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Draft legislative guide on insolvency law

Contents

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Introduction

1. Organization and scope of the Guide

1. The purpose of the *Guide* is to assist in the establishment of an efficient and effective legal framework to address the financial difficulty of debtors. It is intended to be used as a reference by national authorities and legislative bodies when preparing new laws or reviewing the adequacy of existing laws and regulations. The advice provided in the *Guide* aims at achieving a balance between the need to address the debtor's financial difficulty as quickly and efficiently as possible with the interests of the various parties directly concerned with that financial difficulty, principally creditors and other parties with a stake in the debtor's business, as well as with public policy concerns. The *Guide* discusses a number of issues central to the design of an effective and efficient insolvency law, which despite numerous differences of policy and legislative treatment, are recognized in many legal systems. It focuses on insolvency proceedings commenced under the insolvency law and conducted in accordance with that law, with an emphasis on reorganization, but also discusses the increasing use and importance of restructuring negotiations entered into voluntarily between a debtor and its creditors, and not regulated by the insolvency law. In addition to addressing the requirements of domestic insolvency laws, the *Guide* includes the text and Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency.

2. The *Guide* does not provide a single set of model solutions to address the issues central to an effective and efficient insolvency law, but it assists the reader to evaluate different approaches available and to choose the one most suitable in the national or local context. The first section of each chapter of the *Guide* contains a commentary identifying the key issues for consideration and discussing and analysing the various approaches adopted by insolvency laws. The second part of each chapter contains a set of recommended legislative principles. These recommendations are intended to assist in the establishment of a legislative framework for insolvency that is both efficient and effective and reflects modern developments and trends in the area of insolvency. The user is advised to read the legislative recommendations together with the commentary, which provides detailed background information to enhance understanding of the legislative recommendations, as well as a discussion of issues not included as recommendations. In view of the key importance of secured creditors to insolvency proceedings and the policy considerations associated with their treatment under an insolvency law, the user of this *Guide* is also encouraged to consider the UNCITRAL Legislative Guide on Secured Transactions.

3. The recommendations included in the *Guide* deal with core issues that are important to address in legislation specifically concerned with insolvency. They do not deal with other areas of law, which, as discussed throughout the *Guide*, have an impact on both the design of an insolvency law and insolvency proceedings commenced under that law. Moreover, the successful implementation of an insolvency regime requires various measures beyond the establishment of an appropriate legislative framework, especially an adequate institutional infrastructure, organizational capacity, technical professional expertise, and appropriate human and financial resources. Although these matters are discussed in the commentary, they

are generally not addressed in the legislative recommendations, except where they relate to the insolvency professional appointed to administer the insolvency estate.

2. Glossary

A. Notes on terminology

4. The following terms are intended to provide orientation to the reader of the Guide. Many terms such as "secured creditor", "liquidation" and "reorganization" may have fundamentally different meanings in different jurisdictions and the inclusion of a definition in the Guide may assist in ensuring that the concepts as discussed in the Guide are clear and widely understood.

References in the Guide to the "court"

5. The Guide assumes that there is reliance on court supervision throughout the insolvency proceedings which may include the power to commence insolvency proceedings, to appoint the insolvency representative, to supervise its activities and to take decisions in the course of the proceedings. Although this reliance may be appropriate as a general principle, alternatives may be considered where, for example, the courts are unable to handle insolvency work (whether for reasons of lack of resources or lack of requisite experience) or supervision by an administrative agency is preferred (see part one, chapter III, Institutional framework). Given the specialized nature of the process and the task performed by a facilitating agency in the context of the administrative processes described in part one, chapter II, it is not intended that such an agency would necessarily be regarded as a court within the usage of that term in the Guide.

6. For the purposes of simplicity the Guide uses the word "court" in the same way as article 2 (e) of the UNCITRAL Model Law on Cross-Border Insolvency to refer to a judicial or other authority competent to control or supervise an insolvency proceeding.

Reference to "the law"

7. References in the *Guide* to "the law" are to the insolvency law unless otherwise specified.

Rules of interpretation

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

B. Terms and definitions

Administrative claim or expense	Claims which include costs and expenses of the proceedings such as remuneration of the insolvency representative and any professionals employed by the insolvency representative, expenses for the continued operation of the debtor; debts arising from the proper exercise of the insolvency representative's functions and powers, costs arising from continuing contractual obligations, and costs of proceedings.
Application for commencement of insolvency proceedings	An application for the commencement of insolvency proceedings which may be made, inter alia, by the debtor, creditors or a government authority.
[Assets of the debtor	Property, rights and interests of the debtor including rights and interests in property, whether or not in the possession of the debtor, tangible or intangible, movable or immovable, including the debtor's interests in assets subject to a security interest or in third party-owned assets.]
Avoidance provisions	Provisions which permit transactions occurring prior to insolvency proceedings to be cancelled or otherwise rendered ineffective in the collective interests of creditors or the insolvency estate for reasons related to insolvency.
Burdensome assets	Assets that may have no value or an insignificant value to the insolvency estate, for example where the asset is burdened in such a way that retention would require excessive expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money.
Centre of main interests	The place where the debtor conducts the administration of its interests on a regular basis and that is therefore ascertainable by third parties.[1]
Claim	A right to claim from the debtor money or assets which may be based upon a debt or contract, may be liquidated or unliquidated, matured or unmatured, disputed or undisputed, secured or unsecured, fixed or contingent.
Commencement of proceedings	The event determining the date as of which the effects of insolvency are applicable or the judicial decision to commence insolvency proceedings, whether it is a final decision or not.

[1] EC Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings, recital (13).

Creditor committee	Representative body appointed in accordance with the insolvency law having consultative and other powers as specified in the insolvency law.
Debtor	A natural or legal person engaged in a business, which meets the criteria for commencement of insolvency proceedings.
Discharge	Release of a debtor from liabilities that were, or could have been, addressed in the insolvency proceedings.
Disposal	Every means of transferring or parting with an asset or an interest in an asset, whether in whole or in part.
Encumbered asset	An asset in respect of which a security interest has been obtained by a creditor.
Establishment	Any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services [UNCITRAL Model Law on Cross-Border Insolvency, art. 2 (f)].
Estate	See Insolvency estate.
[Financial contract	Any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above [UNCITRAL Convention on the Assignment of Receivables in International Trade (2002), art. 5 (k)]].
[Government authority	A State or subdivision of a State including a department, agency, instrumentality or other representative thereof.]
Insolvency	When the debtor is generally unable to pay its debts as they mature or when its liabilities exceed the value of its assets.
Insolvency estate	Assets and rights of the debtor that are controlled or supervised by the insolvency representative and subject to the insolvency proceedings.
Insolvency proceedings	Collective judicial or administrative proceedings for the purposes of either reorganization or liquidation of the debtor’s business, conducted according to the insolvency law.
Insolvency representative	A person or body responsible for administering the insolvency estate.

