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Draft legislative guide on insolvency law

Report of the Secretary-General

Contents

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General remarks

1. This note sets forth Part Two of the draft legislative guide on insolvency law which deals with core provisions of an effective and efficient insolvency regime. Each subject area is divided into two sections. The first section offers an analytical introduction to the issues raised by each core subject area and discusses policy issues and comparative approaches. The second section provides a summary of the approaches discussed in the first section. Some of the approaches indicated in the summary are reflected in the draft provisions included in Part Three (see document A/CN.9/WG.V/WP.564/Add.2).

2. Where possible, treatment of the subject areas is divided into liquidation and reorganization to distinguish the different issues applicable to each procedure. The paragraphs entitled "General Remarks" are applicable to insolvency proceedings generally and are intended to provide an introduction to the following paragraphs.

3. The material in Part Two is largely based upon the work of the International Monetary Fund, the Asian Development Bank and the World Bank. The Working Group may wish to consider what different approaches and examples could be added to section for each subject area to expand the comparative analysis of different insolvency regimes. The Working Group may also wish to consider whether there are any subject areas and issues which should be addressed in the Guide in addition to those already discussed. Some additional issues that it may be desirable to include in the Guide are noted within square brackets (for example, under Treatment of contracts references are made to set-off and financial contracts and netting which are yet to be completed). Specific questions and issues for consideration by the Working Group are noted throughout the text. Section B has been completed in respect of a number of subject areas to assist the Working Group in considering what approaches it may wish to recommend and how these recommendations might be reflected in the Guide.

Draft legislative guide on insolvency law

Part Two

Core provisions of an effective and efficient insolvency regime

I. Relationship between liquidation and reorganization proceedings

1. General remarks

4. When a debtor is unable to discharge its debts and liabilities as they become due, the need arises to provide for a legal mechanism to address the collective satisfaction of the outstanding claims on all tangible and intangible assets pertaining to that debtor. Most legal systems contain rules on various types of proceedings that may be initiated to address that situation, which may be referred to by the generic

term “insolvency proceedings”. Two types of insolvency proceedings may be distinguished, for which uniform terminology is not always used.

5. The type of proceedings referred to as “liquidation” provides for a public authority (typically, although not necessarily, a judicial court acting through an officer appointed for the purpose) to take charge of the debtor’s assets, with a view to transforming non-monetary assets into monetary form and subsequently distributing the proceeds proportionately to creditors. Such proceedings usually result in liquidation or disappearance of the debtor as a commercial legal entity, although in some instances the assets may be sold together as an operating business.

6. The Asian Development Bank[1] notes that liquidation tends to be close to “universal” in its concept, acceptance and application. It normally follows a pattern that includes the following:

(a) an application to a court or other competent body either by the entity or the creditors;

(b) an order or judgement that the entity be liquidated;

(c) appointment of an independent person to conduct and administer the liquidation;

(d) closure of the business activities of the entity;

(e) termination of the powers of directors and employment of employees;

(f) sale of the entity’s assets;

(g) adjudication of claims of creditors;

(h) distribution of available funds to creditors (under some form of priority); and

(i) dissolution of the entity.

7. Wider uncertainties arise as to the meaning of the second type of proceedings which are often referred to as “reorganization”, “rescue”, “restructuring” or “rehabilitation”. For the purposes of this paper, and for the sake of simplicity, the term “reorganization” is used to refer to proceedings whose ultimate purpose is to allow the debtor to overcome its financial difficulties and resume or continue normal commercial operations. That result may be achieved by changing the organization of the business entity or by rescheduling or rearranging of the debt. Distinctions as to the way in which reorganization is carried out might depend on the size of the business and the degree of complexity of the specific situation. [*Note to the Working Group: it may be desirable to include a more detailed comparative analysis of alternative forms of the processes discussed above.*]

8. The Asian Development Bank[2] points out that despite the fact that the reorganization process has not been as universal as that of liquidation, and may not therefore follow such a common pattern, there are a number of key or essential elements that can be determined:

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[1] Law and Policy Reform at the Asian Development Bank, Report on RETA 5795: Insolvency Law Reforms in the Asian and Pacific Region, April 2000, p. 15.

[2] Supra note 1, p. 16-17.

(a) voluntary submission by an entity to the process, which may or may not involve judicial proceedings and judicial control or supervision;

(b) automatic and mandatory stay or suspension of actions and proceedings against the property of the entity affecting all creditors for a limited period of time;

(c) continuation of the business of the entity, either by existing management, an independent manager or a combination of both;

(d) formulation of a plan which proposes the manner in which creditors, equity holders and the entity itself will be treated;

(e) consideration of, and voting on, acceptance of the plan by creditors;

(f) possibly, the judicial sanction of an accepted plan; and

(g) implementation of the plan.

9. A further difficulty might arise from the fact that the distinction between conventional liquidation and reorganization procedures is not always clear-cut. The term "reorganization" is sometimes used in order to refer to a particular way of ensuring preservation and possible enhancement of the value of the insolvency estate within the context of liquidation proceedings. This is the case, for instance, whenever the law provides for liquidation to be carried out by way of transferring the business to another entity as a going concern. Although such a procedure might seem to evoke the idea of "rescue", as usually associated with reorganization, no actual reorganization occurs. In those situations, the term "reorganization" merely points to a technique other than traditional liquidation (i.e. straightforward sale of the assets), being used in order to obtain as much value as possible out of the insolvency estate.[3]

2. Relationship between liquidation and reorganization proceedings

10. Under certain circumstances, the needs arising in connection with the insolvency of a debtor are best addressed by the liquidation of all of the debtor's assets and the subsequent distribution of proceeds among creditors. Under other circumstances, however, liquidation might not be the best way to maximize the value of the resources of the insolvent enterprise. In reality, straight liquidation of the assets often results in creditors receiving only a portion of the nominal value of their claims. In those cases, the reorganization of the business to preserve the human resources and the goodwill of the enterprise may prove more effective in maximizing the value of the creditors' claims, allowing them to receive more favourable treatment or even to be paid in full. This may be especially true when, for example, the value of the business relies on intangibles (such as intellectual property rights) rather than tangible assets.

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[3] The World Bank Report (April 2001) defines rehabilitation as follows: "The process of reorganizing (restructuring) an enterprises' financial relationships to restore its financial well being and render it financially viable. This process may include organizational measures and the restructuring of business and market relationships through debt forgiveness, debt rescheduling, debt-equity conversions and other means. It can also involve selling the business as a going concern, in which case the procedure may be equivalent to similar sales under a liquidation proceeding".

11. Reasons for preferring reorganization as opposed to liquidation might also arise in connection with the political and social background of a legal system. Protection of the employees of a troubled enterprise might be regarded as a crucial objective. Furthermore, some countries might consider reorganization proceedings as serving a broad social interest, not only encouraging debtors to resort to reorganization before their financial difficulties become too severe, but also offering them a “second chance”, thus ultimately enhancing economic development and growth. Accordingly, many countries recognize that a functioning and effective insolvency regime needs to include both liquidation and reorganization procedures.

12. Although most countries provide for both liquidation and reorganization proceedings, approaches differ widely as to the structure of the procedure possibly leading to one of those outcomes. Some countries provide for a unitary, flexible insolvency proceeding, alternatively resulting in liquidation or reorganization depending on the characteristics of the case. Some 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.

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

14. When the approach of two distinct procedures is followed, the determination of whether the enterprise of the insolvent debtor is viable should, at least in theory, determine which procedure should be used. As a matter of practice, however, at the time of commencement of either procedure, it is often impossible to make a final evaluation as to the financial viability of the business. Hence the need for the law to provide linkages between the proceedings, with a view to allowing the conversion between the two. It is desirable that devices capable of preventing the abuse of reorganization proceedings as a means of avoiding or delaying liquidation are provided, for example […].

15. Whenever both liquidation and reorganization are provided, the issue of the relationship between the two is addressed in many different ways. In some countries, the party applying for the insolvency proceedings is given the initial choice between liquidation and reorganization. When liquidation proceedings are initiated by one or more creditors, the law will often provide a mechanism which enables the debtor to request conversion into reorganization proceedings.

16. 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 will provide for a mechanism enabling reorganization to be converted into liquidation upon a determination that reorganization is not likely to succeed. Another mechanism of protection for creditors might consist of setting forth the maximum period for which reorganization against the will of the creditors might be granted.

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

18. Difficulties of determining at the very outset whether the debtor should be liquidated rather than reorganized have led some countries to revise their insolvency laws by replacing separate proceedings with "unitary" proceedings. Under the "unitary" approach, the same proceeding applies whenever a situation of insolvency occurs; accordingly, for an initial period (usually referred to as "observation period", which in existing examples of unitary laws might last up to three months), there is no presumption as to whether the enterprise will be eventually reorganized or liquidated. The choice between liquidation or reorganization proceedings only occurs once a determination as to whether reorganization is actually possible has been made. The basic advantage offered by this approach relies on its procedural simplicity. A simple, unitary procedure, allowing both reorganization and rehabilitation, might result also in encouraging early recourse to the proceedings by debtors facing financial difficulties, thus enhancing the chances of successful rehabilitation.

II. Initiation and commencement of insolvency proceedings

A. Scope

1. General remarks

19. An important threshold issue in designing an insolvency regime is determining which entities, as debtors, can be subjected to a general insolvency law. To the extent that any entity is excluded from the process, it will not enjoy the protections offered by the process, nor be subject to the discipline of the process. The eligibility provisions will identify those forms of legal person and those natural persons whose businesses may be liquidated or reorganized and any businesses that are to be excluded from the application of the law.

20. A general insolvency regime can apply to all forms of enterprise engaged in business activities, both private and state-owned, especially those state-owned enterprises which compete in the market place as distinct commercial or business entities and are otherwise subject to the same commercial and economic processes

as privately-owned entities. An exception may be where the government has adopted, for example, a policy of excluding the liability of such enterprises or extending an explicit guarantee. Government ownership of an enterprise may not, in and of itself, provide a sufficient basis for excluding an enterprise from the coverage of the general insolvency law.

21. While it may be desirable to extend the protections and discipline of an insolvency regime to as wide a range of entities as possible, separate treatment may be provided for certain entities. This separate treatment may arise for a number of reasons including public policy concerns regarding, for example, consumers, or concerns related to the specialized nature of these entities and the often detailed regulatory legal regimes to which they are subject. Such entities might include banking and insurance institutions, utility companies, stock or commodity brokers.

22. *Centre of main interests*: In addition to embodying the necessary business attributes, a debtor must have a sufficient connection to the host State to be subject to its insolvency laws. Although some laws use tests such as principal place of business, UNCITRAL has adopted, in the Model Law on Cross-Border Insolvency, what is termed the “centre of main interests” of the debtor. In addition to the Model Law, that term is used in the draft UNCITRAL Convention on Assignment of Receivables and in the Council (EC) Regulation No 1346/2000 of 29 May 2000 on insolvency proceedings (“the EC Regulation”). The Model Law does not define the term; the EC Regulation (13th Recital) indicates that the term should correspond to “the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.” As provided in article 16 (3) of the UNCITRAL Model Law on Cross-Border Insolvency, in the absence of proof to the contrary, the debtor’s registered office, or habitual residence in the case of an individual, should be presumed to be the centre of main interests.

23. *Establishment*: 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 Model Law on Cross-Border Insolvency to mean “any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services.” The EC Regulation includes a similar definition but omits the reference to “services”. The definition is important to the structure of the Model Law as it determines those proceedings that may only be recognized as non-main proceedings; main proceedings require the presence of a centre of main interests. The EC Regulation similarly provides that insolvency proceedings may be opened in a jurisdiction where a debtor has an establishment, but that those proceedings will be restricted in their application to the assets of the debtor situated in the territory of that State.

