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Draft legislative guide on insolvency law

Note by the Secretariat

Contents

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

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

Part Two (continued)

II. Applications and commencement

B. Application and commencement criteria

1. Introduction

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

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

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

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

2. Application criteria

(a) Liquidity or cash flow standard

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

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

(b) Balance sheet standard

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

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

[3] Book value – *to be completed*

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

(c) Designing the commencement standard

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

(i) Imminent insolvency (Prospective illiquidity)

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

(ii) Types of proceedings that may be commenced

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

3. Liquidation

(a) Parties who may apply

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

(b) Debtor application

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

(i) Establishing an obligation for debtor to apply

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

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

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

(c) Creditor application

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

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

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

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

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

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

(d) Application by a governmental authority

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

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

4. Reorganization

(a) Debtor application

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

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

(b) Creditor application

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

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

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

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

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

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

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

5. Procedural issues

(a) Initiation of the process

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

(b) The decision to commence insolvency proceedings

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

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

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

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

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

(d) Denial of the application to commence

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

(e) Notice of commencement

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

(i) Notice to creditors

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

(ii) Notice to the debtor

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

(iii) Notice to parties other than creditors

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

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

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

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

(f) Assetless estates

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

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

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

6. Costs of the insolvency proceedings

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

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

Recommendations

Purpose of legislative provisions

The purpose of provisions on application and commencement ~~criteria~~ <u>of insolvency proceedings is</u> to:

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

Content of legislative provisions

Eligibility for application

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

Commencement criteria

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

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

Presumption that the debtor is unable to pay

Version 1

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

Version 2

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

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

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

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

Commencement on debtor application

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

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

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

Commencement on creditor application

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

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

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

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

Notification of commencement

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

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

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

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

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

[(d) information concerning meetings of creditors].

Denial of an application to commence proceedings

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

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

Assetless estates

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

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

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