Liquidation	Proceedings to assemble ad reduce the debtor's assets to money for distribution in accordance with the insolvency law.
[Netting	In one form it can consist of set-off (see "set-off") of non-monetary fungibles (such as securities or commodities deliverable on the same day, known as settlement netting) and in its more important form it consists of a cancellation by a counterparty of open contracts with the debtor, followed by a set-off of losses and gains either way (close-out netting).]
[Netting agreement	An agreement between two or more parties that provides for one or more of the following: (i) The net settlement of payments due in the same currency on the same date whether by novation or otherwise; (ii) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other; or (iii) The set-off of amounts calculated as set forth in subparagraph (ii) of this definition under two or more netting agreements. [UNCITRAL Convention on the Assignment of Receivables in International Trade (2002), art. 5 (l)]].
Ordinary course of business	Transfers or transactions consistent with operation of the business prior to insolvency proceedings.
Pari passu	The principle according to which similarly situated creditors are treated proportionate to their claim and are satisfied proportionately out of the assets of the estate].
Party in interest	The debtor, the insolvency representative, a creditor, an equity holder, a creditor committee a government authority or any other person whose rights, obligations or interest are affected by insolvency proceedings.[2]
Post-commencement claim	A claim arising from an act or omission occurring after commencement.
Preference	A transaction made by an insolvent debtor where a creditor obtains, or receives the benefit of, more than its pro rata share of the debtor's assets.

[2] It is not intended that this definition would include persons with a remote or diffuse interest affected by the insolvency law or proceedings.

[Priority	The right of a person in preference to the right of another person and, to the extent relevant for such purpose, includes the determination of whether the right is a personal or a property right, whether or not it is a security right for indebtedness or other obligation and whether any requirements necessary to render the right effective against a competing claimant have been satisfied [UNCITRAL Convention on the Assignment of Receivables in International Trade, art. 5].]
[Priority claim	A claim that will be paid out of available assets before payment of general unsecured creditors.]
[Priority rules	The rules by which distributions are ordered among creditors and equity interests.]
[Protection of the value of encumbered assets	Measures directed at maintaining the economic value of a security interest during the insolvency proceedings (in some jurisdictions referred to as "adequate protection"). This protection may be particularly relevant where the value of the secured claim is greater than the value of the encumbered asset or even where the value of the encumbered asset exceeds the value of the secured claim, but the value of the encumbered asset is diminishing and ultimately may be insufficient to satisfy the secured claim. Such diminution in value may be affected by the application of the stay to secured creditors or by the use of the encumbered asset in the insolvency proceedings. Protection may be provided by way of cash payments, provision of alternative or additional security or by other means as determined by a court to provide the necessary protection. Where the value of the encumbered asset exceeds that of the secured claim, and is unlikely to diminish, protection may not be required.]
[Related person	A person who is or has been in a position of control of the debtor including a director or officer of a legal entity, a shareholder or member of such legal entity, a director or officer or shareholder of a legal entity that is related to the debtor, including any relative of such a person; a "relative" in relation to a related person means the spouse, parent, grandparent, son, daughter, brother or sister of the related person.]
[Reorganization	Process by which the financial well-being and viability of a debtor's business can be restored and the business continue to operate, using various means possibly including debt forgiveness, debt rescheduling, debt-equity conversions and sale of the business (or parts of it) as a going concern.].

[Reorganization plan	A plan by which the financial well-being and viability of the debtor's business can be restored. The insolvency law may provide for the plan to be submitted by various parties (the debtor, the creditors, the insolvency representative) and may require confirmation of the plan by the court following its approval by the requisite number of creditors. The plan may address issues such as timing of the process, commitments to be undertaken, terms of payment and securities to be offered to creditors, avoidance actions to be filed and treatment of pending contracts including employment contracts.]
[Retention of title	Provision of a contract for the supply of goods which purports to reserve ownership of the goods with the supplier until payment of the purchase price.]
Sale as a going concern	Sale or transfer of a business in whole or substantial part, as opposed to the sale of separate assets of the business.
[Secured claim	A claim assisted by a security interest taken as a guarantee for a debt enforceable in case of the debtor's default when the debt falls due.]
[Secured creditor	A creditor holding either a security interest covering all or part of the debtor's assets or a security interest in a specific asset entitling the creditor to priority ahead of other creditors with respect to the secured asset.]
[Secured debt	[Aggregate amount of secured claims] or [claims pertaining to secured creditors].]
[Security interest	A right or interest granted by a party committing the party to pay or perform an obligation. Whether established voluntarily by agreement or involuntarily by operation of law, a security interest generally includes, but is not necessarily limited to, mortgages, pledges, charges and liens. "Securities" means any shares, bonds or other financial instruments or assets (other than cash), or any interest therein.]
[Set-off	Where a claim for a sum of money owed to a person is "set-off" (balanced) against a claim by the other party for a sum of money owed by that first person. A set-off may operate as a defence in whole or part to a claim for a sum of money.]
[State-owned enterprise	[*to be completed*]]

[Stay of proceedings	A measure which prevents the commencement, or suspends the continuation, of judicial, administrative or other individual actions concerning the debtor's assets, rights, obligations or liabilities, including the perfection or enforcement of any security interest; and prevents execution against the assets of the insolvency estate, the termination of a contract with the debtor, and the transfer, encumbrance or other disposition of any assets or rights of the insolvency estate.]
[Superpriority	A priority that will result in claims to which the superpriority attaches being paid before administrative claims.]
[Suspect period	The period of time by reference to which certain transactions may be subject to avoidance. The period is generally calculated retroactively from the date of the application for commencement of insolvency proceedings or from the date of commencement.]
[Unsecured creditor	Any creditor who does not hold security or any ordinary creditor who has no preferential rights.]
[Unsecured debt	Aggregate amount of claims not supported by security.]
Voluntary restructuring negotiations	Negotiations that are not regulated by the insolvency law and will generally involve the debtor and some or all of its creditors.

Part One
Designing the key objectives and structure of an effective and efficient insolvency law

I. Introduction

9. When a debtor is unable to pay its debts and liabilities as they become due, most legal systems provide a legal mechanism to address the collective satisfaction of the outstanding claims from all assets (whether tangible or intangible) of the debtor. A range of interests needs to be accommodated by that legal mechanism: the parties including the debtor, the owners and management of the debtor, the creditors who may be secured to varying degrees (including tax agencies and other government creditors), employees, guarantors of debt and suppliers of goods and services, as well as the legal, commercial and social institutions and practices that are relevant to the design of the insolvency law, including the institutional framework required for its operation. Generally, the mechanism must strike a balance not only between the different interests of these stakeholders but also between those interests and the relevant social, political and other policy considerations that impact upon the economic and legal goals of insolvency.

10. Most legal systems contain rules on various types of proceedings (which are referred to in this *Guide* by the generic term "insolvency proceedings") that can be initiated to resolve a debtor's financial difficulties. While addressing that resolution as a common goal, these proceedings take a number of different forms, for which uniform terminology is not always used, and may include both what might be described as "formal" and "informal" elements. Formal insolvency proceedings are those commenced under the insolvency law and governed by that law. They generally include both liquidation and reorganization proceedings. Informal insolvency processes are not regulated by the insolvency law and will generally involve voluntary negotiations between the debtor and some or all of its creditors. Often these types of negotiations have been developed through the banking and commercial sectors and typically, provide for some form of reorganization of the insolvent debtor. While not regulated by an insolvency law, these voluntary negotiations nevertheless depend for their effectiveness upon the existence of an insolvency law which can provide some indirect incentives or persuasive force to achieve a reorganization (discussed further below).

A. Key objectives of an effective and efficient insolvency law

11. Although country approaches vary, there is broad agreement that effective and efficient insolvency regimes should aim to achieve the key objectives identified below. Whatever design is chosen for an insolvency law that will meet these key objectives, the insolvency law must be complementary to, and compatible with, the legal and social values of the society in which it is based and which it must ultimately sustain. Although insolvency law generally forms a distinctive regime, it ought not to produce results that are fundamentally in conflict with the premises upon which the general law is based. Where the insolvency law does seek to achieve a result that differs or fundamentally departs from the general law (e.g. with respect

to treatment of contracts, avoidance of antecedent acts and transactions or treatment of the rights of secured creditors) it is highly desirable that that result be the product of careful consideration and conscious policy in that direction.