24. *Presence of assets*: Some laws provide that insolvency proceedings may be commenced against a debtor that has assets within the jurisdiction or has had assets within the jurisdiction without requiring an establishment or centre of main interests within the jurisdiction. The existence of assets raises multi-jurisdictional issues, including multiple proceedings and questions of co-ordination and co-operation which might implicate the UNCITRAL Model Law on Cross-Border Insolvency. Accordingly, where a test of presence of assets is used it might be appropriate to include the protections offered by the Model Law in terms of co-ordination and co-operation.

2. Summary—scope

25. An insolvency law should apply to all debtors engaged in a business enterprise, including state-owned enterprises, with limited exceptions. These may include highly regulated entities such as banks and insurance companies.

26. Insolvency proceedings can be commenced against a debtor if it has its centre of main interests in the enacting State. In the absence of proof to the contrary, a legal person would be presumed to have its centre of main interests in the enacting State if it had its registered office in this State and in the case of a natural person, the presumption would make reference to its habitual residence.

B. Initiation and commencement criteria

1. General remarks

27. Initiation and commencement criteria are instrumental in delineating which entities are brought within the protective and disciplinary mechanisms of the insolvency process and by whom. This section addresses the criteria that must be met before proceedings can be initiated and commenced and, in the case of involuntary (see under “liquidation” below) proceedings, specifies the party that may make an application for insolvency against the debtor.

28. As a general principle, and subject to proper and adequate safeguards to prevent abuse of the process, it is desirable that access to the insolvency process be convenient, inexpensive and quick in order to encourage financially distressed or insolvent enterprises to voluntarily submit themselves to the process. Restrictive access can deter both debtors and creditors, while delay can be harmful in terms of the dissipation of assets and the possibility of reorganization.

29. Commencement criteria are a central element of the design of an insolvency law. How those criteria are set determines what is required in order to initiate proceedings, how proceedings are commenced, the period between initiation and commencement of insolvency and what has to occur in that period.

(a) Liquidation

30. Insolvency laws generally provide for liquidation proceedings to be initiated by one or more creditors (often described as involuntary proceedings) or the debtor (often described as voluntary) or by operation of law where the failure by the debtor to meet some statutory requirement automatically triggers insolvency proceedings (also described as involuntary).

31. Laws differ on the specific criteria that must be satisfied before the proceedings can commence. A number of laws include alternative criteria, and also distinguish between the commencement criteria applicable to liquidation and to reorganization.

32. A criterion that is used extensively for commencement of liquidation proceedings is the liquidity or cash flow standard which requires a general cessation of payment of liabilities as they become due. However, the way in which countries use this criterion varies. In some countries it provides the basis for commencement of either a liquidation or reorganization procedure and, where liquidation is chosen,

it can later be converted to reorganization. In other countries, only a reorganization procedure may be commenced on the basis of this criterion and the procedure may be converted only when it is shown that the enterprise cannot be reorganized. Under a third approach, this criterion is relied upon to commence a unitary procedure, and the choice between liquidation and reorganization is only made later (see section I above).

33. Reliance on the general cessation of payments standard is designed to activate proceedings sufficiently early in the period of the debtor's financial distress to avoid a race by creditors to grab assets, causing dismemberment of the debtor to the collective disadvantage of creditors. An alternative approach would be to adopt the balance sheet approach of excess of liabilities over assets as an indication of greater financial distress. However this approach often leads to proceedings being commenced after the possibilities of reorganization have disappeared. In addition, it suffers from disadvantages of proof and may circumvent the goal of maximization of value. It may also be an inaccurate measure of insolvency where accounting standards and valuation techniques give rise to distorted values that do not reflect fair market value or where markets are not sufficiently developed or stable to establish that value. It would generally require an expert to review books, records and financial data to reach a determination of the enterprise's fair market value. This is especially difficult where those records are not properly maintained or readily available. Such a test is not necessarily meaningful to the debtor's ability to deal collectively with its creditors when the debtor maintains an operating business. The balance sheet approach may be used to assist in defining insolvency, but may not be sufficiently reliable to constitute the sole basis of that definition.

34. Problems associated with the approach of general cessation of payments, such as the commencement of liquidation proceedings of a financially troubled but nevertheless financially viable enterprise, may be resolved by providing for the proceedings to be dismissed or converted to another proceeding (e.g. liquidation to reorganization—see section I) at the request of either the debtor or a creditor or the insolvency representative. Other problems may involve abuse of the process, such as where a debtor uses insolvency as a shield against a single creditor, or an insolvency application is used as a substitute for debt enforcement procedures (which may not be well developed) or creditors use insolvency to attempt to force viable businesses out of the market place or to obtain preferential payments.

(i) Debtor initiation

35. While the "general cessation of payments" requirement technically may be applied to both debtor and creditor applications, as a matter of practice an application by a debtor will generally be a last resort where it is unable to pay its debts. Thus, although the laws of most countries may, in theory, apply a similar criterion for both debtor- and creditor-initiated liquidation proceedings, in practice the application of the criterion will not be scrutinized in the case of debtor-initiated applications. In some laws debtor applications may be initiated without relying on any particular test of financial difficulty. In view of these considerations, it may be desirable for a debtor to be able to make an application under the insolvency regime on the basis of a simple declaration of its financial condition. In the case of a legal person, the directors or other members of a governing body to make the declaration.

36. It may be suggested that the application of such a standard could result in the process being abused by a debtor to prevaricate and deprive creditors of prompt payment of debts in full. In that event, one remedy may be for the law to provide that the relevant court can declare that the debtor is no longer subject to the insolvency law. [*Note to the Working Group: are there other remedies?*] In some countries, denial of access is based upon a determination that the debtor's application is motivated by an attempt to abuse the system by using it to circumvent other legitimate laws and obligations.

37. A matter related to debtor-initiated insolvency proceedings is the possible imposition of a duty on a debtor to make an application for commencement of proceedings at a certain stage of financial difficulty. There may be advantages in establishing an obligation to take early action—in the case of reorganization, the chances of it being successful are increased by early action and in the case of liquidation, creditors' interests would be protected by preventing further dissipation of the debtor's assets. Provisions which establish a duty to make an application, however, may discourage management from pursuing an out-of-court reorganization agreement (which may be the more appropriate alternative in a particular case) on the basis that delay in applying for formal proceedings could lead to personal liability. The adoption of incentives (such as protection from enforcement actions) to encourage debtors to initiate proceedings at an early stage may be preferable to reliance upon penalties aimed at forcing a debtor to take early action.

(ii) Creditor initiation

38. In the case of an application by creditors, while they may be able to show that the debtor has failed to pay their own claim or claims, providing evidence of a general cessation of payments may not be so easy. There is a practical need for a creditor to be able to present proof, in relatively simple form, which establishes a presumption of insolvency on the part of the debtor, without placing an unreasonably heavy burden of proof on creditors.

39. Insolvency laws address the issue of creditor initiation in a number of ways. These include a requirement that the application be made by more than one creditor (to minimise possible abuse of the process by a single creditor who may seek to use the insolvency process as a substitute for a debt enforcement mechanism), a requirement that the creditors represent a certain value of matured claims (or both a number and a value), or a requirement that the debtor is to furnish information to the court to enable a determination of a general cessation of payments to be made (see section IV.1). Specifying a particular value of claims may not be an optimal drafting technique as the value of currencies change, possibly necessitating amendment of the law. 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.

(iii) Initiation by governmental authority

40. In addition to (a) and (b) above, an insolvency law may give a governmental agency (normally the public prosecutor's office or the equivalent) non-exclusive authority to initiate liquidation proceedings against any enterprise if it ceases to make payments or, more broadly in some countries, if initiation is considered to be in the public interest. In the latter case, a demonstration of illiquidity may not be

necessary, thus enabling the government to terminate the operations of otherwise healthy enterprises that have been engaged in certain activities, for example, of a fraudulent or criminal nature. While the exercise of such a police power may be appropriate in certain circumstances, it is clearly desirable that those powers are not abused and are exercised in accordance with clear guidelines.

(b) Reorganization

41. 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. Given that one of the objectives of such proceedings is to provide an opportunity for creditors to enhance the value of their claims through reorganization of the enterprise, it may be desirable that the debtor not be given exclusive authority to initiate reorganization proceedings. The ability of creditors to initiate reorganization is also central to the question of whether creditors can propose a reorganization plan (see section IV.6). A number of countries take the position that, since in many cases creditors are the primary beneficiaries of a successful reorganization, creditors should have an opportunity to propose the plan. If that approach is followed, it seems reasonable to provide also that creditors can initiate reorganization proceedings.

(i) Debtor initiation

42. A commencement criterion which is consistent with the objective of encouraging debtors to address their financial difficulties at an early stage might be one which did not require the debtor to wait until it has ceased to make payments generally (i.e. wait until it is illiquid) before making an application. The merit of this approach of prospective illiquidity is recognized by a number of countries, albeit in different ways. In some laws, the reorganization procedure does not actually involve the application of a substantive criterion: the debtor may make an application whenever it wishes. Other laws 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. Even among countries that have adopted unitary proceedings, such a prospective illiquidity test has been introduced for applications made by debtors.

43. Such a relaxation of the commencement criteria could invite debtors to abuse the procedure. For example, a debtor that is not in financial difficulty may attempt to initiate proceedings and submit a reorganization plan that would enable it to shed onerous obligations, such as labour contracts. Whether such abuse could arise is a question of how the elements of the reorganization procedure are designed, such as the degree of control over the enterprise that the law permits the debtor to retain once the proceedings commence. One means of addressing an application by a debtor that is an abuse of the process may be to permit the proceedings to be dismissed by the court on application of a party in interest provided dismissal would be in the best interest of creditors.

(ii) Creditor initiation

44. Applying the same lower standard to initiation of reorganization proceedings by creditors may be more difficult to justify. If the law allows a debtor to initiate a proceeding on the basis of prospective illiquidity, it would be difficult to envisage

how creditors would have adequate information to assess whether that standard has been met. 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 have been impaired.

45. For those reasons, it may be appropriate to apply the same commencement criterion to initiation of both liquidation and reorganization by creditors (i.e. general cessation of payments see 1(b) above). Such a criterion would appear to be consistent with both the two-track approach and the unitary approach (discussed above in section I), where the application of a different criterion is not so much a function of the proceedings being initiated, but rather whether the applicant is the debtor or a creditor. The exception to this approach would be where either a debtor or creditor is precluded from initiating liquidation proceedings until it has been determined that reorganization is impossible. In that case, the commencement criterion for liquidation would not be general cessation of payments, but a determination that reorganization cannot succeed.

46. As in the case of liquidation, the criteria applicable to creditor applications for reorganization may include a requirement for the application to be made by a certain number of creditors or by creditors holding a certain value of matured claims, or both.

(c) Procedural issues

47. Insolvency proceedings raise a number of procedural issues. A preliminary point is the manner in which the process may be initiated. In many countries the normal practice is for a court of competent jurisdiction to determine, on the basis of the application for commencement, if the requisite conditions for commencement have been met. Some laws take different approaches, such as allowing a voluntary reorganization process to be initiated by lodging a declaration with an administrative authority. [*Note to the Working Group: are there other examples?*]

48. Where a court is required to make the decision as to commencement, there may be a practical need to ensure that the proceedings continue without delay. One means of achieving that may be to provide a specified period of time after the making of an application within which that decision as to commencement must be made.

49. In the event of a voluntary application by a debtor, creditors or other interested persons have a direct interest in receiving notice of the application and an opportunity to dispute the presumptions of eligibility and insolvency, perhaps within a specified time period to prevent the proceedings from being prolonged unnecessarily. While notice may be provided directly to known creditors, the need to inform unknown creditors has led legislators to include a provision requiring publication in an official government publication or a commercial or widely circulated national newspaper. In the event of creditor-initiated proceedings, the debtor may need to be given notice and an opportunity to dispute the presumptions that the creditors' claims are of a determined value, matured and unpaid. Provisions requiring the debtor to supply necessary information and enabling the creditors to seek such information are addressed under section IV.1.

