative applying for recognition is a person or body within the meaning of subparagraph (d) of article 2”.

70. Article 18 addresses a case where, after the application for recognition or after recognition, the foreign proceeding or foreign representative, whether interim or not, ceases to meet the requirements of article 2, subparagraphs (a) and (d). Article 18 obligates the foreign representative to inform the court promptly, after the time of filing the application for recognition of the foreign proceeding, of “any substantial change in the status of the recognized foreign proceeding or the status of the foreign representative’s appointment”. The purpose of the obligation is to allow the court to modify or terminate the consequences of recognition.

71. The definitions of proceedings or persons emanating from foreign jurisdictions avoid the use of expressions that may have different technical meaning in legal systems and instead describe their purpose or function. This technique is used to avoid inadvertently narrowing the range of possible foreign proceedings that might obtain recognition and to avoid unnecessary conflict with terminology used in the laws of the enacting

State. As noted in paragraph 52 above, the expression “insolvency proceedings” may have a technical meaning in some legal systems, but it is intended in subparagraph (a) to refer broadly to proceedings involving companies in severe financial distress.

72. The expression “centre of . . . main interests”, used in subparagraph (b) to define a foreign main proceeding, is used also in the EC Regulation.

73. Subparagraph (c) requires that a “foreign non-main proceeding” take place in the State where the debtor has an “establishment”. Thus, a foreign non-main proceeding susceptible to recognition under article 17, paragraph 2, may be only a proceeding commenced in a State where the debtor has an establishment in the meaning of article 2, subparagraph (f). This rule does not affect the provision in article 28, namely, that an insolvency proceeding may be commenced in the enacting State if the debtor has assets there. It should be noted, however, that the effects of an insolvency proceeding commenced on the basis of the presence of assets only are normally restricted to the assets located in that State; if other assets of the debtor located abroad should, under the law of the enacting State, be administered in that insolvency proceeding (as envisaged in art. 28), that cross-border issue is to be dealt with as a matter of international cooperation and coordination under articles 25-27 of the Model Law.

#### *Subparagraph (e)*

74. A foreign proceeding that meets the requisites of article 2, subparagraph (a), should receive the same treatment irrespective of whether it has been commenced and supervised by a judicial body or an administrative body. Therefore, in order to obviate the need to refer to a foreign non-judicial authority whenever reference is made to a foreign court, the definition of “foreign court” in subparagraph (e) includes also non-judicial authorities. Subparagraph (e) follows a similar definition contained in article 2, subparagraph (d), of the EC Regulation.

#### *Subparagraph (f)*

75. The definition of the term “establishment” (subpara. (f)) has been inspired by article 2, subparagraph (h) of the EC Regulation. The term is used in the definition of “foreign non-main proceeding” (art. 2, subpara. (c)) and in the context of article 17, paragraph 2, according to which, for a foreign non-main proceeding to be recognized, the debtor must have an establishment in the foreign State (see also para. 73 above).

#### *Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 152-158.*

A/CN.9/419, paras. 95-117.

A/CN.9/422, paras. 34-65.

A/CN.9/433, paras. 33-41 and 147.

A/CN.9/435, paras. 108-113.



*Article 3. International obligations of this State*

To the extent that this Law conflicts with an obligation of this State arising out of any treaty or other form of agreement to which it is a party with one or more other States, the requirements of the treaty or agreement prevail.

76. Article 3, expressing the principle of supremacy of international obligations of the enacting State over internal law, has been modelled on similar provisions in other model laws prepared by UNCITRAL.

77. In enacting the article, the legislator may wish to consider whether it would be desirable to take steps to avoid an unnecessarily broad interpretation of international treaties. For example, the article might result in giving precedence to international treaties that, while dealing with matters covered also by the Model Law (e.g. access to courts and cooperation between courts or administrative authorities), were aimed at the resolution of problems other than those the Model Law focuses on. Some of those treaties, only because of their imprecise or broad formulation, may be misunderstood as dealing also with matters dealt with by the Model Law. Such a result would compromise the goal of achieving uniformity and facilitating cross-border cooperation in insolvency matters and would reduce certainty and predictability in the application of the Model Law. The enacting State might wish to provide that, in order for article 3 to displace a provision of the national law, a sufficient link must exist between the international treaty concerned and the issue governed by the provision of the national law in question. Such a condition would avoid the inadvertent and excessive restriction of the effects of the legislation implementing the Model Law. However, such a provision should not go so far as to impose a condition that the treaty concerned has to deal specifically with insolvency matters in order to satisfy that condition.

78. While in some States binding international treaties are self-executing, in other States those treaties are, with certain exceptions, not self-executing in that they require internal legislation for them to become enforceable law. With respect to the latter group of States, in view of their normal practice in dealing with international treaties and agreements, it would be inappropriate or unnecessary to include article 3 in their legislation or it might be appropriate to include it in a modified form.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 160-162.*

A/CN.9/422, paras. 66 and 67.

A/CN.9/433, paras. 42 and 43.

A/CN.9/435, paras. 114-117.

*Article 4. [Competent court or authority]<sup>a</sup>*

The functions referred to in this Law relating to recognition of foreign proceedings and cooperation with foreign courts shall be performed by [*specify the court, courts, authority or authorities competent to perform those functions in the enacting State*].

<sup>a</sup>A State where certain functions relating to insolvency proceedings have been conferred upon government-appointed officials or bodies might wish to include in article 4 or elsewhere in chapter I the following provision:

Nothing in this Law affects the provisions in force in this State governing the authority of [*insert the title of the government-appointed person or body*].

79. If in the enacting State any of the functions mentioned in article 4 are performed by an authority other than a court, the State would insert in article 4 and in other appropriate places in the enacting legislation the name of the competent authority.

80. The competence for the various judicial functions dealt with in the Model Law may lie with different courts in the enacting State and the enacting State would tailor the text of the article to its own system of court competence. The value of article 4, as enacted in a given State, would be to increase the transparency and ease of use of the insolvency legislation for the benefit of, in particular, foreign representatives and foreign courts.

81. In defining jurisdiction in matters mentioned in article 4, the implementing legislation should not unnecessarily limit the jurisdiction of other courts in the enacting State, in particular to entertain requests by foreign representatives for provisional relief.

*Footnote*

82. In a number of States, insolvency legislation has entrusted certain tasks relating to the general supervision of the process of dealing with insolvency cases in the country to government-appointed officials who are typically civil servants or judicial officers and who carry out their functions on a permanent basis. The names under which they are known vary and include, for example, “official receiver”, “official trustee” or “official assignee”. The activities and the scope and nature of their duties vary from State to State. The Model Law does not restrict the authority of such officials, a point that some enacting States may wish to clarify in the law, as indicated in the footnote. However, depending on the wording that the enacting State uses in articles 25 and 26 in referring to the “*title of the person or body administering a reorganization or liquidation under the law of the enacting State*”, the officials may be subjected to the duty to cooperate as provided under articles 25- 27.

83. In some jurisdictions, officials referred to in the preceding paragraph may also be appointed to act as administrators in individual insolvency cases. To the extent that occurs, such officials would be covered by the Model Law.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 163-166.*

A/CN.9/419, para. 69.

A/CN.9/422, paras. 68 and 69.

A/CN.9/433, paras. 44 and 45.

A/CN.9/435, paras. 118-122.

*Article 5. Authorization of [insert the title of the person or body administering a reorganization or liquidation under the law of the enacting State] to act in a foreign State*

*A [insert the title of the person or body administering a reorganization or liquidation under the law of the enacting State] is authorized to act in a foreign State on behalf of a proceeding under [identify laws of the enacting State relating to insolvency], as permitted by the applicable foreign law.*

84. The intent of article 5 is to equip administrators or other authorities appointed in insolvency proceedings commenced in the enacting State to act abroad as foreign representatives of those proceedings. The lack of such authorization in some States has proved to be an obstacle to effective international cooperation in cross-border cases. An enacting State in which administrators are already equipped to act as foreign representatives may decide to forgo inclusion of article 5, although even such a State might want to keep article 5 in order to provide clear statutory evidence of that authority.

85. Article 5 is formulated to make it clear that the scope of the power exercised abroad by the administrator would depend upon the foreign law and courts. Action that the administrator appointed in the enacting State may wish to take in a foreign country will be action of the type dealt with in the Model Law, but the authority to act in a foreign country does not depend on whether that country has enacted legislation based on the Model Law.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 167-169.*

A/CN.9/419, paras. 36-39.

A/CN.9/422, paras. 70-74.

A/CN.9/433, paras. 46-49.

A/CN.9/435, paras. 123 and 124.

*Article 6. Public policy exception*

Nothing in this Law prevents the court from refusing to take an action governed by this Law if the action would be manifestly contrary to the public policy of this State.

86. As the notion of public policy is grounded in national law and may differ from State to State, no uniform definition of that notion is attempted in article 6.

87. In some States the expression “public policy” may be given a broad meaning in that it might relate in principle to any mandatory rule of national law. In many States, however, the public policy exception is construed as being restricted to fundamental principles of law, in particular constitutional guarantees; in those States, public policy would only be used to refuse the application of foreign law, or the recognition of a foreign judicial decision or arbitral award, when that would contravene those fundamental principles.

88. For the applicability of the public policy exception in the context of the Model Law it is important to note that a growing number of jurisdictions recognize a dichotomy between the notion of public policy as it applies to domestic affairs, as well as the notion of public policy as it is used in matters of international cooperation and the question of recognition of effects of foreign laws. It is especially in the latter situation that public policy is understood more restrictively than domestic public policy. This dichotomy reflects the realization that international cooperation would be unduly hampered if “public policy” were to be understood in an extensive manner.

89. The purpose of the expression “manifestly”, used also in many other international legal texts as a qualifier of the expression “public policy”, is to emphasize that public policy exceptions should be interpreted restrictively and that article 6 is only intended to be invoked under exceptional circumstances concerning matters of fundamental importance for the enacting State.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 170-173.*

A/CN.9/419, para. 40.

A/CN.9/422, paras. 84 and 85.

A/CN.9/433, paras. 156-160.

A/CN.9/435, paras. 125-128.

*Article 7. Additional assistance under other laws*

Nothing in this Law limits the power of a court or a [insert the title of the person or body administering a reorganization or liquidation under the law of the enacting State] to provide additional assistance to a foreign representative under other laws of this State.

90. The purpose of the Model Law is to increase and harmonize cross-border assistance available in the enacting State to foreign representatives. However, since the law of the enacting State may, at the time of enacting the Law, already have in place various provisions under which a foreign representative could obtain cross-border assistance and since it is not the purpose of the Law to displace those provisions to the extent that they provide assistance that is additional to or different from the type of assistance dealt with in the Model Law, the enacting State may consider whether article 7 is needed to make that point clear.