1. Provide certainty in the market to promote economic stability and growth

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

2. Maximize value of assets

13. Participants in insolvency proceedings should have strong incentives to achieve maximum value for assets, as this will facilitate higher distributions to creditors as a whole and reduce the burden of insolvency. The achievement of this goal is often furthered by achieving a balance between the risks allocated between the parties involved in insolvency proceedings. The manner in which prior transactions are treated, for example, can ensure that creditors are treated equitably and enhance the value of the debtor's assets by recovering value for the benefit of all creditors. At the same time, the treatment afforded those transactions can undermine the predictability of contractual relations that is critical to investment decisions, creating a tension between the different objectives of an insolvency regime. Similarly, a balance has to be struck between rapid liquidation and longer-term efforts to reorganize the business which may generate more value for creditors, between the need for new investment to preserve or improve the value of assets and the implications and cost of that new investment on existing stakeholders, and between the different roles allocated to the different stakeholders, in particular the discretion that can be exercised by the insolvency representative and the extent to which creditors can monitor the exercise of that discretion to safeguard the process.

3. Strike a balance between liquidation and reorganization

14. The first objective of maximization of value is closely linked to the balance to be achieved in the insolvency law between liquidation and reorganization. An insolvency law needs to balance the advantages of near-term debt collection through liquidation (often the preference of secured creditors) against maintaining the debtor as a viable business through reorganization (often the preference of unsecured creditors). Achieving that balance may implicate other social policy considerations such as encouraging the development of an entrepreneurial class and protecting employment. Insolvency law should include the possibility of reorganization of the debtor as an alternative to liquidation, where creditors would not involuntarily receive less than in liquidation and the value of the debtor to society and to creditors may be maximized by allowing it to continue. This is predicated on the basic economic theory that greater value may be obtained from keeping the essential components of a business together, rather than breaking them up and disposing of

them in fragments. To ensure that insolvency proceedings are not abused by either creditors or the debtor, and that the procedure most appropriate to resolution of the debtor's financial difficulty is available, an insolvency law should also provide for conversion between the different types of proceedings in appropriate circumstances.

4. Ensure equitable treatment of similarly situated creditors

15. The objective of equitable treatment is based on the notion that in collective proceedings, creditors with similar legal rights should be treated equally, receiving a distribution on their claim in accordance with their relative priority and interests. Equitable treatment recognizes that all creditors do not need to be treated equally, but in a manner that reflects the different bargains they have struck with the debtor, although this becomes less relevant as a defining factor where there is no specific debt contract with the debtor, such as in the case of damage claimants (e.g. for environmental damage). To the extent that equitable treatment is modified by social policy on claim priorities and should give way to the prerogatives pertaining to holders of claims or interests that arise, for example, by operation of law, the principle of equitable treatment retains its significance by ensuring that the priority accorded to the claims of a similar class affects all members of the class in the same manner. The policy of equitable treatment permeates many aspects of an insolvency law, including the application of the stay or suspension, provisions to set aside acts and transactions and recapture value for the insolvency estate, classification of claims, voting procedures in reorganization, and distribution mechanisms. An insolvency law should address problems of fraud and favouritism that may arise in cases of financial distress by providing, for example, that acts and transactions detrimental to equitable treatment of creditors can be avoided.

5. Provide for timely, efficient and impartial resolution of insolvency

16. Insolvency should be addressed and resolved in an orderly, quick and efficient manner, with a view to avoiding undue disruption to the business and the activities of the debtor and to minimizing the cost of the proceedings. Achieving timely and efficient administration will support the objective of maximizing asset value, while impartiality supports the goal of equitable treatment. The entire process needs to be carefully considered to ensure maximum efficiency without sacrificing flexibility. At the same time, it should be focused on the goal of liquidating non-viable and inefficient businesses and the survival of efficient, potentially viable businesses.

17. Quick and orderly resolution of a debtor's financial difficulties can be facilitated by an insolvency law that provides easy access to insolvency proceedings by reference to clear and objective criteria, provides a convenient means of identifying, collecting, preserving and recovering assets and rights that should be applied towards payment of the debts and liabilities of the debtor, facilitates participation of the debtor and its creditors with the least possible delay and expense, provides an appropriate structure for supervision and administration of proceedings (including both professionals and the institutions involved) and provides, as an end result, effective relief to the financial obligations and liabilities of the debtor.

6. Preserve the insolvency estate to allow equitable distribution to creditors

18. An insolvency law should preserve the estate and prevent premature dismemberment of the debtor's assets by individual creditor actions to collect individual debts. Such activity often reduces the total value of the pool of assets available to settle all claims against the debtor and may preclude reorganization or the sale of the business as a going concern. A stay of creditor action provides a breathing space for debtors, enabling a proper examination of its financial situation and facilitating both maximization of the value of the estate and equitable treatment of creditors. Some mechanism may be required to ensure that the rights of secured creditors are not impaired by a stay.

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

19. An insolvency law should be transparent and predictable. This will enable potential lenders and creditors to understand how insolvency proceedings operates and to assess the risk associated with their position as a creditor in the event of insolvency. This will promote stability in commercial relations and foster lending and investment at lower risk premiums. Transparency and predictability will also enable creditors to clarify priorities, prevent disputes by providing a backdrop against which relative rights and risks can be assessed, and help define the limits of any discretion. Unpredictable application of the insolvency law has the potential to undermine not only the confidence of all participants in insolvency proceedings, but also their willingness to make credit and other investment decisions. As far as possible, an insolvency law should clearly indicate all provisions of other laws that may affect the conduct of the insolvency proceedings (e.g. labour law; commercial and contract law; tax law; laws affecting foreign exchange, netting and set-off, debt for equity swaps; and even family and matrimonial law).

20. An insolvency law should ensure that adequate information is available in respect of the debtor's situation, providing incentives to encourage the debtor to reveal its positions or, where appropriate, sanctions for failure to do so. The availability of this information will enable those responsible for administering and supervising insolvency proceedings (courts or administrative agencies, the insolvency representative) and creditors to assess the financial situation of the debtor and determine the most appropriate solution.

8. Recognize existing creditor rights and establish clear rules for ranking of priority claims

21. Recognition and enforcement in insolvency proceedings of the differing rights that creditors have outside of insolvency will create certainty in the market and facilitate the provision of credit, particularly with respect to the rights and priorities of secured creditors. Clear rules for the ranking of priorities of both existing and post-commencement creditor claims are important to provide predictability to lenders, and to ensure consistent application of the rules, confidence in the process and that all participants are able to adopt appropriate measures to manage risk. To the greatest extent possible, those priorities should be based upon commercial bargains and not reflect social and political concerns that have the potential to distort the outcome of insolvency. According priority to claims that are not based on commercial bargains should be avoided.

9. Establish a framework for cross-border insolvency

22. To promote coordination among jurisdictions and facilitate the provision of assistance in the administration of an insolvency proceeding originating in a foreign country, insolvency laws should provide rules on cross-border insolvency, including the recognition of foreign proceedings, by adopting the UNCITRAL Model Law on Cross-Border Insolvency.[3]

B. Balancing the key objectives

23. Since an insolvency regime cannot fully protect the interests of all parties, some of the key policy choices to be made when designing an insolvency law relate to defining the broad goals of the insolvency law (rescuing businesses in financial difficulty, protecting employment, protecting the interests of creditors, encouraging the development of an entrepreneurial class) and achieving the desired balance between the specific objectives identified above. Insolvency laws achieve that balance by reapportioning the risks of insolvency in a way that suits a country's economic, social and political goals. As such an insolvency law can have widespread effects in the broader economy.