(d) Costs

50. Applications by both debtors and creditors for insolvency proceedings may be subject to the payment of fees which may be used to help defray the costs of the insolvency system. In determining the level of fees to be imposed, a balance needs to be struck between a level that does not discourage debtors from making application and a level which might help to defray a significant part of the cost of the proceedings. [*Note to the Working Group: to what extent is it desirable to include issues relating to costs in the Guide?*]

2. Summary—initiation and commencement

51. An application for liquidation may be made by:

a. a debtor, on the basis of a general cessation of payments [an inability to pay its debts as and when they fall due];

b. one or more creditors, on the basis of that a specified number of creditors are able to show that they hold claims that are mature and that have not been paid by the debtor.

c. by a [prescribed] [government] authority.

52. An application for reorganization may be made by:

a. a debtor, on the basis of actual or prospective inability to pay its debts as they become due;

b. one or more of its creditors, on the basis that a specified number of creditors are able to show that they hold claims that are mature and that have not been paid by the debtor.

53. The application for commencement of proceedings should be made to the court and the court should make a decision on that application within a specified period of time.

54. Notice of the application should be provided to the debtor (in the case of creditor application) and to the creditors (in the case of a debtor application).

III. Consequences of commencement of insolvency proceedings

A. The insolvency estate

1. General remarks

55. Fundamental to the insolvency process, be it liquidation or reorganization, are identification, collection, preservation, protection and disposition of the assets that comprise the estate to be administered. All systems have some concept of the insolvency estate or the assets that will be subject to the insolvency proceedings. Some laws totally exclude certain types of property or property subject to certain interests from the administration of the insolvency process. Where property is subject to a security interest in favour of a creditor, some insolvency laws provide that it is subject to the insolvency proceedings (and therefore to the application of a stay and other effects of commencements), while others provide that it is unaffected

by the insolvency and creditors may proceed to enforce their legal and contractual rights (see section III.2 Stay of proceedings). Other laws require all property to be subject to the proceedings in the first instance, subject to the proof of harm or prejudice. The question of what is or is not subject to the proceedings (and therefore included or not within the concept of the "estate" where that term is used) will affect the scope and conduct of the proceedings and, particularly in reorganization, will have a significant bearing on the likely success of those proceedings.

(a) Property to be included

56. The assets of the estate may be expected to include the property of the debtor as of the date of commencement of the insolvency proceedings as well as assets acquired by the insolvency representative after that date, whether in the exercise of avoidance powers (see section III.4 Avoidance actions) or in the normal course of operating the debtor's business. In the case of a natural person, the estate might exclude property which relates, for example, to post-application earnings from the provision of personal services, property that is necessary for the debtor to earn a living and personal and household property.

57. The property of the debtor may be expected to include all assets in which the debtor has an interest, whether or not they are in the possession of the debtor at the time of commencement, including all tangible and intangible assets. Tangible assets should be readily found on the debtor's balance sheets, such as cash, equipment, inventory and real estate. Assets to be included within the category of intangible assets [to the extent of the debtor's interest] varies from State to State, depending upon the law. In the case of natural persons, the estate might also include assets such as inheritance rights in which the debtor has an interest or to which the debtor is entitled at the commencement of the insolvency or which come into existence during the insolvency proceedings.

(b) Third party owned property

58. Complex issues may be raised in determining whether an asset is owned by the enterprise or owned by another party but in the debtor's possession subject to use, lease, or licensing arrangements. Those assets owned by a third party but in the possession of the debtor at the time of commencement would not generally be included in the estate. Those assets being used by the debtor, but which are subject to a lease agreement where the lessor retains legal title may require special attention. In countries where title financing (where the provider of finance has title or ownership of the asset as opposed to a mortgage or security interest) is of considerable importance, there may be a need to respect the creditor's legal title in the asset and allow it to be separated from the estate (subject to the rules in section III.3 Treatment of contracts: the right to separate might be limited if the insolvency representative ratifies the lease contract). Other countries may choose to scrutinize such financing arrangements to determine whether the lease is, in fact, a disguised secured lending arrangement, in which case the lessor would be subject to the same restrictions as the secured lender.

(c) Recovery of property

59. Identifying the assets that will be subject to the proceedings may require action by the insolvency representative to recover property of the estate that was

improperly transferred or transferred at a time of insolvency with the result that the *pari passu* principle (i.e. that creditors of the same class are treated equally are paid in proportion to their claim out of the assets of the estate) has been violated. Most legal systems provide a means of setting aside and recovering the value of antecedent transactions that result in preferential treatment to some creditors or were fraudulent in nature or made in an effort to defeat the rights of creditors (see section III.4 Avoidance actions).

2. Summary—insolvency estate

[…]

B. Stay of proceedings

1. General remarks

60. The imposition of a suspension or "stay" on actions and proceedings by creditors against the property of the debtor recognizes the collective nature of insolvency proceedings. By preventing creditors from dismembering the debtor's business enterprise in an attempt to advance their specific interests, imposition of a stay can ensure a fair and orderly administration of the insolvency proceedings. One of the key issues in the design of an effective insolvency regime is how to balance the immediate benefits that accrue to the entity by having a broad stay to limit the actions of creditors and the longer-term benefits that are derived from limiting the degree to which the stay interferes with contractual relations with creditors.

61. The scope of rights that are affected by the stay varies considerably among countries. There is little debate regarding the need for the suspension of actions by unsecured creditors against the debtor or its assets. The application of the stay to secured creditors, however, is potentially more difficult and requires a number of competing interests to be balanced. These include, for example, upholding contracts; ensuring that creditors are paid in proportion to their claim out of the assets of the estate; maximizing asset values for all creditors; and, in cases of reorganization, the successful reorganization of a viable enterprise.

(a) Application of the stay

62. A preliminary question is whether the stay applies automatically or at the discretion of the court. While local policy concerns, and factors such as the availability of reliable financial information and the ability of the debtor and creditors to have access to an independent judiciary with insolvency experience may effect the decision as to whether the stay is applied automatically or granted by the courts on a discretionary basis, the automatic stay is a feature of many modern insolvency law regimes.

(i) Liquidation

63. In a liquidation proceeding, a stay of proceedings allows creditors of the same rank to participate in a fair and orderly realization and distribution of the debtor's assets, conducted for the benefit of all creditors. The emphasis is on selling the

assets, in whole or in part, so that the creditors can be repaid from the proceeds, as quickly as possible. Maximising value is the overriding objective.

64. Despite that objective, the interests of secured creditors need to be balanced against the interests of the general unsecured creditors. Arguably, where there is no interest in preserving the enterprise as a whole for possible sale as a going concern, the balance in liquidation should tilt in favour of upholding the contractual rights of secured creditors. At the same time, protection of those secured rights may need to be balanced against the possibility that maximization of value might require the assets of the business to be sold collectively, rather than in a piecemeal fashion. This is particularly so where the collective value of the assets is higher than the break up value and the result would be of greater benefit to creditors generally. More often than not, the secured creditors will hold security over the most important assets of the business.

65. Some countries adopt the approach that to ensure the effectiveness of the stay, it must be very wide, apply to all remedies and proceedings against the debtor and its assets, whether administrative, judicial or self-help and restrain both unsecured and secured creditors from exercising enforcement rights, as well as governments from exercising priority rights. Legal proceedings against the debtor are often included within the scope of the stay, with provision for those proceedings to be continued if necessary. In some countries, employee actions against the debtor are not included within the stay, but any enforcement action resulting from those proceedings will be included.

66. The creditors to be included within the categories of those subject to the stay needs to be clearly specified. For example, if any categories of creditors, such as preferential creditors (including employees), legislative lienholders, government claimants and officials and their respective agents and employees are be excluded from the scope of the stay, it is desirable that that exclusion be clearly stated. The need for other exemptions, such as for set-off rights and netting of financial contracts, assets that are generally not needed to sell the business as a going concern, such as cash collateral, or exemptions to protect public policy interests or to prevent abuse, such as the use of insolvency proceedings as a shield for illegal activities, may also need to be considered.

67. Any negative impact of the stay on the interests of secured creditors can be addressed in terms of the duration of the stay, protection of the value of the collateral and by providing secured creditors with the possibility of removing the stay where the collateral interests are not sufficiently protected or where the collateral is not necessary to the sale of the entire business or a productive part of it.

(ii) Reorganization

68. In reorganization proceedings, the stay of proceedings allows the debtor a breathing space to reorganize its affairs and for preparation of a reorganization plan and other steps necessary to ensure success of the reorganization. As such, the impact of the stay is greater and therefore more crucial in reorganization than in liquidation and it can provide an important incentive to encourage debtors to initiate reorganization proceedings. A number of the considerations discussed above in respect of application of a stay in liquidation proceedings are also relevant to reorganization proceedings, such as time of application of the stay, whether the stay

applies automatically or at the discretion of the court and the scope of the stay in reorganization proceedings.

69. To protect the assets which may be used to reorganize the business a stay would need to be imposed on all creditors upon formal commencement of the reorganization proceedings. In contrast to liquidation proceedings, some insolvency laws exclude legal proceedings from the scope of the stay.

(b) Provisional measures of protection/time at which stay is applicable

70. A question arises as to the time at which the stay will be effective in both liquidation and reorganization proceedings. In many jurisdictions, there may be a gap between the time at which the application is made and the commencement of insolvency proceedings. During that time there is the potential for the debtor's assets to be dissipated; the debtor may transfer assets out of the business or creditors may take remedial action to pre-empt the effect of the stay that may be imposed later. One approach might be to apply the stay on the making of an application by a debtor and, in the case of a creditor application, after commencement of the proceedings. If the stay is to apply on commencement of proceedings, another approach may be to allow protective or interim measures to be issued during the period between initiation and commencement. These might include: appointing a preliminary insolvency representative; prohibiting the debtor from disposing of assets; sequestering some or all of the debtor's assets; and suspending enforcement of security interests against the debtor. In some jurisdictions, transactions entered into by the debtor during this period are void. Since these are provisional measures that are provided before the decision that the commencement criteria have been met, applying creditors may be required to provide evidence that the measure is necessary and, in some cases, a bond.

(c) Duration of the stay

(i) Unsecured creditors—liquidation and reorganization

71. In both liquidation and reorganization proceedings, many laws provide that the stay applies to unsecured creditors for the duration of the proceedings.

(ii) Secured creditors—liquidation

72. Different approaches are taken to the application of the stay to secured creditors. Some legal systems exclude secured creditors from the scope of the stay, while others adopt that approach that the stay automatically applies upon commencement of proceedings to secured creditors for a brief period, such as 30 or 60 days, except where the collateral is not essential to the sale of the business as a whole. Another approach extends the stay to secured creditors for the duration of the proceedings, subject to a court order for relief. Where the stay is limited to a specified period, the law can include provision for extension of the stay on application by the insolvency representative when it can be demonstrated that the extension is required in order to maximize value. This might, for example, include demonstrating that there is a reasonable possibility that the enterprise, or units of the enterprise, can be sold as a going concern. To provide additional protection, there might be a need for the law to set a limit on the period for which the stay could be extended.

(iii) Secured creditors—reorganization

73. In reorganization proceedings, there may be a need for the stay to apply to secured creditors for the duration of the proceedings to ensure that the reorganization can proceed in an orderly manner without the possibility of assets being separated before the reorganization has been finalised. Exceptions to this principle might be needed where the particular collateral is not essential to the reorganization or where the creditor can demonstrate other reasons for lifting the stay.

(d) Lifting of the stay

74. In both liquidation and reorganization proceedings, circumstances might arise where it is appropriate to provide relief from the application of the stay by allowing the stay to be lifted or cease to apply. To accommodate such circumstances, the law may provide, for example, that the creditor can apply for the stay to be removed where the creditor is not receiving protection for the value of the collateral. Where the provision of protection may not be feasible or would be overly burdensome to the estate, the insolvency representative, of its own initiative, may release the collateral. There are examples of laws which provide that relief from the stay may be granted to an unsecured creditor to allow, for example, a claim to be determined in another forum where litigation may be well advanced and it would be efficient for it to be completed, or a claim against an insurer of the debtor to be pursued.