*Discussion in UNCITRAL*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), para. 175.*

*Article 8. Interpretation*

In the interpretation of this Law, regard is to be had to its international origin and to the need to promote uniformity in its application and the observance of good faith.

91. A provision similar to the one contained in article 8 appears in a number of private law treaties (e.g. art. 7, para. 1, of the United Nations Convention on Contracts for the International Sale of Goods).<sup>1</sup> More recently, it has been recognized that, also in a non-treaty text such as a model law, such a provision would be useful in that a State enacting a model law also has an interest in its harmonized interpretation. Article 8 has been modelled on article 3, paragraph 1, of the UNCITRAL Model Law on Electronic Commerce.<sup>m</sup>

92. Harmonized interpretation of the Model Law will be facilitated by the Case Law on UNCITRAL Texts (CLOUT) information system, under which the UNCITRAL secretariat publishes abstracts of judicial decisions (and, where applicable, arbitral awards) that interpret conventions and model laws emanating from UNCITRAL. (For further information about the system, see para. 202 below.)

*Discussion in UNCITRAL*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), para. 174.*

<sup>1</sup>United Nations, *Treaty Series*, vol. 1489, No. 25567.

<sup>m</sup>United Nations publication, Sales No. E.99.V.4.

*D. Chapter II. Access of foreign representatives and creditors to courts in this State*

*Article 9. Right of direct access*

A foreign representative is entitled to apply directly to a court in this State.

93. Article 9 is limited to expressing the principle of direct access by the foreign representative to courts of the enacting State, thus freeing the representative from having to meet formal requirements such as licences or consular action. Article 4 deals with court competence in the enacting State for providing relief to the foreign representative.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 176-178.*

A/CN.9/419, paras. 77-79, 172 and 173.

A/CN.9/422, paras. 144-151.

A/CN.9/433, paras. 50-58.

A/CN.9/435, paras. 129-133.

*Article 10. Limited jurisdiction*

The sole fact that an application pursuant to this Law is made to a court in this State by a foreign representative does not subject the foreign representative or the foreign assets and affairs of the debtor to the jurisdiction of the courts of this State for any purpose other than the application.

94. Article 10 constitutes a “safe conduct” rule aimed at ensuring that the court in the enacting State would not assume jurisdiction over all the assets of the debtor on the sole ground of the foreign representative having made an application for recognition of a foreign proceeding. The article also makes it clear that the application alone is not sufficient ground for the court of the enacting State to assert jurisdiction over the foreign representative as to matters unrelated to insolvency. The article responds to concerns of foreign representatives and creditors about exposure to all-embracing jurisdiction triggered by an application under the Model Law.

95. The limitation on jurisdiction over the foreign representative embodied in article 10 is not absolute. It is only intended to shield the foreign representative to the extent necessary to make court access a meaningful proposition. It does so by providing that an appearance in the courts of the enacting State for the purpose of requesting recognition would not expose the entire estate under the supervision of the foreign

representative to the jurisdiction of those courts. Other possible grounds for jurisdiction under the laws of the enacting State over the foreign representative or the assets are not affected. For example, a tort or a misconduct committed by the foreign representative may provide grounds for jurisdiction to deal with the consequences of such an action by the foreign representative. Furthermore, a foreign representative who applies for relief in the enacting State will be subject to conditions that the court may order in connection with relief granted (art. 22, para. 2).

96. Article 10 may appear superfluous in States where the rules on jurisdiction do not allow a court to assume jurisdiction over a person making an application to the court on the sole ground of the applicant's appearance. Enacting the article in those States would be useful, however, as it would eliminate possible concerns of foreign representatives or creditors over the possibility of jurisdiction based on the sole ground of applying to the court.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 179-182.*

A/CN.9/422, paras. 160-166.

A/CN.9/433, paras. 68-70.

A/CN.9/435, paras. 134-136.

*Article 11. Application by a foreign representative to commence  
a proceeding under [identify laws of the enacting State  
relating to insolvency]*

A foreign representative is entitled to apply to commence a proceeding under [identify laws of the enacting State relating to insolvency] if the conditions for commencing such a proceeding are otherwise met.

97. Many national laws, in enumerating persons who may request the commencement of an insolvency proceeding, do not mention a representative of a foreign insolvency proceeding; under such laws, it might be doubtful whether a foreign representative might make such a request.

98. Article 11 is designed to ensure that the foreign representative (of a foreign main or non-main proceeding) has standing (or "procedural legitimation") for requesting the commencement of an insolvency proceeding. However, the article makes it clear (by the words "if the conditions for commencing such a proceeding are otherwise met") that it does not otherwise modify the conditions under which an insolvency proceeding may be commenced in the enacting State.

99. A foreign representative has this right without prior recognition of the foreign proceeding because the commencement of an insolvency proceeding might be crucial in cases of urgent need for preserving the assets of the debtor. Article 11 recognizes that not only a representative of a foreign main proceeding but also a representative of a

foreign non-main proceeding may have a legitimate interest in the commencement of an insolvency proceeding in the enacting State. Sufficient guarantees against abusive applications are provided by the requirement that the other conditions for commencing such a proceeding under the law of the enacting State have to be met.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 183-187.*

A/CN.9/422, paras. 170-177.

A/CN.9/433, paras. 71-75.

A/CN.9/435, paras. 137-146.

*Article 12. Participation of a foreign representative in a proceeding under [identify laws of the enacting State relating to insolvency]*

Upon recognition of a foreign proceeding, the foreign representative is entitled to participate in a proceeding regarding the debtor under *[identify laws of the enacting State relating to insolvency]*.

100. The purpose of article 12 is to ensure that, when an insolvency proceeding concerning a debtor is taking place in the enacting State, the foreign representative of a proceeding concerning that debtor will be given procedural standing (or “procedural legitimation”) to make petitions, requests or submissions concerning issues such as protection, realization or distribution of assets of the debtor or cooperation with the foreign proceeding.

101. Article 12 is limited to giving the foreign representative standing and does not vest the foreign representative with any specific powers or rights. The article does not specify the kinds of motions that the foreign representative might make and does not affect the provisions in the insolvency law of the enacting State that govern the fate of the motions.

102. If the law of the enacting State uses a term other than “participate” to express the concept, that other term may be used in enacting the provision. It should be noted, however, that article 24 already uses the term “intervene” to refer to a case where the foreign representative takes part in an individual action by or against the debtor (as opposed to a collective insolvency proceeding).

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 188 and 189.*

A/CN.9/422, paras. 114, 115, 147 and 149.

A/CN.9/433, para. 58.

A/CN.9/435, paras. 147-150.



*Article 13. Access of foreign creditors to a proceeding under  
[identify laws of the enacting State relating to insolvency]*

1. Subject to paragraph 2 of this article, foreign creditors have the same rights regarding the commencement of, and participation in, a proceeding under *[identify laws of the enacting State relating to insolvency]* as creditors in this State.

2. Paragraph 1 of this article does not affect the ranking of claims in a proceeding under *[identify laws of the enacting State relating to insolvency]*, except that the claims of foreign creditors shall not be ranked lower than *[identify the class of general non-preference claims, while providing that a foreign claim is to be ranked lower than the general non-preference claims if an equivalent local claim (e.g. claim for a penalty or deferred-payment claim) has a rank lower than the general non-preference claims].<sup>b</sup>*

<sup>b</sup>The enacting State may wish to consider the following alternative wording to replace paragraph 2 of article 13:

“2. Paragraph 1 of this article does not affect the ranking of claims in a proceeding under *[identify laws of the enacting State relating to insolvency]* or the exclusion of foreign tax and social security claims from such a proceeding. Nevertheless, the claims of foreign creditors other than those concerning tax and social security obligations shall not be ranked lower than *[identify the class of general non-preference claims, while providing that a foreign claim is to be ranked lower than the general non-preference claims if an equivalent local claim (e.g. claim for a penalty or deferred-payment claim) has a rank lower than the general non-preference claims].*”

103. With the exception contained in paragraph 2, article 13 embodies the principle that foreign creditors, when they apply to commence an insolvency proceeding in the enacting State or file claims in such proceeding, should not be treated worse than local creditors.

104. Paragraph 2 makes it clear that the principle of non-discrimination embodied in paragraph 1 leaves intact the provisions on the ranking of claims in insolvency proceedings, including any provisions that might assign a special ranking to claims of foreign creditors. Few States currently have provisions assigning special ranking to foreign creditors. However, lest the non-discrimination principle should be emptied of its meaning by provisions giving the lowest ranking to foreign claims, paragraph 2 establishes the minimum ranking for claims of foreign creditors: the rank of general unsecured claims. The exception to that minimum ranking is provided for cases where the claim in question, if it were of a domestic creditor, would be ranked lower than general unsecured claims (such low-rank claims may be, for instance, those of a State authority for financial penalties or fines, claims whose payment is deferred because of a special relationship between the debtor and the creditor or claims that have been filed after the expiry of the time period for doing so). Those special claims may rank below the general unsecured claims, for reasons other than the nationality or location of the creditor, as provided in the law of the enacting State.

105. The alternative provision in the footnote differs from the provision in the text only in that it provides wording for States that refuse to recognize foreign tax and social security claims to continue to discriminate against such claims.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 190-192.*

A/CN.9/422, paras. 179-187.

A/CN.9/433, paras. 77-85.

A/CN.9/435, paras. 151-156.

*Article 14. Notification to foreign creditors of a proceeding under  
[identify laws of the enacting State relating to insolvency]*

1. Whenever under [*identify laws of the enacting State relating to insolvency*] notification is to be given to creditors in this State, such notification shall also be given to the known creditors that do not have addresses in this State. The court may order that appropriate steps be taken with a view to notifying any creditor whose address is not yet known.

2. Such notification shall be made to the foreign creditors individually, unless the court considers that, under the circumstances, some other form of notification would be more appropriate. No letters rogatory or other, similar formality is required.

3. When a notification of commencement of a proceeding is to be given to foreign creditors, the notification shall:

(a) Indicate a reasonable time period for filing claims and specify the place for their filing;

(b) Indicate whether secured creditors need to file their secured claims; and

(c) Contain any other information required to be included in such a notification to creditors pursuant to the law of this State and the orders of the court.

*Paragraphs 1 and 2*

106. The main purpose of notifying foreign creditors as provided in paragraph 1 is to inform them of the commencement of the insolvency proceeding and of the time limit to file their claims. Furthermore, as a corollary to the principle of equal treatment established by article 13, article 14 requires that foreign creditors should be notified whenever notification is required for creditors in the enacting State.