24. The first task for an insolvency law is to establish a framework of principles that determines how the estate of the insolvent debtor is to be administered for the benefit of all affected parties. The creation of such a framework and its integration with the wider legal process are vital to maintaining social order and stability. All parties need to be able to anticipate how their legal rights will be affected in the event of a debtor's inability to pay, or to pay in full, what is owed to them. This allows both creditors and equity investors to calculate the economic implications of default by the debtor, and so estimate their risks. These issues are discussed in detail throughout the *Guide*.

25. There is no universal solution to the design of an insolvency law because countries vary significantly in their needs, as do their laws on other issues of key importance to insolvency, such as security interests,[4] property and contract rights, remedies and enforcement procedures. Although there may be no universal solution, most insolvency laws address the range of issues raised by the key objectives, albeit with different emphasis and focus. Some laws favour stronger recognition and enforcement of creditor rights and commercial bargains in insolvency and give creditors more control over the conduct of insolvency proceedings than the debtor (sometimes referred to as "creditor-friendly" regimes). Other laws lean towards giving the debtor more control over the proceedings (referred to as "debtor-friendly" regimes), while yet others seek to strike a balance in the middle. Some laws give more prominence to liquidation of the debtor in order to weed out inefficient and incompetent market players, while others favour reorganization. The focus on reorganization may serve a number of different aims: as a means of enhancing the value of creditors' claims as part of an ongoing business concern, providing a

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[3] See chapter VII.

[4] Steps have been taken in recent years towards harmonizing the law on security interests, such as the United Nations Convention on the Assignment of Receivables in International Trade (2001), the Unidroit Convention on International Interests in Mobile Equipment and current work by UNCITRAL to develop a legislative guide on secured transactions.

second chance to the shareholders and management of the debtor; providing strong incentives for the adoption by entrepreneurs and managers of appropriate attitudes to risk; or protecting vulnerable groups, such as the debtor's employees, from the effects of business failure.[5] Some laws give particular emphasis to the protection of employees and the maintenance of employment in insolvency, while others provide that business can be downsized with minimum protections afforded to employees.

26. But adopting a reorganization-friendly approach should not result in establishing a safe haven for moribund enterprises—enterprises that are beyond rescue should be liquidated as quickly and efficiently as possible. To the extent that some interests may be regarded as being of lower priority than others, the establishment of mechanisms outside of the insolvency law may provide a better solution than trying to address those interests under the insolvency regime. For example, where as a matter of policy it is decided that employee claims should rank lower than secured and priority creditors in insolvency, insurance arrangements can be used to protect employee entitlements.

27. Because society is constantly evolving, insolvency law cannot be static, but requires reappraisal at regular intervals to ensure that it meets current social needs. Responses to perceived social change involve an act of judgement that can be informed by international best practice and those practices transposed into national insolvency regimes, taking into account the realities of the system and available human and material resources.

C. General features of an insolvency law

28. Designing an effective and efficient insolvency law involves the consideration of a common set of issues relating to both the legal framework (rights and obligations of the parties, both substantively and procedurally) and the institutional framework (to implement these rights and obligations) required. The substantive issues, which are discussed in detail in part two of the *Guide*, include:

(a) Identifying the debtors that may be subject to insolvency proceedings, including those debtors that may require a special insolvency regime;

(b) Determining when insolvency proceedings may be commenced and the type of proceeding that may be commenced, the party that may request commencement and whether the commencement criteria should differ depending upon the party requesting commencement;

(c) The extent to which the debtor should be allowed to retain control of the business once insolvency proceedings commence or be displaced and an independent party (in the *Guide* referred to as the insolvency representative)

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[5] There is not necessarily a direct correlation between the debtor or creditor friendliness of an insolvency regime, the emphasis on liquidation or reorganization and the subsequent success or failure of reorganization. While it is beyond the scope of this *Guide* to discuss these issues in any detail, they are important for the design of an insolvency regime and deserve consideration. While the rate of successful reorganizations varies considerably among those regimes classified as creditor-friendly, research appears to suggest that the assumption that creditor-friendly regimes lead to fewer or less successful reorganizations than debtor-friendly regimes is not necessarily true.

appointed to supervise and manage the debtor, and the distinction to be made between liquidation and reorganization in that regard;

(d) Protection of the assets of the debtor against the actions of creditors, the debtor itself and the insolvency representative, and where the protective measures apply to secured creditors, the manner in which the economic value of the security interest will be protected during the insolvency proceedings;

(e) The manner in which the insolvency representative may deal with contracts entered into by the debtor before the commencement of proceedings and in respect of which both the debtor and its counterparty have not fully performed their respective obligations;

(f) The extent to which setoff or netting rights can be enforced or will be protected, notwithstanding the commencement of the insolvency proceedings;

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

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

(i) In the case of reorganization, preparation of the reorganization plan and the limitations, if any, that will be imposed on the content of the plan, the preparer of the plan and the conditions required for its approval and implementation;

(j) The ranking of creditors for the purposes of distributing the proceeds of liquidation;

(k) Implementation of the reorganization plan;

(l) Distribution of the proceeds of liquidation;

(m) Discharge or dissolution of the debtor in liquidation; and

(n) Conclusion of the proceedings.

29. In addition to these specific subject areas, a more general issue to be considered is how an insolvency law will relate to other substantive laws and whether the insolvency law will effectively modify those laws. Relevant laws may include labour laws that provide certain protections to employees, laws that limit the availability of set-off and netting, laws that limit debt-for-equity conversions and laws that impose foreign exchange and foreign investment controls that may affect the content of a reorganization plan (see labour contracts and employees, part two, chapters II.E and V.B; setoff and netting, part two, chapters G and H; and content of reorganization plan, part two, chapter IV).

30. While the institutional framework is not discussed in any detail in this *Guide*, some of the issues are touched upon below. Notwithstanding the variety of substantive issues that must be resolved, insolvency laws are highly procedural in nature. The design of the procedural rules plays a critical role in determining how roles are to be allocated among the various participants, particularly in terms of decision-making. To the extent that the insolvency law places considerable responsibility upon the institutional infrastructure to make key decisions, it is essential that that infrastructure be sufficiently developed to perform the required functions.

II. Mechanisms for resolving a debtor's financial difficulties

A. Voluntary restructuring negotiations

31. Voluntary restructuring negotiations were developed some years ago by the banking sector, as an alternative to formal reorganization proceedings under the insolvency law. Led and influenced by internationally active banks and financiers, this type of negotiation has gradually spread to a considerable number of jurisdictions, although use of them varies—in some jurisdictions they are reported to be rarely used, whilst in others most reorganizations are reported to be conducted by way of such negotiations. To some extent these results may reflect the existence (or not) of what is sometimes described as a "rescue culture"—the degree to which participants regard this type of negotiation as likely to be successful, irrespective of the formal absence of features of proceedings under the insolvency law, such as a stay.