75. In liquidation, provision may also be needed to allow assets over which the secured creditor has security to be surrendered to the secured creditor, where its security is determined to be valid and the secured assets have no value to the insolvent estate, or cannot be realized in a reasonable period of time by the insolvency representative.

(e) Protection of economic value

76. A further set of measures designed to address any negative impact of the stay on secured creditors is that directed at maintaining the economic value of secured claims during the period of the stay (in some jurisdictions referred to as “adequate protection”). One approach is to protect the value of the collateral itself on the understanding that, upon liquidation, the proceeds of sale of the collateral will be distributed directly to the creditor to the extent of the value of the secured portion of the claim. In addition to lifting of the stay, this may involve a number of steps including providing compensation for depreciation; payment of interest; and protection and compensation for use of the collateral.

77. Another approach to protecting the interests of secured creditors would be 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 value of the secured portion of the creditor’s claim is determined. This value remains fixed throughout the proceedings and, upon distribution following liquidation, the secured creditor receives a first-priority claim to the extent of that value. 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. Provision of interest is limited in some insolvency systems to situations where the value of the collateral exceeds the

amount claimed. Otherwise, compensation for delay depletes the assets available to unsecured creditors.

78. Guidance may be needed to determine when and how creditors holding some type of security over the debtor's assets would be entitled to the types of protection described above. Although some minor erosion of secured creditors' security positions is to be expected in conjunction with a reorganization proceeding, it is undesirable that a single secured creditor or group of secured creditors solely or primarily bear the burden, nor is it desirable that the body of creditors as a whole be prejudiced in a material way by the continuation of the reorganization proceeding.

2. Summary—stay of proceedings

79. Application of the stay could be automatic or discretionary.

(a) Time of application of the stay

80. In both liquidation and reorganization, the stay could apply:

a. on application (in the case of a debtor application);

b. on commencement (in the case of a creditor application).

(b) Parties to whom the stay will apply

(i) Liquidation

81. Two different approaches may be taken:

a. the stay would apply to both secured and unsecured creditors; or

b. the stay would apply to unsecured creditors with provision for application to secured creditors on request of debtor/insolvency representative.

(ii) Reorganization

82. The stay would apply equally to both secured and unsecured creditors, subject to provision for relief.

(c) Duration of the stay

(i) Unsecured creditors

83. In both liquidation and reorganization, the stay would apply for the duration of the proceedings.

(ii) Secured creditors

84. In liquidation the stay would apply to secured creditors for a limited period (30-60 days), with provision for exceptions such as where the collateral is not essential to the sale of the business as a whole.

85. In reorganization, the stay would apply to secured creditors for the duration of the proceedings, subject to a determination that the collateral is not required for the reorganization proceedings.

(d) Relief from the stay: liquidation and reorganization

86. A secured creditor may apply to have the stay lifted where it can demonstrate severe prejudice (eg. it is not receiving appropriate protection of the economic value of the collateral). The stay may cease to apply where the insolvency representative determines that protection of the value of the collateral is not feasible or is too burdensome.

(e) Protection of economic value

87. [Specific measures to be included]

C. Treatment of contracts

1. General remarks

88. It is inevitable that at the commencement of insolvency proceedings, the debtor will be a party to a contract that has not yet been fully performed. It is a common feature of many insolvency laws that the insolvency representative may interfere in those contracts, electing to either reject and terminate or continue (and possibly subsequently assign) those contracts. As an example, in a contract where the debtor had agreed to purchase a particular good at a price which is half the market price at the time of the insolvency, it would obviously be advantageous to the insolvency representative to continue to purchase at the lower price and sell at the market price. The counter-party would naturally like to get out of what is now an unprofitable agreement, but in many systems it will not be permitted to do so, although it may be entitled to an assurance that it will be paid the contract price in full.

89. As in the case of avoidance actions (see section III.4), the underlying rationale of the insolvency representative’s ability to interfere in contracts is maximization of the value of the estate. Achieving this goal might involve taking advantage of those contracts that are beneficial and contribute value and rejecting those which are burdensome, or where the ongoing cost exceeds the benefit of the contract. Maximization of value must be balanced against competing interests such as the social concerns raised by some types of contracts e.g. labour contracts, and the effect of the insolvency representative’s ability to interfere with the terms of unperformed contracts on the predictability of commercial and financial relations. Whatever rules are adopted with respect to continuation and termination, it is desirable that any right to continue or terminate a contract be limited to the contract as a whole, thus avoiding a situation where the insolvency representative could choose to continue certain parts of a contract while terminating others.

90. As an economy develops, more and more of its wealth is apt to be contained in or controlled by contracts, rather than in land. As a result, the treatment of contracts in insolvency is of overriding importance. There are two overall difficulties in developing legal policies in that regard. The first is that contracts are unlike all other assets of the insolvent estate in that they usually are tied to liabilities or claims. That is, it is often the case that the estate must perform or pay in order to enjoy the rights that are potentially valuable assets. The result is that difficult decisions must be made about the treatment of a contract that will produce the most value for the

estate. Typically, the insolvency representative is charged with making this evaluation. In some jurisdictions, court approval is also required.

91. The second difficulty is that contracts are of so 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. Further, the debtor may have been either buyer or seller, provider or receiver, under a contract and the problems presented in insolvency may be very different when viewed from each side. A common solution is to provide general rules for all kinds of contracts and then exceptions for certain special contracts, as discussed below.

92. Contracts in bankruptcy fall into two financial categories: contracts made before insolvency by the debtor and contracts entered into after the start of an insolvency proceeding. Breach of a pre-insolvency contract in many laws gives rise to a pre-insolvency unsecured claim that is usually paid on a pro-rata basis, while breach of a post-insolvency contract is usually a first claim on the available funds and therefore is paid in full as an expense of the insolvency administration. The line between them is crossed when the insolvency representative seeks to perform a pre-insolvency contract based on an evaluation that performance of the contract will yield greater net returns than its breach. If the estate thus continues the contract, it adopts the debtor's contract as its own and any later breach will also be a first-priority administration claim (see section V.1) in most systems.

93. Some classes of contracts raise social concerns that may require special treatment under insolvency laws. These would include, for example, labour agreements, financial market transactions (see … below) and contracts for personal services, where the identity of the party to perform the agreement, whether the debtor or an employee of the debtor, is of particular importance. The insolvency representative's ability to terminate labour contracts, for example, may be limited by concerns that liquidation can be used as a means of expressly eliminating the protections afforded to employees by such contracts. A related issue is the circumstances in which an insolvency representative may alter the terms and conditions of contracts of the type requiring special treatment.

(a) Termination

(i) Liquidation

94. As a general matter, it is desirable that an insolvency representative have the power to terminate a contract in which both parties have not fully performed their obligations. Different mechanisms may be adopted to facilitate termination. Under one approach the insolvency representative is required to take action to terminate the contract. Under a second approach the contract may be regarded as automatically terminated if the insolvency representative does not elect to continue it within a specified time period. Where such a contract is terminated, the counterparty is excused from performing the rest of the contract and the only serious issue to be determined is calculation of the unsecured damages that results from the termination. The counterparty becomes an unsecured creditor with a claim equal to that amount of damages. There may be circumstances in which it would be desirable for special remedies to apply upon cancellation of certain types of contracts, such as leases, whether the debtor is a lessee or lessor under the lease. If the debtor is a

lessee, a ceiling may be set on damages so that the claim under a long-term lease does not overwhelm the claims of other creditors. Lessors ordinarily can mitigate losses by re-letting the property. If the debtor is a lessor, the occupancy rights of the lessee may need to be protected.

(ii) Reorganization

95. In reorganization, the prospects of success may be enhanced by allowing the insolvency representative to reject burdensome 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.

(iii) Exceptions

96. Irrespective of the extent of the continuation or termination powers given to an insolvency representative, exceptions may be needed for certain contracts. One important exception to the power to terminate is labour contracts. Although particularly relevant to reorganization, such contracts are also relevant in liquidation where the insolvency representative is attempting to sell the enterprise as a going concern. A higher price may be obtained if the insolvency representative is able to terminate onerous employment contracts. To avoid insolvency proceedings being used as a means of eliminating employee protection, some countries specifically limit the ability to terminate labour contracts. A similar limitation on the right to terminate may be appropriately applied to the case of lease agreements where the debtor is the lessor or franchisor or where the debtor is a licensor of intellectual property and termination of the licence would end the licensee’s business, particularly where the advantage to the debtor might be relatively minor.

(b) Continuation

(i) Reorganization

97. In reorganization, where the objective is to enable the enterprise to survive and continue its affairs to the extent possible, the ability to continue contracts that are beneficial to the business and contribute value may be crucial. If an insolvency regime does not establish limits on the effectiveness of contract termination clauses upon initiation or commencement of reorganization, the chance of a successful reorganization may be affected.

98. An initial question is whether the contract under consideration contains a clause providing that commencement of insolvency proceedings constitutes an event of default that gives the counterparty an unconditional right of termination, acceleration or other right. Some laws uphold the validity of such clauses and the insolvency representative will be able to continue the contract only if the counterparty does not elect, or can be persuaded not to elect, to terminate or accelerate the contract. Where a counterparty can terminate a contract, the insolvency law may provide a mechanism that can be used to persuade the counterparty to continue the contract, such as that payment under the contract gives priority for payment of services provided after commencement of the proceedings. Other laws provide that the insolvency representative can continue the contract over the objection of the counterparty, that is, any event of default which is triggered by

commencement of insolvency proceedings which would give rise to a right to terminate or accelerate the contract is overridden by operation of the law.

99. Arguments in favour of overriding termination and acceleration clauses in reorganization include the need to enhance the earnings potential of the business; to reduce the bargaining power of an essential supplier; to capture for creditors the value of the debtor’s contracts; [….].

100. Arguments against overriding the counterparty’s right to terminate the contract might include the need to prevent the debtor from selectively performing contracts which are profitable and cancelling others, an advantage which is not available to the innocent counterparty; the effect of such an override provision on netting; the belief that since an insolvent business will generally be unable to pay, delaying the termination of contracts may potentially increase existing levels of debt; the ability of creators of intellectual property to control the use of that property; and the effect on the counterparty’s business of termination of a contract with respect to a general intangible.

101. Where insolvency laws provide that termination clauses may be overridden, creditors may take pre-emptive action to avoid that outcome by terminating the contract before the application for insolvency proceedings is made. Such a result may be mitigated by providing that the insolvency representative has the power to reinstate those contracts, provided that both pre- and post-commencement obligations are fulfilled.

102. Continued contracts are treated as ongoing obligations of the enterprise that must be performed and all contractual obligations of the estate become post-commencement obligations. Claims arising from the performance of the contract after the commencement of insolvency proceedings are treated in a number of insolvency laws as an administrative expense (see section V.1) and given priority in distribution. Where the insolvency representative breaches an agreement after it has been continued, the party who has been damaged as a result of the breach may be entitled to pursue its rights and remedies under the agreement in accordance with applicable non-insolvency law and to the payment of damages, which might also rank as an administrative claim (as opposed to an unsecured claim).

103. Where the debtor is in default under a contract at the time of the application for insolvency, the policy issue is whether it is fair to require the counter-party to deal with an insolvent debtor when there was already a pre-insolvency default. Some laws require, as a condition of continuation, that the insolvency representative must cure any defaults under the contract and provide assurance as to future performance by providing, for example, a bond or guarantee.

(ii) Liquidation

104. In liquidation, the desirability of continuing contracts is likely to be less important than in reorganization, except where the contract may add value to the business or to a particular asset and therefore promote the sale of it as a going concern. A lease agreement, for example, where the rental is below market value and which still has a substantial term to run, may prove central to any proposed sale of the business.