107. States have different provisions or practices regarding the methods for notifying creditors, for example, publication in the official gazette or in local newspapers, individual notices, affixing notices within the court premises or a combination of such procedures. If the form of notification were to be left to national law, foreign creditors would be in a less advantageous situation than local creditors, since they typically do not have direct access to local publications. For that reason, paragraph 2 in principle

requires individual notification for foreign creditors but leaves discretion to the court to decide otherwise in a particular case (e.g. if individual notice would entail excessive cost or would not seem feasible under the circumstances).

108. With regard to the form of individual notification, States may use special procedures for notifications that have to be served in a foreign jurisdiction (e.g. sending notifications through diplomatic channels). In the context of insolvency proceedings, those procedures would often be too cumbersome and time-consuming and their use would typically not provide foreign creditors timely notice concerning insolvency proceedings. It is therefore advisable for those notifications to be effected by such expeditious means that the court considers adequate. Those considerations are the reason for the provision in paragraph 2 that “no letters rogatory or other, similar formality is required”.

109. Many States are party to bilateral or multilateral treaties on judicial cooperation, which often contain provisions on procedures for communicating judicial or extrajudicial documents to addressees abroad. A multilateral treaty of this kind is the Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil and Commercial Matters of 1965,<sup>9</sup> adopted under the auspices of the Hague Conference on Private International Law. While the procedures envisaged by those treaties may constitute a simplification as compared with traditional communication via diplomatic channels, they would often be, for reasons stated in the preceding paragraph, inappropriate for cross-border insolvency cases. The question may arise whether paragraph 2, which allows the use of letters rogatory or similar formalities to be dispensed with, is compatible with those treaties. Each State would have to consider that question in the light of its treaty obligations, but generally the provision in paragraph 2 would not be in conflict with the international obligations of the enacting State because the purpose of the treaties alluded to above is typically to facilitate communication and not to preclude use of notification procedures that are even simpler than those established by the treaty; for example, article 10 of the above-mentioned Convention reads as follows:

“Provided the State of destination does not object, the present Convention shall not interfere with —

“a) the freedom to send judicial documents, by postal channels, directly to persons abroad,

“b) the freedom of judicial officers, officials or other competent persons of the State of origin to effect service of judicial documents directly through the judicial officers, officials or other competent persons of the State of destination,

“c) the freedom of any person interested in a judicial proceeding to effect service of judicial documents directly through the judicial officers, officials or other competent persons of the State of destination.”

To the extent that there might still be a conflict between the second sentence of paragraph 2 of article 14 and a treaty, article 3 of the Model Law provides the solution.

110. While paragraph 2 mentions letters rogatory as a formality that is not required for a notification under article 14, in many States such notifications would never be transmitted in the form of a letter rogatory. A letter rogatory in those States would be used for other purposes, such as to request evidence in a foreign country or to request

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<sup>9</sup>United Nations, *Treaty Series*, vol. 658, No. 9342.

permission to perform some other judicial act abroad. Such use of letters rogatory is governed, for example, by the Convention on the Taking of Evidence Abroad in Civil or Commercial Matters of 1970,<sup>o</sup> adopted under the auspices of the Hague Conference on Private International Law.

### *Paragraph 3*

111. In some legal systems a secured creditor who files a claim in an insolvency proceeding is deemed to have waived the security or some of the privileges attached to the credit, while in other systems failure to file a claim results in a waiver of such security or privilege. Where such a situation may arise, it would be appropriate for the enacting State to include in paragraph 3, subparagraph (b), a requirement that the notification should include information regarding the effects of filing, or failing to file, secured claims.

### *Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 193-198.*

A/CN.9/419, paras. 84-87.

A/CN.9/422, paras. 188-191.

A/CN.9/433, paras. 86-98.

A/CN.9/435, paras. 157-164.

## *E. Chapter III. Recognition of a foreign proceeding and relief*

### *Article 15. Application for recognition of a foreign proceeding*

1. A foreign representative may apply to the court for recognition of the foreign proceeding in which the foreign representative has been appointed.

2. An application for recognition shall be accompanied by:

(a) A certified copy of the decision commencing the foreign proceeding and appointing the foreign representative; or

(b) A certificate from the foreign court affirming the existence of the foreign proceeding and of the appointment of the foreign representative; or

(c) In the absence of evidence referred to in subparagraphs (a) and (b), any other evidence acceptable to the court of the existence of the foreign proceeding and of the appointment of the foreign representative.

3. An application for recognition shall also be accompanied by a statement identifying all foreign proceedings in respect of the debtor that are known to the foreign representative.

4. The court may require a translation of documents supplied in support of the application for recognition into an official language of this State.

<sup>o</sup>Ibid., vol. 847, No. 12140.

*Article 15 as a whole*

112. Article 15 defines the core procedural requirements for an application by a foreign representative for recognition. In incorporating the provision into national law, it is desirable not to encumber the process with additional requirements beyond those referred to. With article 15, in conjunction with article 16, the Model Law provides a simple, expeditious structure to be used by a foreign representative to obtain recognition.

*Article 15, paragraph 2, and article 16, paragraph 2*

113. The Model Law presumes that documents submitted in support of the application for recognition need not be authenticated in any special way, in particular by legalization: according to article 16, paragraph 2, the court is entitled to presume that those documents are authentic whether or not they have been legalized. “Legalization” is a term often used for the formality by which a diplomatic or consular agent of the State in which the document is to be produced certifies the authenticity of the signature, the capacity in which the person signing the document has acted and, where appropriate, the identity of the seal or stamp on the document.

114. It follows from article 16, paragraph 2, (according to which the court “is entitled to presume” the authenticity of documents accompanying the application for recognition) that the court retains discretion to decline to rely on the presumption of authenticity or to conclude that evidence to the contrary prevails. This flexible solution takes into account the fact that the court may be able to assure itself that a particular document originates from a particular court even without it being legalized, but that in other cases the court may be unwilling to act on the basis of a foreign document that has not been legalized, in particular when documents emanate from a jurisdiction with which it is not familiar. The presumption is useful because legalization procedures may be cumbersome and time-consuming (e.g. also because in some States they involve various authorities at different levels).

115. In respect of the provision relaxing any requirement of legalization, the question may arise whether that is in conflict with the international obligations of the enacting State. Several States are parties to bilateral or multilateral treaties on mutual recognition and legalization of documents, such as the Convention Abolishing the Requirement of Legalisation for Foreign Documents of 1961,<sup>p</sup> adopted under the auspices of the Hague Conference on Private International Law, which provides specific simplified procedures for the legalization of documents originating from signatory States. In many instances, however, the treaties on legalization of documents, like letters rogatory and similar formalities, leave in effect laws and regulations that have abolished or simplified legalization procedures; therefore a conflict is unlikely to arise. For example, as stated in article 3, paragraph 2, of the above-mentioned convention:

“However, [legalisation] cannot be required when either the laws, regulations, or practice in force in the State where the document is produced or an agreement between two or more Contracting States have abolished or simplified it, or exempt the document itself from legalisation.”

According to article 3 of the Model Law, if there is still a conflict between the Model Law and a treaty, the treaty will prevail.

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<sup>p</sup>Ibid., vol. 527, No. 7625.

*Subparagraph 2 (c)*

116. In order not to prevent recognition because of non-compliance with a mere technicality (e.g. where the applicant is unable to submit documents that in all details meet the requirements of subparas. 2 (a) and (b)), subparagraph 2 (c) allows evidence other than that specified in subparagraphs 2 (a) and (b) to be taken into account; that provision, however, does not compromise the court's power to insist on the presentation of evidence acceptable to it. It is advisable to maintain that flexibility in enacting the Model Law. Article 16, paragraph 2, which provides that the court "is entitled to presume" the authenticity of documents accompanying the application for recognition, also applies to documents submitted under subparagraph 2 (c) (see paras. 114 and 115 above).

*Paragraph 3*

117. Paragraph 3 requires that an application for recognition must be accompanied by a statement identifying all foreign proceedings in respect of the debtor that are known to the foreign representative. That information is needed by the court not so much for the decision on recognition itself but for any decision granting relief in favour of the foreign proceeding. In order to tailor such relief appropriately and make sure that the relief is consistent with any other insolvency proceeding concerning the same debtor, the court needs to be aware of all foreign proceedings concerning the debtor that may be under way in third States.

118. An express provision establishing the duty to inform is useful, firstly, because the foreign representative is likely to have more comprehensive information about the debtor's affairs in third States than the court and, secondly, because the foreign representative may be primarily concerned with obtaining relief in favour of his or her foreign proceeding and less concerned about coordination with another foreign proceeding. (The duty to inform the court about a foreign proceeding that becomes known to the foreign representative after the decision on recognition is set out in article 18; as for coordination of more than one foreign proceeding, see article 30.)

*Paragraph 4*

119. Paragraph 4 entitles, but does not compel, the court to require a translation of some or all documents accompanying the application for recognition. If that discretion is compatible with the procedures of the court, it is useful since it allows, when the court understands the documents, to shorten the time needed for a decision on recognition and reduces costs.

*Notice*

120. Different solutions exist also as to whether the court is required to issue notice of an application for recognition. In a number of jurisdictions, fundamental principles of due process, in some cases enshrined in the constitution, may be understood as requiring that a decision on the importance of the recognition of a foreign insolvency proceeding could only be made after hearing the affected parties. In other States, however, it is considered that applications for recognition of foreign proceedings require expeditious treatment (as they are often submitted in circumstances of imminent danger of dissipation or concealment of the assets) and that, because of this need for expeditiousness, the issuance of notice prior to any court decision on recognition is not required. According to that way of thinking, imposing the requirement would cause

undue delay and would be inconsistent with article 17, paragraph 3, which provides that an application for recognition of a foreign proceeding should be decided upon at the earliest possible time.

121. Procedural matters related to such notice are not resolved by the Model Law and are thus governed by other provisions of law of the enacting State. The absence of an express reference to notice of the filing of an application for recognition or of the decision to grant recognition does not preclude the court from issuing such notice, where legally required, in pursuance of its own rules on civil or insolvency proceedings. By the same token, there is nothing in the Model Law that would mandate the issuance of such notice, where such requirement does not exist.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 199-209.*

A/CN.9/419, paras. 62-69 and 178-189.

A/CN.9/422, paras. 76-93 and 152-159.

A/CN.9/433, paras. 59-67 and 99-104.

A/CN.9/435, paras. 165-173.