32. The use of voluntary restructuring negotiations has generally been limited to cases of corporate financial difficulty or insolvency in which there is a significant amount of debt owed to banks and financiers. The negotiations are aimed at securing contractual arrangements both between the lenders themselves and the lenders and the debtor for the restructuring of the debtor, with or without rearrangement of the financing. This can provide a means of introducing flexibility into an insolvency regime by reducing the burden on judicial infrastructure, facilitating an earlier pro-active response from creditors than would normally be possible under formal insolvency proceedings and avoiding the stigma that often attaches to insolvency. While not based or reliant upon the provisions of the insolvency law, use of this type of negotiation depends very largely for its success upon the existence and availability of an effective and efficient insolvency law and supporting institutional framework[6] to provide sanctions that can assist to make the voluntary negotiations successful. Unless the debtor and its bank and financial creditors take the opportunity to join together and voluntarily enter into these negotiations, the debtor or the creditors can invoke the insolvency law, with some potential for detriment to both the debtor and its creditors in terms of delay, cost and outcome.

33. Although not regulated by the insolvency law, many legal systems do contemplate that a debtor can enter into agreements or arrangements with some of all of its creditors which may be governed by, for example, contract law, company or commercial law or civil procedural law, or in some cases relevant banking regulations. However, there are a few jurisdictions which do not allow agreements or arrangements designed to restructure the debtor and its debt to occur outside of the court system or the insolvency law. Some laws would regard the steps associated with such voluntary restructuring negotiations as sufficient for the courts to make a declaration of insolvency. Similarly, there are a number of jurisdictions which, because they impose on the debtor an obligation to commence formal insolvency proceedings within a certain time after a defined event of insolvency, restrict the conduct of such voluntary negotiations to circumstances where the formal conditions for commencement of proceedings have not been met. Nevertheless, it is

[6] See the discussion of institutional framework in chapter III below.

suggested that banks and other creditors in these jurisdictions do often use various techniques to achieve some form of reorganization of debtors.

1. Necessary preconditions

34. Voluntary restructuring negotiations depend for their effectiveness on a number of well-defined initial premises. These may include:

(a) A significant amount of debt owed to a number of main banks or financial institution creditors;

(b) The present inability of the debtor to service that debt;

(c) Acceptance of the view that it may be preferable to negotiate an arrangement, as between the debtor and the financiers and also between the financiers themselves, to resolve the financial difficulties of the debtor;

(d) The use of relatively sophisticated refinancing, security and other commercial techniques that might be employed to alter, rearrange or restructure the debts of the debtor or the debtor itself;

(e) The sanction that if the negotiation process cannot be started or breaks down there can be swift and effective resort to the insolvency law;

(f) The prospect that there may be a greater benefit for all parties through the negotiation process than by direct and immediate resort to the insolvency law (in part because the outcome is subject to the control of the negotiating parties and the process is less expensive and can be accomplished quickly without disrupting the debtor's business);

(g) The debtor does not need relief from trade debts, or the benefits of formal insolvency, such as the automatic stay or the ability to reject burdensome debts; and

(h) Favourable or neutral tax treatment for reorganization both in the debtor's jurisdiction and the jurisdictions of foreign creditors.

2. Main processes

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

(a) Commencing the negotiations

36. Voluntary negotiations essentially involve bringing together the debtor and creditors or at least the main creditors, one or more of whom must initiate the negotiations (as there can be no reliance upon a law or a facilitator for initiation, imposition or assistance of the negotiations). A debtor might be unwilling to commence a dialogue with creditors or at least with all of its creditors and creditors, while concerned for their own position, may have little interest in collective negotiations. It is at this point that the availability and effectiveness of individual creditor remedies or formal insolvency proceedings can be used to encourage the commencement and progress of the such negotiations. A debtor who remains reluctant to participate may find itself subject to individual debt or security

enforcement actions or even insolvency proceedings, which it will not be able to defeat or delay. At the same time, creditors may also find themselves subject to formal insolvency proceedings which effectively prevent them from enforcing their individual rights and might not represent the optimal process for recovery of their debt. Creating a forum in which the debtor and creditors can come together to explore and negotiate an arrangement to deal with the debtor's financial difficulty therefore is crucial.

(b) Coordinating participants—appointing a lead creditor and steering committee

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

(c) Agreeing a "standstill"

38. To allow business operations to continue and to ensure that sufficient time is available to obtain and evaluate information about the debtor and to formulate and assess proposals to resolve the debtor's financial difficulties, a contractual agreement to suspend adverse actions by both the debtor and the main creditors may be required. That agreement would generally need to endure for a defined, usually short period, unless inappropriate in a particular case.

(d) Engaging advisors

39. Few, if any, attempts are made at voluntary restructuring without the involvement of independent experts and advisors from various disciplines (e.g. legal, accounting, finance and business regulation, marketing). While it may be suggested that this involvement will lead to unnecessary cost and intrusion into the affairs of the debtor and creditors, as well as a loss of control, it is generally necessary to ensure the provision of information, independently verified, as well as professionally developed plans for refinancing, restructuring, management and operation that are essential to the success of these negotiations.

(e) Ensuring adequate cash flow and liquidity

40. A debtor that becomes a candidate for voluntary restructuring negotiations will often require continued access to established lines of credit or the provision of fresh credit. Provision of credit by existing secured creditors may not present a problem. Where this is not available, however, and fresh credit is required, there may be difficulties in guaranteeing the eventual repayment of the fresh credit if the negotiations fail. While this issue can be addressed under the insolvency law by providing some form of priority for such ongoing lending (see part two, chapter II.D), the law will not generally extend to an agreement reached by way of voluntary negotiations.

41. Those creditors who participate in voluntary negotiations, nevertheless, can agree amongst themselves that if one or more of them extends further credit the others will subordinate their claims to enable the new credit to be repaid ahead of their own claims. Thus, as between those creditors, there will be a contractual agreement for the repayment of new money where the restructuring negotiations are successful. Where the negotiations fail, however, and the debtor is liquidated, the creditor who has provided the fresh credit may be left with an unsecured claim (unless security was provided) and receive only partial repayment along with other unsecured creditors.

(f) Access to information on the debtor

42. Access to complete, accurate information on the debtor is essential to enable proper evaluation to be made of the financial position of the debtor and any proposals to be made to relevant creditors. Information concerning the assets, liabilities and business of the debtor will need to be made available to all relevant creditors but unless already publicly available, may need to be treated as confidential.

(g) Dealing with creditors

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

44. In many cases, however, it will not be possible (or indeed necessary) to involve every creditor in the negotiations, either because of their number and diverse interests or because of the inefficiency of involving creditors who are owed only small amounts of money or who do not have the commercial expertise, knowledge or will to participate effectively. While creditors who fall into these categories often may be left out of the negotiations, they cannot be ignored as they may be important to the continued operation of the business (as suppliers of essential goods or services or as participants in essential parts of the debtor's production process) and there are no rules which can compel such creditors to accept the decision of a majority of their number.

45. Often in a voluntary restructuring agreement, trade and small creditors recover payment in full. Although this suggests unequal treatment, it may make commercial sense to a group of major creditors. An alternative approach is to secure agreement of the main creditors to a restructuring plan and then use the plan as the basis of a formal court supervised reorganization process in which other creditors participate (sometimes referred to as a "pre-packaged" plan and in this *Guide* as expedited reorganization proceedings—see part two, chapter IV.B). This plan can then bind the other creditors. Without an effective formal insolvency regime, this result could not be achieved in those circumstances.