105. The arguments in favour of overriding termination clauses in liquidation would include the need to keep the business together to maximize its sale value or to enhance its earnings potential; the need to reduce the bargaining power of an essential supplier; and the desirability of locking all parties into the final disposition of the business.

(iii) Exceptions

106. Exceptions to the power of the insolvency representative to continue contracts generally fall into two categories. In respect of the first, where the insolvency representative has power to override termination provisions, specific exceptions may be made for contracts such as short-term financial contracts (e.g. swap and futures agreements). The second category relates to those contracts where, irrespective of how the insolvency law treats termination provisions, the contract cannot be continued because it provides for performance by the debtor of irreplaceable personal services (e.g. an opera singer).

(c) Assignment

107. Contracts which have been continued may subsequently be assigned for value. In some insolvency laws, agreement of the counterparty or of all parties is required, while in other laws non-assignment clauses are made null and void by insolvency proceedings. The insolvency representative is then free to assign the contract for the benefit of the estate. While this latter option is considered of critical importance to the liquidation proceedings of some countries, in other countries it is entirely foreign and is precluded.

108. The ability of the insolvency representative to elect to continue and assign contracts in violation of the terms of the contract can have significant benefits to the estate, and therefore to the beneficiaries of the proceeds of distribution following liquidation. However, this ability clearly undermines the contractual rights of the counterparty to the contract and may raise issues of prejudice, especially where the counterparty has little or no say in the selection of the assignee. Some laws provide that if the counterparty does not consent to assignment, the insolvency representative may assign with permission from the court if it can be shown that the counterparty is withholding consent unreasonably. Some laws which permit continuation and assignment require that the insolvency representative demonstrate to the counterparty that the assignee can adequately perform the contract.

(d) Procedural issues

109. Some laws permit the insolvency representative to make a determination regarding continuation, while in other laws approval of the court is required. To avoid unnecessary delay in the proceedings, it is desirable that that determination be made within a specified period of time. Given the nature of the proceedings, the time period might be longer in reorganization than in liquidation, with flexibility provided to extend the period where it would be beneficial to the reorganization to do so. In the event that the determination is not made within the time specified in the law or ordered by the court (if the counterparty to the contract requests the court to make such a determination where the insolvency representative has failed to do so), some laws include default provisions, such as termination of the agreement automatically or at the election of the counterparty.

110. In many laws, an insolvency representative is not required to give notice of termination, except in cases of employment and lease agreements (for real estate). Some laws however, require the insolvency representative to observe contractual requirements as to notice, although provisions may be made for this to be shortened in cases of long term lease contracts.

111. [Set-off]

112. [Financial contracts and netting]

2. Summary—treatment of contracts

(a) Termination

113. An insolvency representative may terminate contracts in liquidation and reorganization proceedings. Termination may be effective when:

a. the insolvency representative gives notice of termination or

b. automatically in the absence of a decision to continue within a specified period of time.

114. Termination gives rise to an unsecured claim for the damages arising from the termination.

115. The right to terminate certain specified classes of contracts, such as labour contracts, in reorganization proceedings should be limited.

(b) Continuation

116. The insolvency representative, with or without the approval of the court, may continue contracts, with the exception of certain specified classes. Where any provision of the contract has the effect of terminating it upon commencement of insolvency, there are several approaches:

a. the provision may be treated by the insolvency representative or the court as null and void.

b. the insolvency law will provide that it is null and void

117. Contracts continued by the insolvency representative become obligations of the estate from the commencement of proceedings.

(c) Assignment

118. The insolvency representative may assign a continued contract either:

a. by treating a non-assignment provision as void;

b. subject to the agreement of the counterparty [all parties];

c. where the counterparty [all parties] do not agree, the court may approve the assignment.

D. Avoidance actions

1. General remarks—avoiding pre-insolvency transactions

119. Many laws regard some transactions executed prior to the initiation of an insolvency proceeding as unfair or financially harmful to the interests of all of the debtor's stakeholders, especially if they are executed in contemplation of a likely insolvency. A transaction may fall into this category retrospectively—that is, it may be a transaction that would not ordinarily be regarded as legally wrongful, but is seen as harmful in light of a subsequent insolvency. As discussed below, this area is one in which a delicate balancing of competing social benefits, such as between the value of strong powers to maximize the value of the estate for the benefit of all creditors and the possible undermining of contractual predictability and certainty, must be struck. When the balance suggests that a particular transaction is harmful, it may become legally "avoidable," that is, it may be subject to being treated as legally void, so that property the debtor has transferred, or its value, may be recovered by an insolvency representative for the benefit of stakeholders generally.

120. Insolvency proceedings may commence at lengthy periods after a debtor first becomes aware that such an outcome cannot be avoided. In that intervening period, there may be significant opportunities for the debtor to attempt to hide assets from creditors, incur artificial liabilities, make donations to relatives and friends or pay certain creditors to the exclusion of others. The result of such activities, in terms of the eventual insolvency proceedings, is to disadvantage general unsecured creditors, who were not party to such actions and do not have the protection of security, and to undermine the objective of equitable treatment of all creditors. A principal goal of avoidance powers is to ensure that creditors receive a fair allocation of an insolvent debtor's assets consistent with established priorities for payment.

121. Different approaches are taken to avoidance provisions. One approach emphasizes the reliance on generalized, objective criteria for determining whether transactions are avoidable. The question would be, for example, whether the transaction took place within a specified period prior to commencement or whether the transfer or transaction contains any of the general characteristics set forth in the law (e.g. requirements for provision of appropriate value). While generalized criteria may be simple to apply, if relied upon exclusively they can also have arbitrary results, so that legitimate and useful transactions that fall within the specified period may be voided, while fraudulent or preferential transactions that fall outside the period may be protected. 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 was made and whether the counterparty knew of the insolvency. Adopting a balanced approach that combines elements of each may minimize the undesirable aspects of a strictly generalized approach.

122. Four common types of avoidable transactions are found in most legal systems. They are: transfers intended to defraud creditors, transfers at an undervalue, preferential payments to certain creditors, and invalid security interests. Some transactions may have the characteristics of more than one of these different classes, depending upon the individual circumstances of each contract. For example, transactions which appear to be preferential may be more in the character of fraudulent transactions when they occur while the debtor is nearly insolvent or

where they leave the debtor with insufficient assets to conduct its business. In respect of each category, legal systems vary as to whether the transferee—the person who received the property—can be required to return it if they were innocent, gave value, and had no knowledge of the crucial facts. Some systems permit such a defence by the transferee, while others require a return of the property regardless, although with some protection for any value actually given by the transferee.

123. The first three types of avoidable transactions are made avoidable for several reasons, including:

(i) To prevent fraud (for example, transfer of assets to hide them for the later benefit of the debtor);

(ii) To prevent favouritism, where the debtor wishes to advantage certain creditors at the expense of the rest;

(iii) To prevent a sudden loss of value in a company just before court supervision is imposed; and

(iv) To create a framework for out-of-court settlement—creditors will know that last-minute transfers 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.

124. The avoidability of the fourth type of transaction, an invalid security interest, is simply an instance of enforcement of the rules concerning such interests in the context of insolvency. Thus, for example, those systems that require the public registration of certain sorts of security may provide that the security will be unenforceable or void in insolvency proceedings if the registration was not made. The policies served are those established in the laws permitting the grant of security to creditors. On the other hand, a security interest valid under those laws may be avoidable in insolvency under one of the first three headings listed above. For example, the grant of a security interest shortly before insolvency, although otherwise valid, may be found to have favoured unfairly a certain creditor at the expense of the rest.

(a) Fraudulent transactions

125. Fraudulent transfers are those made by the debtor’s management with an intent to defraud creditors or defeat or delay efforts to collect claims, by transferring assets beyond the reach of creditors to any third party. Many insolvency laws do not limit the time period within which these transactions must have occurred in order to be avoided.

(b) Undervalued transactions

126. Transactions may be avoidable where the value received by the debtor as the result of a transfer to any third party was either nominal, or much lower than the true value of the asset transferred. Some laws also require a finding that the debtor was insolvent at the time the transfer was made, or was made insolvent as a result of the transfer.

(c) Preferential transactions

127. Preferential transfers are typically payments which violate the *pari passu* principle by preferring some creditors and third parties over other creditors that may go unpaid during the period leading up to the initiation of proceedings. Such transactions may be subject to avoidance where the transfer was made within a defined period ("the suspect period") before the application for initiation of the insolvency proceeding to a creditor on account of a debt and, as a result of such transfer, the creditor will receive more than its lawful, *pro rata* share of the debtor's assets. Many countries also require evidence of insolvency or near insolvency when the transaction took place. Another category of preferential transaction might include transfers made after the application for initiation of the insolvency proceedings but before commencement, unless the transaction was authorized by the terms of the insolvency law.

128. Gifts might be either fraudulent or entirely innocent, but in either case may be unfair to creditors and therefore avoidable. A setoff occurring within a short time before the initiation of the insolvency proceeding may be considered prejudicial and subject to avoidance (see section III.4).

129. [Unauthorized transfers occurring after initiation of proceedings; avoidance of pre-payments during suspect period; transactions seriously inconsistent with normal commercial practice.]

(d) Establishing the suspect period

130. Some insolvency laws explicitly specify the suspect period (for example, so many days or months before commencement of insolvency) during which each of these types of transactions would be subject to avoidance. In other laws, the suspect period is defined retrospectively by the court after proceedings have commenced. In those laws, the court's decision is often based on a finding as to when the debtor ceased paying its debts in the normal way ("cessation of payments"). [*Discuss advantages of each approach*]. Some systems may have one suspect period for all types of avoidable transactions, while others have different periods depending upon factors such as whether the injury to creditors was intentional, whether the transferee was an insider (i.e. a person who has a close corporate or family relation to the debtor or its creditors). Because fraudulent transactions involve intentionally wrongful conduct, substantial suspect periods, which might be anything from one to six years, are often fixed. Where preferential transactions involve creditors who are not insiders, the suspect may be relatively brief, perhaps no more than several months. Where insiders of the debtor are involved, many countries adopt the approach that stricter rules, including longer suspect periods and shifted burdens of proof, apply. For example, an undervalued transfer to an insider may be avoided although the debtor was neither insolvent at the time of such transfer, nor rendered insolvent as a result of such transfer.

(e) Liability of transferees

131. With regard to each of these types of transactions, the questions arise of whether the transferee may be exempted from liability and whether annulment of the transfer is desirable. Such a decision may be subject to different considerations for each type of transaction and will involve balancing requirements of fairness in respect to innocent parties against the difficulties of proving motive and knowledge and the harm occasioned to creditors independent of the transferee's state of mind.

In the case of fraudulent transactions, for example, the extent to which the transferee paid adequate value and had knowledge of the debtor's actual intent to defraud creditors will be relevant. In the case of undervalued transfers, the question of whether or not the transferee was an insider and had knowledge of the debtor’s actual or imminent insolvency or that the debtor was likely to become insolvent as a result of the transfer will be relevant.

132. With regard to an action to avoid a preferential transactions, different approaches may be taken. Under one approach, where the creditor transferee acted in good faith and had no knowledge that the debtor was insolvent at the time of the transfer or was rendered insolvent as a result of the transfer, the creditor is not subject to liability and the transfer is not annulled. Another approach provides the same result where the transfer by the debtor was substantially contemporaneous with the creation of the creditor's claim, was subsequently followed by provision of value, or occurred in the ordinary course of business.

(f) Void and voidable transactions

133. Where a transaction falls into any of these categories, insolvency laws will either render it automatically void or make it voidable. In those laws where it is voidable, the insolvency representative is required to decide whether the avoidance of the transaction will be beneficial to the estate, taking into account delays in recovering either the assets involved or the value of the assets or the possible costs of litigation. That discretion would generally be subject to the insolvency representative’s obligation to maximize the value of the estate, and it may be responsible for its failure to do so. Where the insolvency representative does not take action to avoid certain transactions, some insolvency laws permit a creditor or the creditor committee to take action to require the insolvency representative to initiate an avoidance action where it appears to be beneficial to the estate to do so. Other laws also permit a creditor itself or the creditor committee to commence an action to avoid these transactions. Where this latter action is permitted, some laws provide that assets or value recovered by the creditor are be treated as part of the estate; in other cases whatever is recovered can be applied to satisfy the claim of the creditor which takes the action.