*Article 16. Presumptions concerning recognition*

1. If the decision or certificate referred to in paragraph 2 of article 15 indicates that the foreign proceeding is a proceeding within the meaning of subparagraph (a) of article 2 and that the foreign representative is a person or body within the meaning of subparagraph (d) of article 2, the court is entitled to so presume.

2. The court is entitled to presume that documents submitted in support of the application for recognition are authentic, whether or not they have been legalized.

3. In the absence of proof to the contrary, the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the centre of the debtor's main interests.

122. Article 16 establishes presumptions that allow the court to expedite the evidentiary process; at the same time they do not prevent, in accordance with the applicable procedural law, calling for or assessing other evidence if the conclusion suggested by the presumption is called into question by the court or an interested party.

123. For comments on paragraph 2, which dispenses with the requirement of legalization, see paragraphs 113-115 above.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 204-206.*

A/CN.9/435, paras. 170-172.

*Article 17. Decision to recognize a foreign proceeding*

1. Subject to article 6, a foreign proceeding shall be recognized if:
  - (a) The foreign proceeding is a proceeding within the meaning of subparagraph (a) of article 2;
  - (b) The foreign representative applying for recognition is a person or body within the meaning of subparagraph (d) of article 2;
  - (c) The application meets the requirements of paragraph 2 of article 15; and
  - (d) The application has been submitted to the court referred to in article 4.
2. The foreign proceeding shall be recognized:
  - (a) As a foreign main proceeding if it is taking place in the State where the debtor has the centre of its main interests; or
  - (b) As a foreign non-main proceeding if the debtor has an establishment within the meaning of subparagraph (f) of article 2 in the foreign State.
3. An application for recognition of a foreign proceeding shall be decided upon at the earliest possible time.
4. The provisions of articles 15, 16, 17 and 18 do not prevent modification or termination of recognition if it is shown that the grounds for granting it were fully or partially lacking or have ceased to exist.

*Paragraphs 1-3*

124. The purpose of article 17 is to indicate that, if recognition is not contrary to the public policy of the enacting State and if the application meets the requirements set out in the article, recognition will be granted as a matter of course.

125. Apart from the public policy exception (see art. 6), the conditions for recognition do not include those which would allow the court considering the application to evaluate the merits of the foreign court's decision by which the proceeding has been commenced or the foreign representative appointed. The foreign representative's ability to obtain early recognition (and the consequential ability to invoke in particular arts. 20, 21, 23 and 24) is often essential for the effective protection of the assets of the debtor from dissipation and concealment. For that reason, paragraph 3 obligates the court to decide on the application "at the earliest possible time" and the court should in practice be able to conclude the recognition process within such a short period of time.



126. Article 17 draws in paragraph 2 the basic distinction between foreign proceedings categorized as the “main” proceedings and foreign proceedings that are not so characterized, depending upon the jurisdictional basis of the foreign proceeding (see para. 75 above). The relief flowing from recognition may depend upon the category into which a foreign proceeding falls. For example, recognition of a “main” proceeding triggers an automatic stay of individual creditor actions or executions concerning the assets of the debtor (art. 20, para. 1 (a) and (b)) and an automatic “freeze” of those assets (art. 20, para. 1 (c)), subject to certain exceptions referred to in article 20, paragraph 2.

127. It is not advisable to include more than one criterion for qualifying a foreign proceeding as a main proceeding and provide that on the basis of any of those criteria a proceeding could be deemed a main proceeding. An approach involving such a “multiple criteria” would raise the risk of competing claims from foreign *proceedings for recognition as the main proceeding*.

128. With regard to subparagraph 2 (b), as noted in paragraph 73 above, the Model Law does not envisage recognition of a proceeding commenced in a foreign State in which the debtor has assets but no establishment as defined in article 2, subparagraph (c).

#### *Paragraph 4*

129. A decision to recognize a foreign proceeding would normally be subject to review or rescission, as any other court decision. Paragraph 4 clarifies that the question of revisiting the decision on recognition, if grounds for granting it were fully or partially lacking or have ceased to exist, is left to the procedural law of the enacting State other than the provisions implementing the Model Law.

130. Modification or termination of the recognition decision may be a consequence of a change of circumstances after the decision on recognition, for instance, if the recognized foreign proceeding has been terminated or its nature has changed (e.g. a reorganization proceeding might be transformed into a liquidation proceeding). Also, new facts might arise that require or justify a change of the court’s decision, for example, if the foreign representative disregarded the conditions under which the court granted relief.

131. A decision on recognition may also be subject to a review of whether in the decision-making process the requirements for recognition were observed. Some appeal procedures under national laws give the appeal court the authority to review the merits of the case in its entirety, including factual aspects. It would be consistent with the purpose of the Model Law and with the nature of the decision granting recognition (which is limited to verifying whether the applicant fulfilled the requirements of art. 17) if an appeal of the decision would be limited to the question whether the requirements of articles 15 and 16 were observed in deciding to recognize the foreign proceeding.

#### *Notice of decision to recognize foreign proceedings*

132. As noted in paragraphs 120 and 121 above, procedural matters regarding requirements of notice of the decision to grant recognition are not dealt with by the Model Law and are left to other provisions of law of the enacting State.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 29-33, 201 and 202.*

A/CN.9/419, paras. 62-69.

A/CN.9/422, paras. 76-93.

A/CN.9/433, paras. 99-104.

A/CN.9/435, paras. 167 and 173.

*Article 18. Subsequent information*

From the time of filing the application for recognition of the foreign proceeding, the foreign representative shall inform the court promptly of:

(a) Any substantial change in the status of the recognized foreign proceeding or the status of the foreign representative's appointment; and

(b) Any other foreign proceeding regarding the same debtor that becomes known to the foreign representative.

*Subparagraph (a)*

133. It is possible that, after the application for recognition or after recognition, changes occur in the foreign proceeding that would have affected the decision on recognition or the relief granted on the basis of recognition. For example, the foreign proceeding may be terminated or transformed from a liquidation proceeding into a reorganization proceeding, or the terms of the appointment of the foreign representative may be modified or the appointment itself terminated. Subparagraph (a) takes into account the fact that technical modifications in the status of the proceedings or the terms of the appointment are frequent, but that only some of those modifications are such that they would affect the decision granting relief or the decision recognizing the proceeding; therefore, the provision only calls for information of "substantial" changes. The court would likely be particularly anxious to be kept so informed when its decision on recognition concerns a foreign "interim proceeding" or a foreign representative has been "appointed on an interim basis" (see art. 2, subparas. (a) and (d)).

*Subparagraph (b)*

134. Article 15, paragraph 3, requires that an application for recognition be accompanied by a statement identifying all foreign proceedings in respect of the debtor that are known to the foreign representative. Article 18, subparagraph (b), extends that duty to the time after the application for recognition has been filed. That information will allow the court to consider whether relief already granted should be coordinated with the existence of the insolvency proceedings that have been commenced after the decision on recognition (see art. 30).

*Discussion in UNCITRAL*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 113-116, 201, 202 and 207.*

*Article 19. Relief that may be granted upon application  
for recognition of a foreign proceeding*

1. From the time of filing an application for recognition until the application is decided upon, the court may, at the request of the foreign representative, where relief is urgently needed to protect the assets of the debtor or the interests of the creditors, grant relief of a provisional nature, including:

(a) Staying execution against the debtor's assets;

(b) Entrusting the administration or realization of all or part of the debtor's assets located in this State to the foreign representative or another 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;

(c) Any relief mentioned in paragraph 1 (c), (d) and (g) of article 21.

2. *[Insert provisions (or refer to provisions in force in the enacting State) relating to notice.]*

3. Unless extended under paragraph 1 (f) of article 21, the relief granted under this article terminates when the application for recognition is decided upon.

4. The court may refuse to grant relief under this article if such relief would interfere with the administration of a foreign main proceeding.

*Paragraph 1*

135. Article 19 deals with "urgently needed" relief that may be ordered at the discretion of the court and is available as of the moment of the application for recognition (unlike relief under art. 21, which is also discretionary but which is available only upon recognition).

136. Article 19 authorizes the court to grant the type of relief that is usually available only in collective insolvency proceedings (i.e. the same type of relief available under art. 21), as opposed to the "individual" type of relief that may be granted before the commencement of insolvency proceedings under rules of civil procedure (i.e. measures covering specific assets identified by a creditor). However, the discretionary "collective" relief under article 19 is somewhat more narrow than the relief under article 21.

137. The reason for the availability of collective measures, albeit in a restricted form, is that relief of a collective nature may be urgently needed already before the decision on recognition in order to protect the assets of the debtor and the interests of the

creditors. Exclusion of collective relief would frustrate those objectives. On the other hand, recognition has not yet been granted and, therefore, the collective relief is restricted to urgent and provisional measures. The urgency of the measures is alluded to in the opening words of paragraph 1, while subparagraph (a) restricts the stay to execution proceedings and the measure referred to in subparagraph (b) is restricted to perishable assets and assets susceptible to devaluation or otherwise in jeopardy. Otherwise, the measures available under article 19 are essentially the same as those available under article 21.

#### *Paragraph 2*

138. Laws of many States contain requirements for notice to be given (either by the insolvency administrator upon the order of the court or by the court itself) when relief of the type mentioned in article 19 is granted. Paragraph 2 is the location where the enacting State should make appropriate provision for such notice.

#### *Paragraph 3*

139. Relief available under article 19 is provisional in that, as provided in paragraph 3, the relief terminates when the application for recognition is decided upon; however, the court is given the opportunity to extend the measure, as provided in article 21, paragraph 1 (f). The court might wish to do so, for example, to avoid a hiatus between the provisional measure issued before recognition and the measure issued after recognition.

#### *Paragraph 4*

140. Article 19, paragraph 4, pursues the same objective as the one underlying article 30, subparagraph (a), namely that, if there is a foreign main proceeding pending, any relief granted in favour of a foreign non-main proceeding must be consistent (or should not interfere) with the foreign main proceeding. In order to foster such coordination of pre-recognition relief with any foreign main proceeding, the foreign representative applying for recognition is required, by article 15, paragraph 3, to attach to the application for recognition a statement identifying all foreign proceedings with respect to the debtor that are known to the foreign representative.

#### *Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 34-46.*

A/CN.9/419, paras. 174-177.

A/CN.9/422, paras. 116, 119, 122 and 123.

A/CN.9/433, paras. 110-114.

A/CN.9/435, paras. 17-23.

*Article 20. Effects of recognition of a foreign main proceeding*

1. Upon recognition of a foreign proceeding that is a foreign main proceeding:

(a) Commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities is stayed;

(b) Execution against the debtor's assets is stayed; and

(c) The right to transfer, encumber or otherwise dispose of any assets of the debtor is suspended.