3. Rules and guidelines for voluntary restructuring

46. To assist the conduct of voluntary restructuring negotiations, and in particular to address the problems noted above in the context of complex, multinational businesses, a number of organizations have developed non-binding principles and guidelines. One such approach is called the "London Approach" named after the non-binding guidelines issued to commercial banks by the Bank of England. Banks are urged to take a supportive attitude toward their debtors that are in financial difficulties. Decisions about the debtor's longer-term future should only be made on the basis of comprehensive information, which is shared among all the banks and other parties that would be involved in any agreement as to the future of the debtor. Interim financing is facilitated by a standstill and subordination agreement, and banks work together with other creditors to reach a collective view on whether and on what terms a debtor entity should be given a financial lifeline. Similar guidelines have been developed by the central banks of other countries. An international organization which has undertaken work in this area is the International Federation of Insolvency Professionals (INSOL), which has developed *Principles for a global approach to multi-creditor workouts*. The *Principles* are designed to expedite voluntary restructuring negotiations and increase the prospects of success by providing guidance to diverse creditor groups about how to proceed on the basis of some common agreed rules.

B. Insolvency proceedings

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

48. The traditional division or distinction between these two types of proceedings can be somewhat artificial and can create unnecessary polarization and inflexibility. It does not accommodate, for example, cases not easily situated at the poles—those cases where a flexible approach to the debtor's financial situation is likely to achieve the best result for both the debtor and the creditors in terms of maximizing the value of the insolvency estate. For example, the term "reorganization" is sometimes used to refer to a particular way of ensuring preservation and possible enhancement of the value of the insolvency estate in the context of liquidation proceedings, such as where the law provides for liquidation to be carried out by transferring the business to another entity as a going concern. In that situation, the term "reorganization" merely points to a technique other than traditional liquidation (i.e. straightforward, piecemeal sale or realization of the assets), being used in order to obtain as much value as possible from the insolvency estate. To achieve such a sale or realization, the insolvency law may need to include an element of flexibility not generally available in laws which define liquidation as a sale of assets as soon as possible and allow the business to be continued only for that purpose. Some laws, for example, actually provide the power for the insolvency representative to effect a more advantageous sale or realization of the debtor's assets than would be effected in liquidation. Similarly, reorganization may require the sale of significant parts of the debtor's business or contemplate an eventual liquidation or sale of the business to a new company and the dissolution of the existing debtor.

49. For these reasons, it is desirable that an insolvency law provides more than a choice between a single, narrowly defined type of reorganization and strictly traditional liquidation. Since the concept of reorganization can accommodate a variety of arrangements, it is desirable that an insolvency law adopt an approach that is not prescriptive and supports arrangements that will achieve a result that provides more value to creditors than if the debtor was liquidated.

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

1. Reorganization proceedings

51. A means of resolving a debtor's financial difficulties is a reorganization which is designed to save a company or, failing that, a business. This process may take one of several forms and may be more varied as to its concept, acceptance and application than liquidation. For the sake of simplicity, the term "reorganization" is used in the *Guide* in a broad sense to refer to the type of proceedings whose ultimate purpose is to allow the debtor to overcome its financial difficulties and resume or continue normal commercial operations (even though in some cases it may include a reduction in the scope of the business, its sale as a going concern to another company or its eventual liquidation).

52. Not all debtors that falter or experience serious financial difficulty in a competitive marketplace should necessarily be liquidated; a debtor with a reasonable prospect of survival (such as one which has a potentially profitable business) should be given that opportunity where it can be demonstrated that there is greater value (and, by deduction, greater benefit for creditors in the long term) in keeping the essential business and other component parts of the debtor together. Reorganization proceedings are designed to give a debtor some breathing space to recover from its temporary liquidity difficulties or more permanent overindebtedness and, where necessary, provide it with an opportunity to restructure its operations and its relations with creditors. Where reorganization is possible, generally it will be preferred by creditors if the value derived from the continued operation of the debtor's business will enhance the value of their claims. Reorganization, however, does not imply that all of the stakeholders must be wholly protected or that they should be restored to the financial or commercial position that would have obtained had the event of insolvency not occurred. It does not imply that the debtor will be completely restored or its creditors paid in full or that ownership and management of an insolvent debtor will maintain and preserve their respective positions. Management may be terminated and changed, the equity of shareholders may be reduced to nothing, employees may be retrenched and the source of a market for suppliers may disappear. In general, however, reorganization

does imply that whatever form of plan, scheme or arrangement is agreed, the creditors will eventually receive more than if the debtor was to be liquidated.

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

54. Reorganization may take a number of different forms. It may include a simple agreement concerning debts (referred to as a composition) where, for example, the creditors agree to receive a certain percentage of the debts owed to them in full, complete and final satisfaction of their claims against the debtor. The debts are thus reduced and the debtor becomes solvent and can continue to trade. They may also include a complex reorganization under which, for example, debts are restructured (e.g. by extending the length of the loan and the period in which payment may be made, deferring payment of interest or changing the identity of the lenders); some debt may be converted to equity together with a reduction (or even extinguishment) of existing equity; the non-core assets may be sold; and the unprofitable business activities closed. The choice of the way in which reorganization is carried out is typically a response to the size of the business and the degree of complexity of the debtor's specific situation.

55. Although reorganization may not be as widely included in insolvency laws as liquidation, and may not, therefore, follow such a common pattern, there are a number of key or essential elements that can be determined:

(a) Submission of the debtor to the proceedings (whether on its own application or on the basis of an application by creditors), which may or may not involve judicial control or supervision;

(b) Automatic and mandatory stay or suspension of actions and proceedings against the assets of the debtor affecting all creditors for a limited period of time;

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

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

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

(f) Possibly, the judicial approval/confirmation of an accepted plan; and

(g) Implementation of the plan.

56. The benefits of reorganization are increasingly accepted, and many insolvency laws include provisions on formal reorganization proceedings. The extent to which formal reorganization proceedings, as opposed to some form of voluntary negotiations, are relied upon to achieve the objectives of reorganization varies

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

57. There is often, however, a correlation between the degree of financial difficulty being experienced by the debtor, the complexity of its business arrangements, and the difficulty of the appropriate solution. Where, for example, a single bank is involved, it is likely that the debtor can negotiate a voluntary restructuring agreement with that bank and resolve its difficulties without involving trade creditors and without the need to commence proceedings under the insolvency law. Where the financial situation is more complex and requires the involvement of a large number of different types of creditors, a greater degree of formality may be needed to find a solution that addresses the disparate interests and objectives of these creditors, since voluntary restructuring agreements require unanimity of the parties participating. Reorganization proceedings may assist in achieving the desired goal where those proceedings enable the debtor and a majority of creditors to impose a plan upon a dissenting minority of creditors, especially where there are creditors who "hold out" during out-of-court negotiations. In some cases, proceedings under the insolvency law work well precisely because they are regulated by that law, while in other cases voluntary negotiations succeed because of the lack of regulation.

2. Expedited reorganization proceedings

58. Some countries have adopted what can be described as "pre-insolvency" or "pre-packaged" procedures (in the *Guide*, referred to as "expedited reorganization proceedings") that are, in effect, a combination of voluntary restructuring negotiations and reorganization proceedings under the insolvency law. One insolvency law, for example, permits proceedings to be commenced to obtain formal court approval of a reorganization plan that was negotiated voluntarily and approved by creditors through a vote that occurred before the commencement of the proceedings. Such proceedings are designed to minimize the cost and delay associated with formal reorganization proceedings while at the same time providing a means by which a reorganization plan negotiated voluntarily nevertheless can be approved in the absence of unanimous support of the creditors. Such a process allows the approval of the restructuring plan obtained in the voluntary negotiations to be used to achieve a reorganization that will bind all creditors, at the same time providing the protections of the insolvency law to affected creditors.

