United Nations A/CN.9/WG.V/WP.63/Add.3

General Assembly

Distr.: Limited
4 September 2002

Original: English

United Nations Commission on International Trade Law
Working Group V (Insolvency Law)
Twenty-seventh session
Vienne, 9-13 December 2002

Draft legislative guide on insolvency law

Note by the Secretariat

Contents

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

V.02-57330 (E)

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

Part Two (continued)

II. Applications and commencement

A. Eligibility and jurisdiction

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

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

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

(a) Debtors: individuals engaged in commercial activities

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

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

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

(b) State-owned enterprises

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

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

(c) Entities requiring special treatment

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

2. Jurisdiction

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

(a) Centre of main interests

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

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

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

(b) Establishment

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

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

(c) Presence of assets

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

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

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

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

Recommendations

Purpose of legislative provisions

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

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

Content of legislative provisions

Eligibility

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

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

Jurisdiction

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

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[2] UNCITRAL Model Law, article 28.

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

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

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

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

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

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

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