2. The scope, and the modification or termination, of the stay and suspension referred to in paragraph 1 of this article are subject to [*refer to any provisions of law of the enacting State relating to insolvency that apply to exceptions, limitations, modifications or termination in respect of the stay and suspension referred to in paragraph 1 of this article*].

3. Paragraph 1 (a) of this article does not affect the right to commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor.

4. Paragraph 1 of this article does not affect the right to request the commencement of a proceeding under [*identify laws of the enacting State relating to insolvency*] or the right to file claims in such a proceeding.

141. While relief under articles 19 and 21 is discretionary, the effects provided by article 20 are not, for they flow automatically from recognition of the foreign main proceeding. Another difference between discretionary relief under articles 19 and 21 and the effects under article 20 is that discretionary relief may be issued in favour of main and non-main proceedings, while the automatic effects apply only to main proceedings.

142. In States where an appropriate court order is needed for the effects of article 20 to become operative, the enacting State, in order to achieve the purpose of the article, should include (perhaps in the opening words of paragraph 1) language directing the court to issue an order putting into effect the consequences specified in subparagraphs (a)-(c) of that paragraph.

143. The automatic consequences envisaged in article 20 are necessary to allow steps to be taken to organize an orderly and fair cross-border insolvency proceeding. In order to achieve those benefits, it is justified to impose on the insolvent debtor the consequences of article 20 in the enacting State (i.e. the country where it maintains a limited business presence), even if the State where the centre of the debtor's main interests is situated poses different (possibly less stringent) conditions for the commencement of insolvency proceedings or even if the automatic effects of the insolvency proceeding in the country of origin are different from the effects of article 20 in the enacting State. This approach reflects a basic principle underlying the Model Law according to which recognition of foreign proceedings by the court of the enacting State grants effects that are considered necessary for an orderly and fair conduct of a cross-border insolvency. Recognition, therefore, has its own effects rather than importing the consequences of the

foreign law into the insolvency system of the enacting State. If recognition should in a given case produce results that would be contrary to the legitimate interests of an interested party, including the debtor, the law of the enacting State should provide possibilities for protecting those interests, as indicated in article 20, paragraph 2 (and discussed in para. 149 below).

144. By virtue of article 2, subparagraph (a), the effects of recognition extend also to foreign “interim proceedings”. That solution is necessary since, as explained in paragraph 69 above, interim proceedings (provided they meet the requisites of article 2, subparagraph (a)), should not be distinguished from other insolvency proceedings merely because they are of an interim nature. If after recognition the foreign “interim proceeding” ceases to have a sufficient basis for the automatic effects of article 20, the automatic stay could be terminated pursuant to the law of the enacting State, as indicated in article 20, paragraph 2. (See also article 18, which deals with the obligation of the foreign representative “to inform the court promptly of any substantial change in the status of the recognized foreign proceeding or the status of the foreign representative’s appointment”.)

145. Paragraph 1 (a), by not distinguishing between various kinds of individual action, also covers actions before an arbitral tribunal. Thus, article 20 establishes a mandatory limitation to the effectiveness of an arbitration agreement. This limitation is added to other possible limitations restricting the freedom of the parties to agree to arbitration that may exist under national law (e.g. limits as to arbitrability or as to the capacity to conclude an arbitration agreement). Such limitations are not contrary to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958.<sup>9</sup> However, bearing in mind the particularities of international arbitration, in particular its relative independence from the legal system of the State where the arbitral proceeding takes place, it might not always be possible, in practical terms, to implement the automatic stay of arbitral proceedings. For example, if the arbitration does not take place in the enacting State and perhaps also not in the State of the main proceeding, it may be difficult to enforce the stay of the arbitral proceedings. Apart from that, the interests of the parties may be a reason for allowing an arbitral proceeding to continue, a possibility that is envisaged in paragraph 2 and left to the provisions of law of the enacting State.

146. Paragraph 1 (a) refers not only to “individual actions” but also to “individual proceedings” in order to cover, in addition to “actions” instituted by creditors in a court against the debtor or its assets, also enforcement measures initiated by creditors outside the court system, measures that creditors are allowed to take under certain conditions in some States. Paragraph 1 (b) has been added to make it abundantly clear that executions against the assets of the debtor are covered by the stay.

147. The Model Law does not deal with sanctions that might apply to acts performed in defiance of the suspension of transfers of assets provided under article 20, paragraph 1 (c). Those sanctions vary, depending on the legal system; they might include criminal sanctions, penalties and fines or the acts themselves might be void or capable of being set aside. From the viewpoint of creditors, the main purpose of such sanctions is to facilitate recovery for the insolvency proceeding of any assets improperly transferred by the debtor and, for that purpose, the setting aside of such transactions is preferable to the imposition of criminal or administrative sanctions on the debtor.

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<sup>9</sup>Ibid., vol. 330, No. 4739.

### *Paragraph 2*

148. Notwithstanding the “automatic” or “mandatory” nature of the effects under article 20, it is expressly provided that the scope of those effects depends on exceptions or limitations that may exist in the law of the enacting State. Those exceptions may be, for example, the enforcement of claims by secured creditors, payments by the debtor in the ordinary course of business, initiation of court action for claims that have arisen after the commencement of the insolvency proceeding (or after recognition of a foreign main proceeding) or completion of open financial-market transactions.

149. Sometimes it may be desirable for the court to modify or terminate the effects of article 20. The rules governing the power of the court to do so vary. In some legal systems the courts are authorized to make individual exceptions upon request by an interested party, under conditions prescribed by local law, while in others the courts do not have that power, in line with the principle that, in general, courts do not have the power to set aside the application of a statutory rule of law. If courts are to be given such a power, some legal systems would normally require setting out grounds on which the court could modify or terminate the mandatory effects of recognition under article 20, paragraph 1. In view of that situation, article 20, paragraph 2, provides that the modification or termination of the stay and the suspension provided in the article is subject to the provisions of law of the enacting State relating to insolvency.

150. Generally, it is useful for persons that are adversely affected by the stay or suspension under article 20, paragraph 1, to have an opportunity to be heard by the court, which should then be allowed to modify or terminate those effects. It would be consistent with the objectives of the Model Law if the enacting State were to spell out, or refer to, the provisions that govern this question.

### *Paragraph 3*

151. The Model Law does not cover the question of whether the limitation period for a claim ceases to run when the claimant is unable to commence individual proceedings as a result of article 20, paragraph 1 (*a*). A harmonized rule on that question would not be feasible; however, since it is necessary to protect creditors from losing their claims because of a stay pursuant to paragraph 1 (*a*), paragraph 3 has been added to authorize the commencement of individual action to the extent necessary to preserve claims against the debtor. Once the claim has been preserved, the action continues to be covered by the stay.

152. Paragraph 3 might seem unnecessary in a State where a demand for payment or performance served by the creditor on the debtor causes the cessation of the running of the limitation period or where the stay of the kind envisaged in paragraph 1 (*a*) triggers such cessation. However, paragraph 3 may still be useful even in such States because the question of the cessation of the running of the limitation period might, pursuant to rules concerning conflict of laws, be governed by the law of a State other than the enacting State; furthermore, the paragraph would be useful as assurance to foreign claimants that their claims would not be prejudiced in the enacting State.

### *Paragraph 4*

153. Paragraph 4 merely clarifies that the automatic stay and suspension pursuant to article 20 do not prevent anyone, including the foreign representative or foreign creditors, from requesting the commencement of a local insolvency proceeding and from participating in that proceeding. The right to apply to commence a local insolvency

proceeding and to participate in it is in a general way dealt with in articles 11-13. If a local proceeding is indeed initiated, article 29 deals with the coordination of the foreign and the local proceedings.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 47-60.*

A/CN.9/419, paras. 137-143.

A/CN.9/422, paras. 94-110.

A/CN.9/433, paras. 115-126.

A/CN.9/435, paras. 24-48.

*Article 21. Relief that may be granted upon recognition  
of a foreign proceeding*

1. Upon recognition of a foreign proceeding, whether main or non-main, where necessary to protect the assets of the debtor or the interests of the creditors, the court may, at the request of the foreign representative, grant any appropriate relief, including:

(a) Staying the commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities, to the extent they have not been stayed under paragraph 1 (a) of article 20;

(b) Staying execution against the debtor's assets to the extent it has not been stayed under paragraph 1 (b) of article 20;

(c) Suspending the right to transfer, encumber or otherwise dispose of any assets of the debtor to the extent this right has not been suspended under paragraph 1 (c) of article 20;

(d) Providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor's assets, affairs, rights, obligations or liabilities;

(e) Entrusting the administration or realization of all or part of the debtor's assets located in this State to the foreign representative or another person designated by the court;

(f) Extending relief granted under paragraph 1 of article 19;

(g) Granting any additional relief that may be available to [*insert the title of a person or body administering a reorganization or liquidation under the law of the enacting State*] under the laws of this State.

2. Upon recognition of a foreign proceeding, whether main or non-main, the court may, at the request of the foreign representative, entrust the distribution of all or part of the debtor's assets located in this State to the



foreign representative or another person designated by the court, provided that the court is satisfied that the interests of creditors in this State are adequately protected.

3. In granting relief under this article to a representative of a foreign non-main proceeding, the court must be satisfied that the relief relates to assets that, under the law of this State, should be administered in the foreign non-main proceeding or concerns information required in that proceeding.

154. Post-recognition relief under article 21 is discretionary, as is pre-recognition relief under article 19. The types of relief listed in article 21, paragraph 1, are typical of or most frequent in insolvency proceedings; however, the list is not exhaustive and the court is not restricted unnecessarily in its ability to grant any type of relief that is available under the law of the enacting State and needed in the circumstances of the case.

155. The explanation relating to the use of the expressions “individual actions” and “individual proceedings” in article 20, subparagraph 1 (a), and to coverage of execution proceedings (see paras. 145 and 146 above) applies also to article 21, subparagraph 1 (a).

156. It is in the nature of discretionary relief that the court may tailor it to the case at hand. This idea is reinforced by article 22, paragraph 2, according to which the court may subject the relief granted to conditions that it considers appropriate.

#### *Paragraph 2*

157. The “turnover” of assets to the foreign representative (or another person), as envisaged in paragraph 2, is discretionary. It should be noted that the Model Law contains several safeguards designed to ensure the protection of local interests before assets are turned over to the foreign representative. Those safeguards include the following: the general statement of the principle of protection of local interests in article 22, paragraph 1; the provision in article 21, paragraph 2, that the court should not authorize the turnover of assets until it is assured that the local creditors’ interests are protected; and article 22, paragraph 2, according to which the court may subject the relief that it grants to conditions it considers appropriate.