(g) Evidentiary issues

134. Insolvency laws adopt different approaches to establishing the elements of an avoidance action. In some laws, the debtor is required to prove that the transaction did not fall into any category of avoidable transactions. In other laws, a creditor or other person challenging the transaction, such as the insolvency representative, is required to prove the existence of each element of an avoidance action. Some laws allow for the burden of proof to be shifted where, for example, it is difficult for the insolvency representative to establish the debtor’s actual intent to defraud creditors except through external indications, objective manifestations, or other circumstantial evidence of such intent. The burden of establishing the debtor’s innocent motive is shifted in those laws to the transferee.

2. Summary—avoidance

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IV. Administration of proceedings

A. Debtor's rights and obligations

1. General remarks

(a) Control of debtor's management

(i) Liquidation

135. 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's managers or owners. For this reason, many insolvency laws divest the debtor's management or owners of all rights to manage and operate the business and an insolvency representative is appointed to assume all responsibilities divested. These might 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. Upon commencement of the liquidation proceedings, any actions taken by the debtor that are detrimental to the estate would normally be void.

136. Where it is determined that the most effective means of liquidating the estate is to sell it as a viable business, some laws provide the insolvency representative with the power to permit the debtor's managers or owners to retain some control to facilitate the sale of the assets and the business under the supervision and control of the insolvency representative. Under that approach, the insolvency representative may be made liable for the wrongful acts of the debtor during the period of its control.

(ii) Reorganization

137. In the case of proceedings for reorganization, there is no agreed approach on the extent to which displacement of the debtor is the most appropriate course of action and whether there may be an ongoing role for the debtor's management. In many circumstances, the debtor's management, notwithstanding its role in the financial difficulties of the enterprise, will have immediate and intimate knowledge of the business of the debtor. This knowledge may provide a basis for management to have a continuing role in making short term management decisions. For similar reasons, the debtor's management is often well positioned to propose a reorganization plan for approval by creditors and the court. In such circumstances, total displacement of the management of the debtor, notwithstanding its role in creating the financial difficulties of the debtor, might eliminate the incentive for debtors to commence reorganization procedures at an early stage and may undermine the chances of success of the reorganization.

138. There are different approaches to balancing these considerations. One approach would be to establish a sharing arrangement between the debtor and the insolvency representative, where the latter supervises the activities of the debtor and approves significant transactions and the debtor continues to operate the enterprise on a day-to day basis. This approach may need to be supported by relatively precise rules to ensure that there is clarity as to the division of responsibility between the insolvency representative and the debtor, and certainty as to how the reorganization

will proceed. However, if there is evidence of gross mismanagement or misappropriation of assets or the goal of reorganization is no longer realistic, it may be appropriate for the debtor's managers or owners to be displaced by the court, on its own motion or on that of the insolvency representative or perhaps the creditors or creditor committee. Where the power is given to creditors or the creditor committee there may be a need for protections which would prevent possible abuse by creditors seeking to frustrate the reorganization proceedings or gain improper leverage. This could be achieved by requiring, for example, the vote of an appropriate majority of creditors before such relief can be sought.

139. Another approach which is used in very few insolvency laws is to enable the debtor to retain full control over the operation of the business, with the consequence that the court does not appoint an independent representative once the proceedings begin (known as "debtor in possession"). While such an approach might have advantages in terms of the chances of a successful reorganization, there may also be disadvantages. These disadvantages might include the process being used where the outcome is clearly not likely to be successful, that is where the process is used to delay the inevitable with the result that assets continue to be dissipated, and the possibility that management may act irresponsibly and even fraudulently during the period of control undermining the reorganization as well as the confidence of creditors. These difficulties may be mitigated by adopting certain protections such as appointment of an insolvency representative to supervise the debtor or a mechanism that allows the court (either on its own motion or at the request of creditors) to convert the proceedings to liquidation, as well as giving the creditors a significant role in supervising or overseeing the debtor. Nevertheless, this approach is a very complex one which affects a number of different aspects of the design of an insolvency regime and requires detailed consideration.

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

(b) Provision of information

141. To enable the court, creditors and affected parties to reasonably evaluate the debtor's immediate liquidity needs and the advisability of new financing; the enterprise's business prospects and long term viability; and whether management is qualified to continue to lead the enterprise, they will need to have information concerning the business that can be provided by the debtor. To satisfy that need in both types of insolvency proceedings, but particularly in reorganization proceedings, it is desirable that the debtor have a continuing obligation to disclose information regarding its business and financial affairs in some detail. To ensure that the information provided can be used for these purposes, it needs to be current and therefore be provided as soon as possible after the commencement of the proceedings. Where the debtor is not a natural person, the information could be supplied by officers and other relevant third parties of the debtor to the insolvency representative. An alternative approach is to require one or more of the directors to be represented at and required to attend a main meeting of creditors to answer questions, except where this is not physically possible when directors are not

located in the place in which creditors meetings may be held. Often the information in question will be commercially sensitive and it is desirable that an insolvency law include provisions to protect confidential information. Where information is withheld, there may be a need for some mechanism to compel the provision of relevant information. This might take the form of a “public examination” of the debtor or, following the practice of a number of countries, the imposition of criminal sanctions.

142. To facilitate the provision of information by the debtor, some laws have developed standardized information schedules that set out the specific information required. These are to be completed by the debtor (with appropriate sanctions for false or misleading information) or by an independent person or administrator.

2. Summary—debtor’s rights and obligations

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B. Insolvency representative’s rights and obligations

1. General remarks

143. The insolvency representative plays a central role in the effective implementation of the law. Where it is a court appointed official, many laws provide that the insolvency representative has an obligation to ensure that the law is applied effectively and impartially. Since it normally has the most information regarding the situation of the debtor, the insolvency representative is in the best position to make informed decisions. That does not mean that the insolvency representative is a substitute for the court: a court of competent jurisdiction would adjudicate a dispute between the insolvency representative and an interested party. Even in countries where the role of the court in insolvency proceedings is restricted, there is a limit to the amount of authority that would normally be conferred upon an insolvency representative.

(a) Selection and appointment of insolvency representative

144. In some jurisdictions, the court selects, appoints and supervises the insolvency representative. In other jurisdictions, a separate office or institute selects the insolvency representative after the court directs it to do so, and it is charged with the general regulation of all insolvency representatives. A third 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 that capacity in the specific case. Although these latter approaches may serve to avoid perceptions of bias, they may have the disadvantage of requiring additional resources and infrastructure.

(b) Qualifications

145. 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. A related issue is whether the insolvency representative must be a natural person, or whether a legal person may also be eligible for appointment. However appointed, the complexity of many insolvency proceedings makes it desirable that the insolvency representative have knowledge of the law, be impartial and have adequate experience in commercial and financial matters. If specialized knowledge is required, it can always be provided by hired experts. Conflicts of interest arising from a pre-existing relationship with the debtor, a creditor or a member of the court may be sufficient in some countries to preclude the appointment of that person as an insolvency representative.

(c) Duty of care

146. The standard of care to be employed by the insolvency representative and its personal liability are important to the conduct of insolvency proceedings. The insolvency representative serves as a fiduciary in the performance of its duties, owing a general duty of loyalty to the estate and the various constituencies in the case. As such, the insolvency representative may be liable for a breach of those duties. Establishing a measure for the care, diligence and skill which is owed requires a standard that will take into account the difficult circumstances in which the insolvency representative finds itself when fulfilling its duties, such as a standard of negligence. Some insolvency laws require the insolvency representative to post a bond or provide insurance coverage against a breach of its duties. Where losses are sustained by the estate as a result of the negligence, incompetence or dishonesty of agents and employees of the insolvency representative, some laws provide that the insolvency representative is not personally liable except where it fails to exercise the proper degree of care in the performance of its duties. [*Note to the Working Group: are there other approaches to liability of the insolvency representative?*]

147. 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. In terms of remuneration of those professionals, some laws require an application to and approval by the court, while another approach might be to require approval of the creditor body. Professionals may be paid periodically during the proceedings, or may be required to wait until the proceedings are completed.

(d) Replacement or removal

148. In the event of the death or resignation of the insolvency representative, disruption of the proceedings and the delay that may be occasioned by failure to provide for succession may be avoided by providing for the appointment of a successor insolvency representative. Some insolvency laws permit the insolvency representative to be removed in certain circumstances. These could include that the insolvency representative had violated or failed to comply with its legal duties under the insolvency regime or had demonstrated gross incompetence or gross negligence. Different approaches provide that removal may occur on the basis of a decision of the court, acting on its own motion or at the request of an interested party, or a decision taken by an appropriate majority of unsecured creditors.

2. Summary—insolvency representative's rights and obligations

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C. Creditor claims

1. General remarks

149. Claims operate at two levels in insolvency proceedings—for purposes of determining which creditors may vote and how they may vote (according to the class of creditor into which they fall) and for purposes of distribution. Laws differ in the types of claims that may be made. In some laws, a distinction is made between secured and unsecured claims. A secured creditor does not generally make a claim unless it surrenders its security or is undersecured (i.e. the value of the claim exceeds the value of the collateral) and wishes to claim for the unsecured portion (which may be a provisional claim). Some laws provide that certain claims are not admitted on public policy grounds, for example, foreign revenue claims, judgements obtained by fraud, fines and penalties, and gambling debts.

(a) Making of claims

150. Different mechanisms may be used for the making of claims. The laws of many countries place the burden upon creditors to produce evidence of their claims to the insolvency representative for its review. Some laws provide that, as an initial step, a list of creditors and claims is prepared, either by the court or by the debtor. Once the list is prepared, creditors may be invited to make their claims to the insolvency representative. Preparation of such a list by the debtor takes advantage of the knowledge the debtor will have about its creditors and their claims and gives the insolvency representative an early indication of the state of the enterprise. Presentation of claims by creditors and their subsequent verification by the insolvency representative tends to assure proper distributions.

(b) Provisional claims

151. Creditors claims may be of two types: those that involve a determined amount and those where the amount owed by the debtor has not been or cannot presently be determined. Such claims may be either contractual or tortious in nature and may arise in respect of both secured and unsecured claims. Where the amount of the claim cannot be or has not been ascertained at the time the claim has to be made to the insolvency representative, many laws provide for a claim to be made provisionally or to be given a provisional value. Admission of provisional claims raises a number of issues. These concern valuation of the claim and the party to undertake that valuation; voting of provisional creditors on important issues such as determining whether the case is one of liquidation or reorganization or approval of the reorganization plan; and whether as minority creditors, they can be bound by a plan to which they have not agreed (see section IV.6 Reorganization plan).

(c) Verification of claims

152. Although most laws provide for the insolvency representative to verify the claims of the creditors, some laws do not require verification unless a claim is

challenged. Verification involves not only an assessment of the underlying legitimacy and amount of the claim, but also a determination of the category within which a claim fits for purposes of voting and distribution (e.g. secured as opposed to unsecured claims; pre-commencement as opposed to post-commencement claims).

(d) Procedural issues

(i) Notice to creditors

153. Most laws provide that all identified and identifiable creditors are entitled to receive notice of claims that have been made. That notification may be given personally or by publishing notices in appropriate commercial publications. An insolvency representative may additionally be required to prepare a list of claims, both [admitted][approved] and disputed, and file it with the court or other administrative body to facilitate the provision of notice to unknown creditors and provide updated information on progress with regard to [admission][approval] or rejection of disputed claims.

(ii) Requirements for filing claims

154. To ensure that claims are made in a timely fashion and that the insolvency proceedings are not unnecessarily prolonged, deadlines for the making of claims with the insolvency representative can be of assistance. Where creditors fail to meet those deadlines, they may be treated in different ways. These may include exclusion from the receipt of dividends or from distributions, or limitation of their participation in the distribution of assets to those assets remaining after the verification of claims.

