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Draft legislative guide on insolvency law

Note by the Secretariat

Contents

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

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

Part Two (continued)

IV. Participants and institutions

A. The debtor

1. Introduction

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

2. Continued operation of the debtor's business

(a) Liquidation

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

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

(b) Reorganization

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

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

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

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

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

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

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

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

(ii) Possible approaches - total displacement of the debtor

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

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

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

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

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

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

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

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

(iv) Possible approaches – full control by the debtor

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

3. Rights of the debtor

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

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

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

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

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

4. Obligations of the debtor

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

(a) Co-operation and assistance

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

(b) Provision of information

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

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

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

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

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

(c) Confidentiality

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

(d) Ancillary obligations

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

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

(e) Employment of professional to assist the debtor

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

(f) Failure to observe obligations

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

5. Debtor's liability

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

Recommendations

Purpose of legislative provisions

The purpose of provisions concerning the debtor is to:

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

Content of legislative provisions

Right to be heard

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

Right to participate and request information

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

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

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

Obligations

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

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

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

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

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

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

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

Confidentiality

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

Continued operation of the debtor's business

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

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

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

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

Sanctions for failure to comply

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

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

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

B. The insolvency representative

1. Introduction

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

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

2. Qualifications

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

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

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

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

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

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

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

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

3. Selection and appointment of the insolvency representative

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

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

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

4. Duties and functions of the insolvency representative

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

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

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

(xviii) closing the estate promptly, efficiently and in accordance with the best interests of the various constituencies in the case;
(xix) submitting a final report and accounting of the insolvency estate's administration to the court or the creditors, as required;
(xx) any other matters that may be referred to the insolvency representative by the creditors or determined by the court.

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

5. Confidentiality

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

6. Remuneration of the insolvency representative

(a) Determination of quantum

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

(i) Time-based systems

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

(ii) Commission-based systems

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

(iii) Involvement of creditors

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

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

(b) Means of payment

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

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

(c) Review of remuneration

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

7. Duty of care [Liability]

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

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

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

8. Agents of the insolvency representative

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

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

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

9. Removal of the insolvency representative

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

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

10. Replacement of the insolvency representative

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

Recommendations

Purpose of legislative provisions

The purpose of provisions concerning the insolvency representative is to:

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

Content of legislative provisions

Qualifications

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

Appointment

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

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

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

Conflict of interest

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

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

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

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

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

Liability

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

Removal and replacement

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

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

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

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

Remuneration

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

~~Judicial review~~

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

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