#### *Paragraph 3*

158. One salient factor to be taken into account in tailoring the relief is whether it is for a foreign main or non-main proceeding. The interests and the authority of a representative of a foreign non-main proceeding are typically narrower than the interests and the authority of a representative of a foreign main proceeding, who normally seeks to gain control over all assets of the insolvent debtor. Paragraph 3 reflects that idea by providing (a) that relief granted to a foreign non-main proceeding should be limited to assets that are to be administered in that non-main proceeding and (b) that, if the foreign representative seeks information concerning the debtor’s assets or affairs, the relief must concern information required in that proceeding. The objective is to admonish the court that relief in favour of a foreign non-main proceeding should not give unnecessarily broad powers to the foreign representative and that such relief should not interfere with the administration of another insolvency proceeding, in particular the main proceeding.

159. The proviso “under the law of this State” reflects the principle underlying the Model Law that recognition of a foreign proceeding does not mean extending the effects of the foreign proceeding as they may be prescribed by the law of the foreign State. Instead, recognition of a foreign proceeding entails attaching to the foreign proceeding consequences envisaged by the law of the enacting State.

160. The idea underlying article 21, paragraph 3, has been reflected also in article 19, paragraph 4 (pre-recognition relief), article 29, subparagraph (c) (coordination of a foreign proceeding with a local proceeding) and article 30 (coordination of more than one foreign proceeding).

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 61-73.*

A/CN.9/419, paras. 148-152 and 154-166.

A/CN.9/422, paras. 111-113.

A/CN.9/433, paras. 127-134, 138 and 139.

A/CN.9/435, paras. 49-61.

*Article 22. Protection of creditors and other interested persons*

1. In granting or denying relief under article 19 or 21, or in modifying or terminating relief under paragraph 3 of this article, the court must be satisfied that the interests of the creditors and other interested persons, including the debtor, are adequately protected.
2. The court may subject relief granted under article 19 or 21 to conditions it considers appropriate.
3. The court may, at the request of the foreign representative or a person affected by relief granted under article 19 or 21, or at its own motion, modify or terminate such relief.

161. The idea underlying article 22 is that there should be a balance between relief that may be granted to the foreign representative and the interests of the persons that may be affected by such relief. This balance is essential to achieve the objectives of cross-border insolvency legislation.

162. The reference to the interests of creditors, the debtor and other interested parties in article 22, paragraph 1, provides useful elements to guide the court in exercising its powers under article 19 or 21. In order to allow the court to tailor the relief better, the court is clearly authorized to subject the relief to conditions (para. 2) and to modify or terminate the relief granted (para. 3). An additional feature of paragraph 3 is that it expressly gives standing to the parties who may be affected by the consequences of

articles 19 and 21 to petition the court to modify and terminate those consequences. Apart from that, article 22 is intended to operate in the context of the procedural system of the enacting State.

163. In many cases the affected creditors will be “local” creditors. Nevertheless, in enacting article 22, it is not advisable to attempt to limit it to local creditors. Any express reference to local creditors in paragraph 1 would require a definition of those creditors. An attempt to draft such a definition (and to establish criteria according to which a particular category of creditors might receive special treatment) would not only show the difficulty of crafting such a definition but would also reveal that there is no justification for discriminating creditors on the basis of criteria such as place of business or nationality.

164. Protection of all interested persons is linked to provisions in national laws on notification requirements; those may be general publicity requirements, designed to apprise potentially interested persons (e.g. local creditors or local agents of a debtor) that a foreign proceeding has been recognized or there may be requirements for individual notifications that the court, under its own procedural rules, has to issue to persons that would be directly affected by recognition or relief granted by the court. National laws vary as to the form, time and content of notice required to be given of the recognition of foreign proceedings and the Model Law does not attempt to modify those laws (see also para. 132 above).

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 82-93.*

A/CN.9/422, para. 113.

A/CN.9/433, paras. 140-146.

A/CN.9/435, paras. 72-78.

*Article 23. Actions to avoid acts detrimental to creditors*

1. Upon recognition of a foreign proceeding, the foreign representative has standing to initiate [*refer to the types of action to avoid or otherwise render ineffective acts detrimental to creditors that are available in this State to a person or body administering a reorganization or liquidation*].

2. When the foreign proceeding is a foreign non-main proceeding, the court must be satisfied that the action relates to assets that, under the law of this State, should be administered in the foreign non-main proceeding.

165. Under many national laws both individual creditors and insolvency administrators have a right to bring actions to avoid or otherwise render ineffective acts detrimental to creditors. Such a right, insofar as it pertains to individual creditors, is often not governed by insolvency law but by general provisions of law (such as the civil code);

the right is not necessarily tied to the existence of an insolvency proceeding against the debtor so that the action may be instituted prior to the commencement of such a proceeding. The person having such a right is typically only an affected creditor and not another person such as the insolvency administrator. Furthermore, the conditions for these individual-creditor actions are different from the conditions applicable to similar actions that might be initiated by an insolvency administrator. The procedural standing conferred by article 23 extends only to actions that are available to the local insolvency administrator in the context of an insolvency proceeding and the article does not equate the foreign representative with individual creditors who may have similar rights under a different set of conditions. Such actions of individual creditors fall outside the scope of article 23.

166. The Model Law expressly provides that a foreign representative has “standing” (a concept in some systems referred to as “active procedural legitimation”, “active legitimation” or “legitimation”) to initiate actions to avoid or otherwise render ineffective legal acts detrimental to creditors. The provision is drafted narrowly in that it does not create any substantive right regarding such actions and also does not provide any solution involving conflict of laws. The effect of the provision is that a foreign representative is not prevented from initiating such actions by the sole fact that the foreign representative is not the insolvency administrator appointed in the enacting State.

167. Granting procedural standing to the foreign representative to institute such actions is not without difficulty. In particular, such actions might not be looked upon favourably because of their potential for creating uncertainty about concluded or performed transactions. However, since the right to commence such actions is essential to protect the integrity of the assets of the debtor and is often the only realistic way to achieve such protection, it has been considered important to ensure that such right would not be denied to a foreign representative on the sole ground that he or she has not been locally appointed.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 210-216.*

A/CN.9/433, para. 134.

A/CN.9/435, paras. 62-66.

*Article 24. Intervention by a foreign representative  
in proceedings in this State*

Upon recognition of a foreign proceeding, the foreign representative may, provided the requirements of the law of this State are met, intervene in any proceedings in which the debtor is a party.

168. The purpose of article 24 is to avoid the denial of standing to the foreign representative to intervene in proceedings merely because the procedural legislation may not have contemplated the foreign representative among those having such standing. The article applies to foreign representatives of both main and non-main proceedings.

169. The word “intervene” in the context of article 20 is intended to refer to cases where the foreign representative appears in court and makes representations in proceedings, whether those proceedings be individual court actions or other proceedings (including extrajudicial proceedings) instituted by the debtor against a third party or proceedings instituted by a third party against the debtor. The proceedings where the foreign representative might intervene could only be those which have not been stayed under article 20, paragraph 1 (a), or article 21, paragraph 1 (a).

170. Article 24, which is limited to providing procedural standing, makes it clear (by stating “provided the requirements of the law of this State are met”) that all other conditions of the local law for a person to be able to intervene remain intact.

171. Many if not all national procedural laws contemplate cases where a party (the foreign representative in this article) who demonstrates a legal interest in the outcome of a dispute between two other parties may be permitted by the court to be heard in the proceedings. Those procedural laws use different expressions to refer to such situations, the expression “intervention” being frequently used. If the enacting State uses another expression for that concept, the use of such other expression in enacting article 24 would be appropriate.

172. The word “participate” as used in the context of article 12 refers to cases where the foreign representative makes representations in a collective insolvency proceeding (see para. 102 above), whereas the word “intervene” as used in article 24 covers cases where the foreign representative takes part in proceedings concerning an individual action by or against the debtor.

#### *Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 117-123.*

A/CN.9/422, paras. 148 and 149.

A/CN.9/433, paras. 51 and 58.

A/CN.9/435, paras. 79-84.

#### *F. Chapter IV. Cooperation with foreign courts and foreign representatives*

173. Chapter IV (arts. 25-27), on cross-border cooperation, is a core element of the Model Law. Its objective is to enable courts and insolvency administrators from two or more countries to be efficient and achieve optimal results. Cooperation as described in the chapter is often the only realistic way, for example, to prevent dissipation of assets, to maximize the value of assets (e.g. when items of production equipment located in two States are worth more if sold together than if sold separately) or to find the best solutions for the reorganization of the enterprise.

174. Articles 25 and 26 not only authorize cross-border cooperation, they also mandate it by providing that the court and the insolvency administrator “shall cooperate to the maximum extent possible”. The articles are designed to overcome the widespread problem of national laws lacking rules providing a legal basis for cooperation by local courts with foreign courts in dealing with cross-border insolvencies. Enactment of such

a legal basis would be particularly helpful in legal systems in which the discretion given to judges to operate outside areas of express statutory authorization is limited. However, even in jurisdictions in which there is a tradition of wider judicial latitude, enactment of a legislative framework for cooperation has proved to be useful.

175. To the extent that cross-border judicial cooperation in the enacting State is based on the principle of comity among nations, the enactment of articles 25-27 offers an opportunity for making that principle more concrete and adapted to the particular circumstances of cross-border insolvencies.

176. In the States in which the proper legal basis for international cooperation in the area of cross-border insolvency is not the principle of comity, but an international agreement (e.g. a bilateral or multilateral treaty or an exchange of letters between the cooperating authorities) based on the principle of reciprocity, chapter IV of the Model Law may serve as a model for the development of such international cooperation agreements.

177. The articles in chapter IV leave certain decisions, in particular when and how to cooperate, to the courts and, subject to the supervision of the courts, to the insolvency administrators. For a court (or a person or body referred to in arts. 25 and 26) to cooperate with a foreign court or a foreign representative regarding a foreign proceeding, the Model Law does not require a previous formal decision to recognize that foreign proceeding.

178. The importance of granting the courts flexibility and discretion in cooperating with foreign courts or foreign representatives was emphasized at the Second UNCITRAL/INSOL Multinational Judicial Colloquium on Cross-Border Insolvency. At that Colloquium, reports of a number of cases in which judicial cooperation in fact occurred were given by the judges involved in the cases. From those reports a number of points emerged that might be summarized as follows: (a) communication between courts is possible but should be done carefully and with appropriate safeguards for the protection of substantive and procedural rights of the parties; (b) communication should be done openly, in the presence of the parties involved (except in extreme circumstances), who should be given advance notice; (c) communications that might be exchanged are various and include, for example, exchanges of formal court orders or judgements; supply of informal writings of general information, questions and observations; and transmission of transcripts of court proceedings; (d) means of communication include, for example, telephone, facsimile, electronic mail facilities and video; and (e) where communication is necessary and is intelligently used, there could be considerable benefits for the persons involved in, and affected by, the cross-border insolvency.