59. Another insolvency law provides that, in order to facilitate the conclusion of an amicable settlement with its creditors, a debtor may ask the court to appoint a "conciliator". The conciliator has no particular powers but may request the court to impose a stay of execution against all creditors if, in his or her judgement, a stay would facilitate the conclusion of a settlement agreement. During the stay, the debtor may not make any payments to discharge existing debts (except salaries) or dispose of any assets other than in the regular course of business. The procedure ends when agreement is reached either with all creditors or (subject to court

approval) with the main creditors; in the latter case, the court may continue the stay against non-participating creditors by providing a grace period to the debtor of up to two years.

60. These types of procedures are discussed in more detail in part two, chapter IV.B.

3. Liquidation

61. The type of proceedings referred to as "liquidation" are regulated by the insolvency law and generally provide for a public authority (typically, although not necessarily, a judicial court acting through a person appointed for the purpose) to take charge of the debtor's assets, with a view to terminating the commercial activity of the debtor, transforming non-monetary assets into monetary form and subsequently distributing the proceeds of sale or realization of the assets proportionately to creditors. Although generally requiring the sale or realization of assets to occur in a piecemeal manner as quickly as possible, some insolvency laws permit liquidation to involve sale of the business in productive units or as a going concern; under other laws that is only permissible in reorganization. Liquidation usually results in the dissolution or disappearance of the debtor as a commercial legal entity.

62. Liquidation proceedings tend to be very similar in their concept, acceptance and application and normally follow a pattern that includes:

(a) An application to a court or other competent body either by the debtor or by creditors;

(b) An order or judgement that the debtor be liquidated;

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

(d) Closure of the business activities of the debtor, if the business of a debtor cannot be sold as a going concern, and termination of the powers of owners and management and the employment of employees;

(e) Sale or realization of the debtor's assets, either piecemeal or as a going concern;

(f) Adjudication of the claims of creditors;

(g) Distribution of available funds to creditors (under some form of priority); and

(h) Dissolution of the debtor, where it is a corporation or some other form of legal person, or discharge, in the case of an natural person.

63. There are a number of legal and economic justifications for liquidation. Broadly speaking, it can be argued that a commercial business that is unable to compete in a market economy should be removed from the marketplace. A principal identifying mark of an uncompetitive business is one that satisfies one of the tests of insolvency, that is, it is unable to meet its mature debts as they become due or its debts exceed its assets. More specifically, the need for liquidation proceedings can

be viewed as addressing inter-creditor problems (when an insolvent debtor's assets are insufficient to meet the claims of all creditors it will be in a creditor's own best interests to take action to recover its claim before other creditors can take similar action) and as a disciplinary force that is an essential element of a sustainable debtor-creditor relationship. Orderly and effective liquidation proceedings address the inter-creditor problem by setting in motion a collective proceeding that seeks to avoid those actions which, while viewed by individual creditors as being in their own best self interest, essentially lead to the loss of value for all creditors. A collective proceeding is designed to provide equitable treatment to creditors, by treating similarly situated creditors in the same way, and to maximize the value of the debtor's assets for the benefit of all creditors. This is normally achieved by the imposition of a stay on the ability of creditors to enforce their individual rights against the debtor and the appointment of an independent person whose primary duty is to maximize the value of the debtor's assets for distribution to creditors.

64. An orderly and relatively predictable mechanism for the enforcement of the collective rights of creditors can also provide creditors with an element of predictability at the time they make their lending decisions, and as well, can more generally promote the interest of all participants in the economy by facilitating the provision of credit and the development of financial markets. This is not to say that an insolvency law should function as a means of enforcing the rights of individual creditors, although there is a clear and important relationship between enforcement and insolvency mechanisms. The efficiency and effectiveness of procedures for the individual enforcement of creditors' rights will mean that creditors are not forced to use insolvency proceedings for that purpose, especially since insolvency proceedings generally require a level of proof, cost and procedural complexity that makes it unsuitable for use in that way. Nevertheless, effective insolvency proceedings will ensure that where debt enforcement mechanisms fail, creditors will have an avenue of final recourse that can operate as an effective incentive to a recalcitrant debtor to encourage payment to the particular creditor.

4. Organization of the insolvency law

65. Approaches differ widely as to the structure of the procedure that leads to the choice of one of these processes. Some insolvency laws provide for unitary, flexible insolvency proceedings with a single commencement requirement alternatively resulting in liquidation or reorganization, depending on the circumstances of the case. Other laws provide for two distinct proceedings, each setting forth its own access and commencement requirements, with different possibilities for conversion between the two proceedings. Those laws that treat liquidation and reorganization proceedings as distinct from one another do so on the basis of different social and commercial policy considerations. However, a significant number of issues are common to both liquidation and reorganization, resulting in considerable overlaps and linkages between them, in terms of both procedural steps and substantive issues, as will become evident from the discussion in Part Two, which follows.

66. The determination of whether the business of the insolvent debtor is viable should determine, at least in theory, which proceedings will be sought. As a matter

of practice, however, at the time of commencement of either reorganization or liquidation, it is often impossible to make a final evaluation as to the financial viability of the business. Some of the disadvantages of this approach are that it may create an undesirable degree of polarization between liquidation and reorganization and can result in delay, increased expense and inefficiency, especially, for example, where the failure of reorganization requires a new and separate application to be made for liquidation. This inefficiency can be overcome, to some extent, by providing linkages between the two proceedings, with a view to allowing conversion of one type of proceeding to the other in certain specific circumstances, and by including devices designed to prevent the abuse of insolvency proceedings, such as commencing reorganization proceedings as a means of avoiding or delaying liquidation.

67. As to the question of choice between proceedings, some countries provide that the party applying for the insolvency proceedings will have the initial choice between liquidation and reorganization. When liquidation proceedings are initiated by one or more creditors, the law will often provide a mechanism that enables the debtor to request conversion into reorganization proceedings where feasible. When the debtor applies for reorganization proceedings, whether on its own motion or as a consequence of an application for liquidation by a creditor, the application for reorganization should logically be decided first. With a view to protecting creditors, however, some insolvency laws will provide a mechanism enabling reorganization to be converted into liquidation upon a determination, either at an early stage of the proceedings or later, that reorganization is not likely to, or cannot, succeed. Another mechanism for protection of creditors may consist of setting forth the maximum period for which reorganization against the will of the creditors may be continued.

68. As a general principle, although usually presented as separate, liquidation and reorganization proceedings are normally carried out sequentially; that is, liquidation proceedings will only run their course if reorganization is unlikely to be successful or if reorganization efforts have failed. In some insolvency systems, the general presumption is that a business should be reorganized and liquidation proceedings may be commenced only when all attempts to reorganize the entity have failed. In insolvency systems providing for conversion, a request for reorganization to be converted into liquidation may be made by the debtor, the creditors or the insolvency representative, depending upon the circumstances set forth by the law. These circumstances may include where the debtor is unable to pay post-petition debts as they fall due; where the reorganization plan is not approved by creditors or the court; where the debtor fails to fulfil its obligations under an approved plan; or where the debtor attempts to defraud creditors (see part two, chapter IV). While it is often possible for reorganization proceedings to be converted to liquidation proceedings, most insolvency systems do not allow reconversion to reorganization once conversion of reorganization to liquidation has already occurred.