155. Under some laws, the insolvency representative has the power to verify claims and where disputes arise they are to be resolved by the court. Other laws provide that the court would verify all claims and resolve disputes. Some laws allow claims to be disputed only by the insolvency representative, while other laws permit other interested parties, including creditors, to challenge a claim. Where this occurs, one means of addressing it may be to provide for final review of the list of creditors' claims at a creditors assembly, following preparation of the list by the insolvency representative or the court. Where disputes as to claims arise, whether between a creditor and the insolvency representative or the debtor and the insolvency representative, and including disputes as to collateral or security rights, a mechanism for quick resolution is essential to ensure efficient and orderly progress of the proceedings. If resolution of disputed claims cannot be quickly and efficiently addressed, the ability to dispute a claim may be used to frustrate the proceedings and create unnecessary delay.

2. Summary—creditor claims

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D. Creditor committees

1. General remarks

156. Creditors have a significant interest in the enterprise once an insolvency proceeding is commenced. As a general proposition, these creditor interests are safeguarded by the appointment of an insolvency representative. However, creditors may also be given the power of decision making in a number of key areas in both liquidation and reorganization. In some laws, for example, they have the authority to dismiss an insolvency representative, approve a private sale of the business in liquidation, propose and approve a plan in reorganization and to request or recommend action from the court, such as conversion of reorganization to liquidation. Creditors are given a role in the insolvency process for a number of reasons. As the party with the primary economic stake in the outcome of the proceedings they may lose confidence in a process where key decisions are made by individuals that are perceived as having limited experience, expertise or independence. In addition, creditors are often in the best position to monitor the actions of the insolvency representative, thus discouraging fraud, abuse and excessive administrative costs.

157. In cases where there are a large number of creditors, the formation of a creditor committee can provide a mechanism to facilitate creditor participation in the administration of the case, whether it is liquidation or reorganization proceedings. The creditor committee can be appointed to undertake a number of tasks including monitoring the progress of the case, consulting with other principals in the proceeding, especially an insolvency representative and the existing management of the debtor, and advising the insolvency representative on the wishes of the creditor body. The committee's duty would be to the general body of creditors. As a representative body, it would not have any liability or fiduciary duty to the owners of the insolvent enterprise.

(a) Involvement of creditors in decision-making process

158. There are varying possible degrees of involvement by creditors in the decision making process of the proceedings. In some systems, the insolvency representative makes all key decisions on uncontested general matters of administration and liquidation, with the creditors playing a marginal role and having little influence. Such an approach may be very efficient where it is handled by an experienced insolvency representative because it avoids the delays involved in managing the participation of creditors. That approach may be supported where the system already provides a high level of regulation of the process and its participants. Some approaches which limit the participation of creditors distinguish between liquidation and reorganization, allowing creditors to participate only in the decision whether to proceed as a liquidation or reorganization and to vote on a reorganization plan.

159. Other approaches afford creditors greater participation in the proceedings. Under some laws, in liquidation proceedings, creditors may be able to select and replace the insolvency representative, approve the temporary continuation of the business by the insolvency representative and approve private sales of assets. In reorganization proceedings, they may perform a vital role in the proceedings, serving as a primary check on the activities of the enterprise (especially where the system allows the debtor to remain in possession after commencement) and the insolvency representative, and proposing and approving reorganization plans. They may also have a role in requesting or recommending action from the court,

including, for example, a recommendation that the reorganization be converted to liquidation.

(b) Creditors to be represented

160. Different approaches may be taken to the composition of creditor committees. In some systems, although a creditor committee would generally represent only unsecured creditors, it is recognized that there may be cases where a separate committee of secured creditors might be justified. Those systems base this approach on the fact that the interests of the different types of creditors do not always converge and the ability of secured creditors to participate in and potentially affect the outcome of decisions by the committee may not always be appropriate or in the best interests of other creditors. Other systems provide for both types of creditors to be represented on the same committee. Under those systems the exclusion of secured creditors from the committee is viewed as effectively excluding them from participation in the making of important decisions. The participation of shareholders of the enterprise may be controversial, especially where the creditor committee has the power to affect the rights of secured creditors or where they are involved with the management of the debtor.

(c) Formation of creditors committee

161. Where the law provides for the formation of creditor committees, details of the manner in which the committee is formed, the scope and extent of its duties, its governance and operation, including voting eligibility and powers, quorum and conduct of meetings, as well as replacement and substitution of members are often also addressed. A further issue is that of situations where the input, not only from the creditor committee but also from all creditors is appropriate, and how that input is to be obtained.

162. To facilitate administration and oversight of the committee, some insolvency laws specify the size of the committee which would preferably an odd number in order to ensure the achievement of a majority vote. Membership of the committee may be limited to the largest unsecured creditors, who are representative of the overall creditor body. These creditors can be identified by a number of means, including requesting the debtor’s managers to prepare a listing of the debtor’s largest creditors. To ensure equality of treatment of creditors, classes of creditors such as those whose claims have not yet been approved and foreign creditors can be eligible for appointment to the committee.

163. Representatives to the committee can be appointed or selected in a number of ways. One approach is for the insolvency representative to appoint representatives to the committee. Alternatively, and with the consent of the insolvency representative or pursuant to provisions of the law, creditors may select the members of the committee at an initial meeting of creditors. Another approach is for the court or some other authorized body to appoint the creditors’ committee. Oversight of the committee, to ensure that it fulfils its duty to fairly represent unsecured creditors, may be required and could be undertaken by the insolvency representative.

(d) Duties of creditors committee

164. The committee can undertake a number of functions, including meeting periodically with the insolvency representative to be advised on the progress of the case, including proposals to sell significant assets, to operate some or all of the debtor's business, and to pursue, forgo or settle significant litigation; reviewing claims; and negotiating reorganization proposals on behalf of the unsecured creditors. To perform its functions, the committee may require administrative and expert assistance. Provision may be made in the law for the committee to request the insolvency representative for permission to hire a secretary and, if circumstances warrant, consultants and professionals at the expense of the insolvency estate.

(e) Voting of creditors

165. 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 are entitled to receive notice of, and to vote on, those actions. A number of different approaches may be taken with respect to achieving that vote, depending upon the nature of the matter to be voted upon. Some laws provide for voting to occur 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.

166. Different approaches are taken to the type of vote that is required to bind creditors. Some laws provide that the vote of a supermajority of the value of the claims that actually vote is sufficient to bind all creditors, where the proportion required for a supermajority may be three-fourths or two-thirds. In other examples, the law provides that a simple majority is sufficient on some issues such as election or removal of the insolvency representative. In some laws, secured creditors will only participate in the vote on specified matters such as selection of the insolvency representative and matters affecting their collateral.

2. Summary—creditor committees

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E. Post-commencement finance

1. General remarks

167. The continued operation of the enterprise is critical for reorganization. To facilitate that continuing operation it is important that the insolvency representative [or the debtor] be able to obtain credit to pay for crucial supplies of goods and services and to maintain business activities. An insolvency law can recognize the need for such post-commencement lending, provide authorization for it and create priority for repayment of the lender. The central issue is the scope of the power, in particular, the inducements that the insolvency representative can offer a potential creditor as a means of obtaining credit. To the extent that the solution adopted impacts the rights of existing secured creditors or those holding an interest in assets that is prior in time, it is desirable that provisions addressing post-commencement financing are balanced against the general need to uphold commercial bargains and the need to protect the rights and priorities of creditors.

168. Many laws provide that the insolvency representative can obtain unsecured credit with out approval by the court or by creditors, while other laws require approval by the court or creditors in certain circumstances. Credit can also be obtained by giving a security interest on unencumbered property or a second-priority security interest on encumbered property. Where these inducements are not sufficient or not available, a number of different approaches may be taken to obtain the necessary credit. Pre-commencement lenders will have a key interest in security granted to secure the post-commencement lending in terms of the priority of their own security over any security that is later in time. In some insolvency systems, parties that lend to the business after the commencement of proceedings are entitled to priority in repayment ahead of all creditors. Such a priority is effectively a surcharge against the entire estate and assets. Another form of priority is an administrative priority (see section V.1 Distribution priorities), which gives a priority in repayment over the general unsecured creditors, but not over a secured creditor with respect to its collateral. An intermediate approach allows for lenders and those advancing goods to take a security interest in the debtor’s secured and unsecured assets. Some countries also allow the insolvency representative to give a “super” administrative priority, that is, priority over other administrative creditors. An extreme approach is one that allows the granting of a “super” priority security interest that is senior to all existing securities. In some legal systems, all of these options are available. Some laws provide that the insolvency representative can approve such priorities, while in other laws approval by the court or creditors is required in respect of some forms of priorities.

2. Summary—post-commencement finance

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F. Reorganization plans

1. General remarks

169. Insolvency laws address a number of issues in the context of formulation of a reorganization plan, such as when the plan is to be prepared; who is able to prepare the plan; what is to be included in the plan; how the plan is to be approved and the effect of the plan.

(a) Preparation of a plan

170. Some laws adopt the approach that the plan for reorganization forms a part of the application for reorganization proceedings (where the application may be called a “proposal” for reorganization), while other laws provide for it to be prepared after commencement of reorganization proceedings.

171. Different participants in the reorganization proceedings might prepare the reorganization plan. Some insolvency laws require the debtor to prepare the reorganization plan. This approach may have the advantage of encouraging debtors to utilize reorganization proceedings and to make the best use of the debtor’s familiarity with its business and knowledge of the steps necessary to make the enterprise viable again. That opportunity could be made exclusive or exclusive for a

specified period, with the court having the power to extend the period if it will be of advantage to the reorganization proceedings.

172. Since the plan will only be successful if it is approved by a requisite majority of creditors, there is always a risk that reorganization will fail if the plan presented by the debtor is not acceptable. For example, creditors may only wish to approve a plan that deprives the debtor's shareholders of a controlling equity interest in the enterprise and may also deprive the incumbent management of any management responsibilities. If the debtor is given the exclusive opportunity to prepare the plan and refuses to consider such an arrangement, there is a danger that the reorganization will fail, to the detriment of the creditors, the employees, and the enterprise. To address that concern, some insolvency laws provide that, if the debtor fails to provide an acceptable plan, the creditors are given the opportunity to propose a plan at the end of the exclusive period. This may be achieved through a creditor committee (see section IV.4 Creditor committee). This option may provide the leverage necessary for one participant (the creditors) to persuade the other participant (the debtor) to compromise

173. A further approach would be to give the insolvency representative an opportunity to prepare the plan, whether as an alternative to preparation by the debtor or creditors or as a supplement. The importance of providing for participation by the insolvency representative or the creditors depends upon the design of the law. In circumstances where approval by the requisite majority of creditors is a necessary condition for effectiveness of the plan, a plan that takes account of proposals that will be acceptable to creditors has a greater likelihood of being approved than one which does not. This consideration will not apply where the law provides that creditor approval is not necessary or can be overruled by the court. Where a number of parties are given the opportunity to participate in preparation of a plan, the preparation of a number of plans simultaneously may complicate the process, although it may also promote the preparation of a mutually acceptable plan.

174. Some laws provide for the court to consider the opinions of third parties on the plan, such as governmental agencies and labour unions. Since such a procedure may have the potential to lengthen the duration of the process, it may be desirable only if carefully monitored and with time limits imposed.

(b) Content

175. Most countries have laws requiring that the reorganization plan adequately and clearly disclose to all parties information regarding both the financial condition of the enterprise and the transformation of legal rights that is being proposed by the proponent of the plan. The question of what is to be included in the plan is closely related to the question of approval and effect of the plan. To the extent that a plan can be approved and enforced upon dissenting creditors, there may be a need to ensure that the content of the plan provides appropriate protection for those dissenting creditors.