*Article 25. Cooperation and direct communication between a court of this State and foreign courts or foreign representatives*

1. In matters referred to in article 1, the court shall cooperate to the maximum extent possible with foreign courts or foreign representatives, either directly or through a *[insert the title of a person or body administering a reorganization or liquidation under the law of the enacting State]*.

2. The court is entitled to communicate directly with, or to request information or assistance directly from, foreign courts or foreign representatives.

179. The ability of courts, with appropriate involvement of the parties, to communicate “directly” and to request information and assistance “directly” from foreign courts or foreign representatives is intended to avoid the use of time-consuming procedures traditionally in use, such as letters rogatory. This ability is critical when the courts consider that they should act with urgency. In order to emphasize the flexible and potentially urgent character of cooperation, the enacting State may find it useful to include in the enactment of the Model Law an express provision that would authorize the courts, when they engage in cross-border communications under article 25, to forgo use of the formalities (e.g. communication via higher courts, letters rogatory or other diplomatic or consular channels) that are inconsistent with the policy behind the provision.

*Article 26. Cooperation and direct communication between the  
[insert the title of a person or body administering  
a reorganization or liquidation under the  
law of the enacting State]  
and foreign courts or foreign representatives*

1. In matters referred to in article 1, a *[insert the title of a person or body administering a reorganization or liquidation under the law of the enacting State]* shall, in the exercise of its functions and subject to the supervision of the court, cooperate to the maximum extent possible with foreign courts or foreign representatives.

2. The *[insert the title of a person or body administering a reorganization or liquidation under the law of the enacting State]* is entitled, in the exercise of its functions and subject to the supervision of the court, to communicate directly with foreign courts or foreign representatives.

180. Article 26 on international cooperation between persons who are appointed to administer assets of insolvent debtors reflects the important role that such persons can play in devising and implementing cooperative arrangements, within the parameters of their authority. The provision makes it clear that an insolvency administrator acts under the overall supervision of the competent court (by stating “in the exercise of its functions and subject to the supervision of the court”). The Model Law does not modify the rules already existing in the insolvency law of the enacting State on the supervisory functions of the court over the activities of the insolvency administrator. Generally, a certain degree of latitude and initiative on the part of administrators, within the broad confines of judicial supervision, are mainstays of cooperation in practical terms; it is therefore advisable that the enacting State not change that in enacting the Model Law. In particular, there should be no suggestion that ad hoc authorization would be needed for each communication between the administrator and a foreign body.

*Article 27. Forms of cooperation*

Cooperation referred to in articles 25 and 26 may be implemented by any appropriate means, including:

- (a) Appointment of a person or body to act at the direction of the court;
- (b) Communication of information by any means considered appropriate by the court;
- (c) Coordination of the administration and supervision of the debtor's assets and affairs;
- (d) Approval or implementation by courts of agreements concerning the coordination of proceedings;
- (e) Coordination of concurrent proceedings regarding the same debtor;
- (f) [*The enacting State may wish to list additional forms or examples of cooperation*].

181. Article 27 is suggested to be used by the enacting State to provide courts with an indicative list of the types of cooperation that are authorized by articles 25 and 26. Such an indicative listing may be particularly helpful in States with a limited tradition of direct cross-border judicial cooperation and in States where judicial discretion has traditionally been limited. Any listing of forms of possible cooperation should not purport to be exhaustive, as this might inadvertently preclude certain forms of appropriate cooperation.

182. The implementation of cooperation would be subject to any mandatory rules applicable in the enacting State; for example, in the case of requests for information, rules restricting the communication of information (e.g. for reasons of protection of privacy) would apply.

183. Subparagraph (f) of article 27 offers the enacting State the possibility to include additional forms of possible cooperation. Those might include, for example, suspension or termination of existing proceedings in the enacting State.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 124-129.*

A/CN.9/419, paras. 75, 76, 80-83 and 118-133.

A/CN.9/422, paras 129-143.

A/CN.9/433, paras. 164-172.

A/CN.9/435, paras. 85-94.



*G. Chapter V. Concurrent proceedings*

*Article 28. Commencement of a proceeding under [identify laws of the enacting State relating to insolvency] after recognition of a foreign main proceeding*

After recognition of a foreign main proceeding, a proceeding under [*identify laws of the enacting State relating to insolvency*] may be commenced only if the debtor has assets in this State; the effects of that proceeding shall be restricted to the assets of the debtor that are located in this State and, to the extent necessary to implement cooperation and coordination under articles 25, 26 and 27, to other assets of the debtor that, under the law of this State, should be administered in that proceeding.

184. Article 28, in conjunction with article 29, provides that recognition of a foreign main proceeding will not prevent the commencement of a local insolvency proceeding concerning the same debtor as long as the debtor has assets in the State.

185. The position taken in article 28 is in substance the same as the position taken in a number of States. In some States, however, for the court to have jurisdiction to commence a local insolvency proceeding, the mere presence of assets in the State is not sufficient. For such jurisdiction to exist, the debtor must be engaged in an economic activity in the State (to use the terminology of the Model Law, the debtor must have an “establishment” in the State, as defined in art. 2, subpara. (f)). In article 28, the less restrictive solution was opted for in a context where the debtor is already involved in a foreign main proceeding. While the solution leaves a broad ground for commencing a local proceeding after recognition of a foreign main proceeding, it serves the purpose of indicating that, if the debtor has no assets in the State, there is no jurisdiction for commencing an insolvency proceeding.

186. Nevertheless, the enacting State may wish to adopt the more restrictive solution of allowing the initiation of the local proceeding only if the debtor has an establishment in the State. The rationale may be that, when the assets in the enacting State are not part of an establishment, the commencement of a local proceeding would typically not be the most efficient way to protect the creditors, including local creditors. By tailoring relief to be granted to the foreign main proceeding and cooperating with the foreign court and foreign representative, the court in the enacting State would have sufficient opportunities to ensure that the assets in the State would be administered in such a way that local interests would be adequately protected. Therefore, the enacting State would act in line with the philosophy of the Model Law if it enacts the article by replacing the words “only if the debtor has assets in this State”, as they currently appear in article 28, with the words “only if the debtor has an establishment in this State”.

187. Ordinarily, the local proceeding of the kind envisaged in article 28 would be limited to the assets located in the State. In some situations, however, a meaningful administration of the local insolvency proceeding may have to include certain assets abroad, especially when there is no foreign proceeding necessary or available in the State where the assets are situated (for example, where the local establishment would have an operating plant in a foreign jurisdiction, where it would be possible to sell the debtor’s assets in the enacting State and the assets abroad as a “going concern”, or where assets were fraudulently transferred abroad from the enacting State). In order to

allow such limited cross-border reach of a local proceeding, the article includes the words “and ... to other assets of the debtor that ... should be administered in that proceeding”. Two restrictions have been included in the article concerning the possible extension of effects of a local proceeding to assets located abroad: firstly, the extension is permissible “to the extent necessary to implement cooperation and coordination under articles 25, 26 and 27”; and, secondly, those foreign assets must be subject to administration in the enacting State “under the law of [the enacting State]”. Those restrictions are useful in order to avoid creating an open-ended faculty to extend the effects of a local proceeding to assets located abroad, a faculty that would generate uncertainty as to the application of the provision and that might lead to conflicts of jurisdiction.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 94-101.*

A/CN.9/422, paras. 192-197.

A/CN.9/433, paras. 173-181.

A/CN.9/435, paras. 180-183.

*Article 29. Coordination of a proceeding under  
[identify laws of the enacting State relating to insolvency]  
and a foreign proceeding*

Where a foreign proceeding and a proceeding under [*identify laws of the enacting State relating to insolvency*] are taking place concurrently regarding the same debtor, the court shall seek cooperation and coordination under articles 25, 26 and 27, and the following shall apply:

(a) When the proceeding in this State is taking place at the time the application for recognition of the foreign proceeding is filed,

- (i) Any relief granted under article 19 or 21 must be consistent with the proceeding in this State; and
- (ii) If the foreign proceeding is recognized in this State as a foreign main proceeding, article 20 does not apply;

(b) When the proceeding in this State commences after recognition, or after the filing of the application for recognition, of the foreign proceeding,

- (i) Any relief in effect under article 19 or 21 shall be reviewed by the court and shall be modified or terminated if inconsistent with the proceeding in this State; and
- (ii) If the foreign proceeding is a foreign main proceeding, the stay and suspension referred to in paragraph 1 of article 20 shall be modified or terminated pursuant to paragraph 2 of article 20 if inconsistent with the proceeding in this State;

(c) In granting, extending or modifying relief granted to a representative of a foreign non-main proceeding, the court must be satisfied that the relief relates to assets that, under the law of this State, should be administered in the foreign non-main proceeding or concerns information required in that proceeding.

188. Article 29 gives guidance to the court that deals with cases where the debtor is subject to a foreign proceeding and a local proceeding at the same time. The opening words of the provision direct the court that in all such cases it must seek cooperation and coordination pursuant to chapter IV (arts. 25-27) of the Model Law.

189. The salient principle embodied in article 29 is that the commencement of a local proceeding does not prevent or terminate the recognition of a foreign proceeding. This principle is essential for achieving the objectives of the Model Law in that it allows the court in the enacting State in all circumstances to provide relief in favour of the foreign proceeding.

190. However, the article maintains a pre-eminence of the local proceeding over the foreign proceeding. This has been done in the following ways: firstly, any relief to be granted to the foreign proceeding must be consistent with the local proceeding (art. 29, subpara. (a) (i)); secondly, any relief that has already been granted to the foreign proceeding must be reviewed and modified or terminated to ensure consistency with the local proceeding (art. 29, subpara. (b) (i)); thirdly, if the foreign proceeding is a main proceeding, the automatic effects pursuant to article 20 are to be modified and terminated if inconsistent with the local proceeding (those automatic effects do not terminate automatically since they may be beneficial, and the court may wish to maintain them) (art. 29, subpara. (b) (ii)); and fourthly, where a local proceeding is pending at the time a foreign proceeding is recognized as a main proceeding, the foreign proceeding does not enjoy the automatic effects of article 20 (art. 29, subpara. (a) (ii)). Article 29 avoids establishing a rigid hierarchy between the proceedings since that would unnecessarily hinder the ability of the court to cooperate and exercise its discretion under articles 19 and 21. It is desirable not to restrict that latitude of the court when article 29 is enacted.