69. Difficulties of determining at the very outset whether the debtor should be liquidated rather than reorganized have led some countries to revise their insolvency

laws by replacing separate proceedings with "unitary" proceedings.[7] Under the "unitary" approach there is an initial period (usually referred to as an "observation period", which in existing examples of unitary laws may last up to three months) during which no presumption is made as to whether the business will be eventually reorganized or liquidated. The choice between liquidation or reorganization proceedings only occurs once the financial situation of the debtor has been assessed and a determination made as to whether reorganization is actually possible. The basic advantages offered by this approach are its procedural simplicity, its flexibility and possible cost efficiency. Simple, unitary proceedings may also encourage early recourse to the proceedings by debtors facing financial difficulties, thus enhancing the chances of successful reorganization. A disadvantage of this approach, however, may be the delay that occurs between the decision to commence and the decision as to which proceedings should be followed, and the consequences for the debtor's business and the value of the debtor's assets that may flow from that delay. However the insolvency law is arranged in terms of liquidation and reorganization, it should ensure that once a debtor is in the system, it cannot exit without some final determination of its future.

C. Administrative processes

70. In recent years a number of crisis-affected jurisdictions have developed semi-official "structured" forms of insolvency processes, largely inspired by government or central banks, to deal with systemic financial problems within the banking sector. These processes have been developed on a similar pattern. First, each has a facilitating agency to encourage and, in part, coordinate and administer the process to provide the incentive and motivation necessary for its development. Second, each process is underpinned by an agreement between commercial banks in which the participants agree to follow a set of "rules" in respect of corporate debtors who are indebted to one or more of the banks and which may participate in the process. The rules provide the procedures to be followed and the conditions to be imposed in cases where corporate reorganization is attempted. In some of the jurisdictions, a debtor corporation that seeks to negotiate a reorganization under this process is required to agree to the application of these rules. Third, time limits are provided for various parts of the process and, in some cases, agreements in principle can be referred to the relevant court for reorganization proceedings to commence under the insolvency law. In addition, one jurisdiction established a special agency which has extremely wide powers under its governing legislation to acquire non-performing loans from the banking and finance sector and then to impose extra-judicial processes upon a defaulting corporate debtor, including a forced or imposed reorganization.

71. Both because these processes are relatively complex and involve the development of special rules and regulations and because they address particular situations of systemic failure, they are not discussed in the *Guide*.

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[7] Where a unitary system is chosen, some changes will need to be made to the various core elements of the insolvency law.

III. Institutional framework

72. An insolvency law is a part of an overall commercial legal system and is heavily reliant for its proper application not only on a developed commercial legal system, but also on a developed institutional framework for administration of the law. The choices made in developing or reforming an insolvency law will therefore need to be closely linked to the capacities of existing institutions. The insolvency system will only be effective if the courts and officials responsible for its implementation have the necessary capacity to provide the most efficient, timely and fair outcome to those for whose benefit an insolvency systems exists. If that institutional capacity does not already exist, it is highly desirable that reform of the insolvency law is accompanied by institutional reform, where the costs of establishing and maintaining the necessary institutional framework are weighed against the benefits of providing a system that is efficient, effective and in which the public have confidence. Although a detailed discussion of the means by which this institutional capacity can be developed or enhanced is beyond the scope of the *Guide*, a number of general observations can be made.

73. In most jurisdictions, the insolvency process is administered by a judicial authority, often through commercial courts or courts of general jurisdiction or, in a few cases, through specialized bankruptcy courts. Sometimes judges have specialized knowledge and responsibility only for insolvency matters, while in other cases insolvency matters are just one of a number of wider judicial responsibilities. In a few jurisdictions non-judicial or quasi-judicial institutions fulfil the role that, in other jurisdictions, is played by the courts.

74. In designing the insolvency law it may be appropriate to consider the extent to which courts will be required to supervise the process and whether or not their role can be limited with respect to different parts of the process or balanced by the role of other participants in the process, such as the creditors and the insolvency representative. This is of particular importance where the insolvency law requires judges to deal quickly with difficult insolvency issues (which often involve commercial and business questions) and the capacity of the judiciary is limited, whether because of its size, a general lack of resources in the court system or a lack of specific knowledge and experience of the types of issues likely to be encountered in insolvency.

75. To limit the role to be played by the court, an insolvency law can provide that the representative, for example, is authorized to make decisions on a number of issues, such as verification and admission of claims, the need for post-commencement funding, surrender of secured assets of no value to the estate, sale of major assets, commencement of avoidance actions, and treatment of contracts, without the court being required to intervene, except in the case of a dispute. The use of this approach depends upon the availability of a body of suitably qualified professionals to serve as insolvency representatives. Creditors also can be authorized to provide advice to, or to approve certain decisions of, the insolvency representative, such as approving the sale of important assets or obtaining post-commencement finance, without requiring the court to intervene, except in the case of dispute. An insolvency law can specify those procedures that will require court approval, such as the provision of a priority ranking above the rights of existing secured creditors to secure post-commencement finance.

76. The court's capacity to handle the often complex commercial issues involved in insolvency cases is often not only a question of knowledge and experience of specific law and business practices, but also a question of that knowledge and experience being current and regularly updated. To address the issue of judicial capacity, a special focus on the education and ongoing training of court personnel, not only of judges but also of clerks and other court administrators, will assist in supporting an insolvency regime that has the ability to respond effectively and efficiently to its insolvency caseload.

77. A further consideration related to the court's capacity to supervise insolvency cases is the balance in the insolvency law between mandatory and discretionary components. While mandatory elements, such as automatic commencement or automatic application of the stay, may provide a high degree of certainty and predictability for debtor and creditors, as well as limiting the matters requiring consideration by the courts, it may also lead to rigidity if there are too many of these types of elements. A discretionary approach allows the court to weigh facts and circumstances, taking into account precedent, community interests, and the interests of persons affected by the decision and market conditions. It may also impose a burden on the court where it does not have the knowledge or experience required to weigh these considerations or the resources to respond in a timely manner. Where the insolvency law provides for confirmation of a reorganization plan by the court, for example, it is not desirable to ask the court to undertake complex economic assessments of the feasibility or desirability of the plan, but rather to limit its consideration to the conduct of the approval process and other specified issues. Where an insolvency law requires the exercise of discretion by a decision-maker, such as a court, it is preferable that adequate guidance as to the proper exercise of that discretion also be included, particularly where economic or commercial issues are involved. This approach is consistent with a general objective of an insolvency regime of transparency and predictability.

78. The adequacy of the legal infrastructure and in particular, the resources available to courts dealing with insolvency cases, may be a significant influence on the efficiency with which insolvency cases are handled and the length of time required for insolvency proceedings. This may be a relevant consideration in deciding whether the insolvency law should impose time limits for the conduct of certain parts of the process. If the court infrastructure is not able to respond to the demands placed upon it in a timely manner to ensure that time limits are observed by the parties and the insolvency process is moved quickly along, the inclusion of such provisions in the law will not achieve the goal of an effective and efficient insolvency regime. Procedural rules will also be of importance to the conduct of cases and well-developed rules will assist courts and the professionals handling insolvency cases to provide an effective and orderly response to the economic situation of the debtor, minimizing the delays that can result in diminution in value of the debtor's assets and impair the prospects of a successful insolvency proceedings (whether liquidation or reorganization). Such rules will also assist in achieving a degree of predictability and uniformity of treatment from one case to the next.

79. Implementing an insolvency system depends not only on the court, but also on the professionals involved in the insolvency process, whether they are insolvency representatives, legal advisers, accountants, valuation specialists or other

professional advisers. The adoption of professional standards and training may assist in developing capacity. It may be appropriate to assess which insolvency functions are truly public in nature and which should be performed in the public sector in order to ensure the level of trust and confidence required to make the insolvency system effective, and those functions which can be performed by the creation of adequate incentives for private-sector participants in the insolvency process. The insolvency representative might be one example.