176. Content of the plan also raises issues related to other laws. For example, to the extent that national company law precludes debt-for-equity conversions, a plan that provides for such a conversion could not be approved. Since debt-for-equity conversion can be an important feature of reorganization, it would be necessary to eliminate the prohibition if such provisions are to be included in the plan and

approved. Similarly, if the plan is limited to debt forgiveness or the extending of maturity dates, it might not receive adequate support from creditors for it to be successful. Some insolvency cases raise similarly straightforward and uncontroversial issues of the relationship between the insolvency law and other laws. Other cases may raise more complicated questions. These may include limits on foreign investment, especially in cases where many of the creditors are non-residents, or the treatment of employees under relevant labour laws where, for example, the reorganization may raise questions of modification of collective bargaining agreements.

(c) Approval and effect of the plan

177. Designing the law with regard to the approval and effect of the plan requires balancing of a number of competing considerations. On the one hand, it may be desirable to provide a way of imposing an agreed plan upon a minority of dissenting creditors, in order to increase the chances of success of the reorganization. On the other, to the extent that the approval procedure results in a significant impairment of creditors' claims without their consent, there is a risk that the willingness of creditors to provide credit in the future might be undermined.

(i) Secured and priority claims

178. Different approaches may be taken to the approval of the plan by secured and priority creditors. In many cases, secured claims will represent a significant portion of the value of the debt owed by the debtor. Under one approach, where the law ensures that an approved plan will not preclude secured creditors from exercising their rights, there is generally no need to give these creditors the right to vote since their interests will not be impaired by the plan. Priority creditors are in a similar position under this approach—the plan cannot impair the value of their claims and they are entitled to receive full payment. The disadvantage of this approach is that it may reduce the chances for a successful reorganization, particularly where the assets securing the claim are vital to the success of the plan—if secured creditor elects to exercise its rights it may make the plan impossible to implement. Similarly, the plan may provide that, in order for it to succeed, priority creditors receive less than the full value of their claims.

179. To resolve some of these difficulties, secured and priority creditors may be permitted to vote as separate classes on a plan that would otherwise impair the value of their claims. The creation of these classes recognises that the respective rights and interests of those creditors differ from those of unsecured creditors. To the extent that majority support is obtained from both secured and priority classes of creditors, they will be bound by the terms of the plan. In those circumstances, laws generally require that dissenting creditors be entitled to receive at least as much as they would have received under liquidation.

(ii) General unsecured creditors

180. Even if voting by secured or priority creditors is not permitted, it is desirable that the general unsecured creditors have an effective means for voting on a plan. Different mechanisms may be used.

181. *Majorities*. Some laws identify the minimum threshold of support required of general unsecured creditors in order make the plan binding on those creditors, as well as the voting procedures that are to be used to determine this support. One issue of importance is the manner in which votes are calculated, whether on the basis only of the percentage of value of the debt that supports the plan or also of the number of creditors that are supportive. Some laws require, for example, that the plan be supported by two-thirds of the value of the debt and one-half of the number of creditors. Other combinations are also used. Although increasing the difficulty of achieving approval, such a procedure 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.

182. With regard to voting procedures, many countries adopt the approach of calculating the percentage of support on the basis of those actually participating in the voting. Absentees are considered to have little interest in the proceedings. Such an approach requires adequate notice provisions and their effective implementation, especially where creditors are non-residents.

183. *Classes*. Some countries that have established classes for secured and priority creditors also provide for the division of unsecured creditors into different classes. The creation of these classes is designed to enhance the prospects of reorganization in at least three respects, by providing a useful means of identifying the varying economic interests of unsecured creditors; a framework for structuring the terms of the plan; and a means for the court to utilize the requisite majority support of one class to make the plan binding on other classes which do not support the plan.

184. "*Cram-down*" authority. A few countries that provide for voting by secured and priority creditors and for the creation of different classes of unsecured creditors also include a mechanism that will enable the support of one class to make the plan binding on other classes (including classes of secured and priority creditors) without their consent. This is often referred to as a "cram-down" provision. The creation of classes and the application of such rules complicate both the insolvency law and its application by the insolvency representative and the court and may require for example, the exercise of considerable discretion on economic matters, such as categorization of unsecured creditors by the court on the basis of their economic interests. This discretion, where it is not exercised in an informed, independent and predictable manner, has the potential to undermine creditor confidence.

185. *Shareholders*. Some laws provide for the approval of plans by shareholders of the debtor enterprise, at least where the corporate form, the capital structure or the membership will be affected by the plan. In addition, where the debtor's management proposes a plan, the terms of the plan may already have been approved by the shareholders (depending upon the enterprise in question, this may be required under the constitutive instrument of the enterprise). This is often the case where the plan directly affects shareholders such as by providing for debt-for-equity

conversions, either through the transfer of existing shares or the issuance of new shares.

186. In circumstances where the law permits creditors or an insolvency representative to propose a plan, and the plan contemplates debt-for-equity conversion, some countries allow the plan to be approved over the objection of shareholders, irrespective of the terms of the constitutive instrument of the enterprise. Such plans may result in existing shareholders being entirely displaced without their consent.

187. *Court approval*. The court would normally be expected to approve a plan that has been approved by the requisite majority of creditors. Many countries enable the courts to play an active role in "binding in" creditors by making the plan enforceable upon a class of creditors where they have not approved the plan. Conversely, in cases where the plan has been approved by the requisite majority of creditors, the court will normally have the authority to reject the plan on the grounds that the interests of dissenting creditors have not been adequately protected (because, for example, they have not received as much as they would have received in liquidation), or there is evidence of fraud in the approval process.

188. Some laws also give the court the authority to reject a plan on the grounds that it is not feasible. This may be justified, for example, where secured creditors are not bound by the plan but the plan does not provide for full satisfaction of the secured claims of these creditors. The court may reject the plan in such a case if it considers that secured creditors will exercise their rights against the collateral, thus rendering the plan impossible to perform. The risk of this occurring can be addressed in provisions relating to preparation and approval of the plan.

189. Several countries also provide that the court has an ongoing role in supervision of the debtor after approval and confirmation of the plan, pending completion of implementation of the plan. This may be important where issues of interpretation of the performance or obligations of the debtor or others arise.

[*Note to the Working Group:*

The Working Group may wish to consider whether the following issues should be addressed under the topic of reorganization—

(a) The role of the reorganization plan: is the plan the tailpiece of reorganization proceedings dealing with the pay-out of a dividend in full and final settlement of all claims (also referred to as a composition or a scheme of arrangement) or does the plan set out the way the debtor and the business enterprise should be dealt with during the reorganization period, which plan is set out at the beginning of the proceedings;

(b) Can a reorganization plan may be prepared in liquidation as well as in reorganization proceedings;

(c) Minimum requirements of the reorganization plan, including provision for distribution of funds and the continuation or termination of contracts that are not fully executed and non-expired leases, the settlement of claims, the sale of collateral, minimum dividend pay-out to creditors, the disclosure and acceptance procedure, the rights of disputed claims to take part in the voting process and

provisions for disputed claims to be dealt with; voting rights and powers of "insiders"; restriction on content of the plan;

(d) Amendment of the reorganization plan;

(e) Conversion to liquidation where a plan is not approved or implementation fails;

(f) Challenges to the reorganization plan;

(g) Oversight of implementation of the reorganization plan;

(h) Discharge of debts and claims;

(i) Termination of proceedings.]

2. Summary—reorganization plans

[…]

V. Liquidation and distribution

Distribution priorities

1. General remarks

190. For the purposes of determining the priority of distribution of the proceeds of the estate in liquidation, many laws adopt the general principle that creditors be ranked by categories which reflect a balance of the legal and commercial relationships entered into with the debtor. That balance is aimed at preserving legitimate commercial expectations and fostering predictability in commercial relationships. While distribution policies reflect choices that recognize important public interests, these broader public interests often compete with private interests and may lead to a distortion of normal commercial incentives.

(a) Secured creditors

191. The method of distribution to secured creditors depends on the method used to protect the secured creditor during the proceedings. If those interests were protected by preserving the value of the collateral, the secured creditor will have a first-priority claim on the proceeds of its collateral to the extent of the value of the secured claim. Alternatively, if the interests of the secured creditor were protected by fixing the value of the secured portion of the claim at the time of the commencement of the proceedings, the creditor will have a first priority claim to the general proceeds with respect to that value. It is desirable that exceptions to the first priority rule be limited. One exception may relate to the administrative expenses associated with the maintenance of the collateral.

(b) Administrative claims

192. Insolvency proceedings often require the assistance of professionals, such as the official insolvency representative and advisors to the debtor or insolvency representative. Also creditor committees may incur costs. These expenses of the insolvency proceeding often have a top priority, as administrative claims, over other

claims, and are often treated differently from other claims, to ensure proper payment for the parties dealing with the insolvency process. Expenses of insolvency proceedings may include many or all post-commencement debts: not just professional fees incurred by the debtor, insolvency representative and creditors committee, but also post-commencement claims of employees, lease costs and similar claims.

(c) Privileged creditors

193. Once secured claims and administrative expenses have been satisfied, the means by which remaining resources are distributed vary considerably among countries. Insolvency laws often identify priority rights which are rights attributed by domestic law to certain (mainly unsecured) debts to be paid in priority to other, unsecured and non-preferential (or less preferential) debts. In some countries, some priority rights, such as those relating to employees, rank ahead of secured creditors. Priority rights militate against the principle of *pari passu* distribution and operate to the detriment of ordinary, unsecured debts. The types of privileges provided by countries vary, but two categories are particularly prevalent. The first type provides priority for employee salaries and benefits (social security and pension claims) while the second type relates to government tax claims. Although some recent insolvency laws have significantly reduced the number of priority rights, reflecting a change in the public acceptability of such preferential treatment, in other countries there is a tendency to increase the categories of debt that enjoy priority. Maintaining a number of different preferential positions for many types of claims has the potential to complicate the basic goals of the insolvency process and to make the achievement of an efficient and effective process difficult. It may create inequities and, in reorganization, complicates preparation of the plan.

(d) Unsecured creditors

194. Once all privileged creditors have had their claims satisfied the balance would be distributed *pro rata* to unsecured creditors. There may be subdivisions within the class, with some claims being treated as subordinate. Some countries subordinate claims such as gratuities, fines and penalties, shareholder loans and post-petition interest to general unsecured claims, while in others they are treated as excluded claims.

(e) Owners

195. Many insolvency laws adopt the general rule that the owners of the business are not entitled to a distribution of the proceeds of assets until the creditors, who are senior in priority, have been fully repaid. This may or may not require the payment of interest. Where a distribution is made, it would be in accordance with the ranking of shares specified in the company law and corporate charter.

(f) Method of distribution

196. In systems where the preferential debts of the same priority rank equally amongst themselves after the expenses of the insolvency procedure, they will be paid in full unless the assets subject to their payment are insufficient to meet them. In that case they would abate in equal proportions according to their priority. Thus, each level of priority would be paid in full before the next is paid. Once a priority is

reached where there are insufficient funds to pay all the creditors in full, the creditors of that priority share *pro rata*. In some laws which do not have different levels of priority, all the creditors share *pro rata* if there are insufficient funds to pay them in full. It may be desirable to provide in reorganization proceedings that priority claims must be paid in full as a predicate to confirmation of a plan unless the affected priority creditors agree otherwise.

197. [A plan of reorganization may propose distribution priorities that are different to those provided by the insolvency law, provided that such a modification has been approved by creditors voting on the plan.]

2. Summary—distribution

198. The amount available for distribution to creditors would be paid in the following order:

a. [Secured claims]

b. Expenses and remuneration in connection with the appointment, duties and functions of the insolvency representative;

c. Administrative expenses;

d. [other approved claims].

199. Priority rights can be [maintained for employee claims and other privileged creditors][kept to a minimum].

200. The claims in each of these categories are ranked equally between themselves. All the claims in a particular class would be paid in full before the next class was paid. If there is not sufficient to pay them in full they would be paid in proportion.