191. Article 29, subparagraph (c), incorporates the principle that relief granted to a foreign non-main proceeding should be limited to assets that are to be administered in that non-main proceeding or must concern information required in that proceeding. That principle is expressed in article 21, paragraph 3, which deals in a general way with the type of relief that may be granted to a foreign representative, and is restated in article 29, which deals with coordination of local and foreign proceedings. Article 19, paragraph 4, on pre-recognition relief, and article 30, on coordination of more than one foreign proceeding, are inspired by the same principle (see also the comments in para. 140 above).

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 106-110.*

A/CN.9/435, paras. 190 and 191.

*Article 30. Coordination of more than one foreign proceeding*

In matters referred to in article 1, in respect of more than one foreign proceeding regarding the same debtor, the court shall seek cooperation and coordination under articles 25, 26 and 27, and the following shall apply:

*Article 30 (continued)*

(a) Any relief granted under article 19 or 21 to a representative of a foreign non-main proceeding after recognition of a foreign main proceeding must be consistent with the foreign main proceeding;

(b) If a foreign main proceeding is recognized after recognition, or after the filing of an application for recognition, of a foreign non-main proceeding, any relief in effect under article 19 or 21 shall be reviewed by the court and shall be modified or terminated if inconsistent with the foreign main proceeding;

(c) If, after recognition of a foreign non-main proceeding, another foreign non-main proceeding is recognized, the court shall grant, modify or terminate relief for the purpose of facilitating coordination of the proceedings.

192. Article 30 deals with cases where the debtor is subject to insolvency proceedings in more than one foreign State and foreign representatives of more than one foreign proceeding seek recognition or relief in the enacting State. The provision applies whether or not an insolvency proceeding is pending in the enacting State. If, in addition to two or more foreign proceedings, there is a proceeding in the enacting State, the court will have to act pursuant to both article 29 and article 30.

193. The objective of article 30 is similar to the objective of article 29 in that the key issue in the case of concurrent proceedings is to promote cooperation, coordination and consistency of relief granted to different proceedings. Such consistency will be achieved by appropriate tailoring of relief to be granted or by modifying or terminating relief already granted. Unlike article 29 (which, as a matter of principle, gives primacy to the local proceeding), article 30 gives preference to the foreign main proceeding if there is one. In the case of more than one foreign non-main proceeding, the provision does not a priori treat any foreign proceeding preferentially. Priority for the foreign main proceeding is reflected in the requirement that any relief in favour of a foreign non-main proceeding (whether already granted or to be granted) must be consistent with the foreign main proceeding (art. 30, subparas. (a) and (b)).

*Discussion in UNCITRAL*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 111 and 112.*

*Article 31. Presumption of insolvency based on recognition of a foreign main proceeding*

In the absence of evidence to the contrary, recognition of a foreign main proceeding is, for the purpose of commencing a proceeding under [*identify laws of the enacting State relating to insolvency*], proof that the debtor is insolvent.

194. In some jurisdictions, proof that the debtor is insolvent is required for the commencement of insolvency proceedings. In other jurisdictions, insolvency proceedings may be commenced under specific circumstances defined by law that do not necessarily mean that the debtor is in fact insolvent; those circumstances may be, for example, cessation of payments by the debtor or certain actions of the debtor such as a corporate decision, dissipation of its assets or abandonment of its establishment.

195. In jurisdictions where insolvency is a condition for commencing insolvency proceedings, article 31 establishes, upon recognition of a foreign main proceeding, a rebuttable presumption of insolvency of the debtor for the purposes of commencing an insolvency proceeding in the enacting State. The presumption does not apply if the foreign proceeding is a non-main proceeding. The reason is that an insolvency proceeding commenced in a State other than the State where the debtor has the centre of its main interests does not necessarily mean that the debtor is to be subject to laws relating to insolvency in other States.

196. For the national laws where proof that the debtor is insolvent is not required for the commencement of insolvency proceedings, the presumption established in article 31 may be of little practical significance and the enacting State may decide not to enact it.

197. Article 31 would have particular significance when proving insolvency as the prerequisite for an insolvency proceeding would be a time-consuming exercise and of little additional benefit, bearing in mind that the debtor is already in an insolvency proceeding in the State where it has the centre of its main interests and the commencement of a local proceeding may be urgently needed for the protection of local creditors. Nonetheless, the court of the enacting State is not bound by the decision of the foreign court, and local criteria for demonstrating insolvency remain operative, as is clarified by the words “in the absence of evidence to the contrary”.

*Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 94 and 102-105.*

A/CN.9/422, para. 196.

A/CN.9/433, paras. 173 and 180-189.

A/CN.9/435, paras. 180 and 184.

*Article 32. Rule of payment in concurrent proceedings*

Without prejudice to secured claims or rights *in rem*, a creditor who has received part payment in respect of its claim in a proceeding pursuant to a law relating to insolvency in a foreign State may not receive a payment for the same claim in a proceeding under [*identify laws of the enacting State relating to insolvency*] regarding the same debtor, so long as the payment to the other creditors of the same class is proportionately less than the payment the creditor has already received.

198. The rule set forth in article 32 (sometimes referred to as the “hotchpotch” rule) is a useful safeguard in a legal regime for coordination and cooperation in the administration of cross-border insolvency proceedings. It is intended to avoid situations in which a creditor might obtain more favourable treatment than the other creditors of the same class by obtaining payment of the same claim in insolvency proceedings in different jurisdictions. For example, an unsecured creditor has received 5 per cent of its claim in a foreign insolvency proceeding; that creditor also participates in the insolvency proceeding in the enacting State, where the rate of distribution is 15 per cent; in order to put the creditor in the equal position as the other creditors in the enacting State, the creditor would receive 10 per cent of its claim in the enacting State.

199. Article 32 does not affect the ranking of claims as established by the law of the enacting State and is solely intended to establish the equal treatment of creditors of the same class. To the extent claims of secured creditors or creditors with rights *in rem* are paid in full (a matter that depends on the law of the State where the proceeding is conducted), those claims are not affected by the provision.

200. The words “secured claims” are used to refer generally to claims guaranteed by particular assets, while the words “rights *in rem*” are intended to indicate rights relating to a particular property that are enforceable also against third parties. A given right may fall within the ambit of both expressions, depending on the classification and terminology of the applicable law. The enacting State may use another term or terms for expressing those concepts.

#### *Discussion in UNCITRAL and in the Working Group*

*Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17 (A/52/17), paras. 130-134.*

A/CN.9/419, paras. 89-93.

A/CN.9/422, paras. 198 and 199.

A/CN.9/433, paras. 182 and 183.

A/CN.9/435, paras. 96, 197 and 198.

## **VI. Assistance from the UNCITRAL secretariat**

### *A. Assistance in drafting legislation*

201. The UNCITRAL secretariat assists States with technical consultations for the preparation of legislation based on the Model Law. Further information may be obtained from the UNCITRAL secretariat (mailing address: Vienna International Centre, P.O. Box 500, 1400 Vienna, Austria; telephone: (+43-1) 26060-4060; facsimile: (+43-1) 26060-5813; electronic mail: [uncitral@uncitral.org](mailto:uncitral@uncitral.org); Internet home page: <http://www.uncitral.org>).

*B. Information on the interpretation of legislation  
based on the Model Law*

202. Once enacted, the Model Law will be included in the CLOUT information system, which is used for collecting and disseminating information on case law relating to the conventions and model laws that have emanated from the work of UNCITRAL. The purpose of the system is to promote international awareness of the legislative texts formulated by UNCITRAL and to facilitate their uniform interpretation and application. The secretariat publishes, in the six official languages of the United Nations, abstracts of decisions and makes available, against reimbursement of copying expenses, the decisions on the basis of which the abstracts were prepared. The system is explained in a user's guide that is available from the secretariat in hard copy (A/CN.9/SER.C/GUIDE/1) and on the above-mentioned Internet home page of UNCITRAL.





## Appendix

### General Assembly resolution 52/158 of 15 December 1997

#### **52/158. Model Law on Cross-Border Insolvency of the United Nations Commission on International Trade Law**

*The General Assembly,*

*Recalling* its resolution 2205 (XXI) of 17 December 1966, by which it created the United Nations Commission on International Trade Law with a mandate to further the progressive harmonization and unification of the law of international trade and in that respect to bear in mind the interests of all peoples, in particular those of developing countries, in the extensive development of international trade,

*Noting* that increased cross-border trade and investment leads to greater incidence of cases where enterprises and individuals have assets in more than one State,

*Noting also* that when a debtor with assets in more than one State becomes subject to an insolvency proceeding, there often exists an urgent need for cross-border cooperation and coordination in the supervision and administration of the insolvent debtor's assets and affairs,

*Considering* that inadequate coordination and cooperation in cases of cross-border insolvency reduce the possibility of rescuing financially troubled but viable businesses, impede a fair and efficient administration of cross-border insolvencies, make it more likely that the debtor's assets would be concealed or dissipated and hinder reorganizations or liquidations of debtors' assets and affairs that would be the most advantageous for the creditors and other interested persons, including the debtors and the debtors' employees,

*Noting* that many States lack a legislative framework that would make possible or facilitate effective cross-border coordination and cooperation,

*Convinced* that fair and internationally harmonized legislation on cross-border insolvency that respects the national procedural and judicial systems and is acceptable to States with different legal, social and economic systems would contribute to the development of international trade and investment,

*Considering* that a set of internationally harmonized model legislative provisions on cross-border insolvency is needed to assist States in modernizing their legislation governing cross-border insolvency,

1. *Expresses its appreciation* to the United Nations Commission on International Trade Law for completing and adopting the Model Law on Cross-Border Insolvency contained in the annex to the present resolution;

2. *Requests* the Secretary-General to transmit the text of the Model Law, together with the Guide to Enactment of the Model Law prepared by the Secretariat, to Governments and interested bodies;

3. *Recommends* that all States review their legislation on cross-border aspects of insolvency to determine whether the legislation meets the objectives of a modern and efficient insolvency system and, in that review, give favourable consideration to the Model Law, bearing in mind the need for an internationally harmonized legislation governing instances of cross-border insolvency;

4. *Recommends also* that all efforts be made to ensure that the Model Law, together with the Guide, become generally known and available.

*72nd plenary meeting*

*15 December 1997*

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<sup>a</sup> The references in the index are to the relevant part, chapter and paragraph of the *Legislative Guide*. For example, “Two II 135” refers to part two, chapter II, paragraph 135.

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