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INSOLVENCY LAW

Possible future work in the area of insolvency law

Proposal by Australia

Introduction

1. Australia proposes that the United Nations Commission on International Trade Law (UNCITRAL) establish a Working Group to develop a model law on corporate insolvency to foster and encourage the adoption of effective national corporate insolvency regimes.

2. In light of regional financial crises, it is clear that there is a serious and urgent need to strengthen national insolvency regimes, not only as a means of crisis prevention but also of crisis management. In this regard, the Australian Prime Minister's Task Force on International Financial Reform[1] has indicated that strong and efficient insolvency regimes are essential for addressing the financial difficulties of debt ridden firms before accumulated corporate difficulties result in an economy-wide crisis.

3. Australia considers that the valuable work UNCITRAL has already undertaken in the area of insolvency through the development of a Model Law on Cross-Border Insolvency, should be further progressed and enhanced, as a matter of high priority, by undertaking work on a model national corporate insolvency law.

4. The benefits of effective insolvency laws are widely recognised and accepted by most nations. Effective insolvency laws and processes are one of the primary means for maintaining financial discipline and ensuring efficient resource allocation in an economy. They provide a predictable legal process for addressing the financial difficulties of troubled firms before their accumulated financial

difficulties lead to an economy-wide payments crisis and thus contribute to crisis prevention. They also provide the necessary framework for the efficient restructuring or orderly liquidation of troubled firms. They reduce creditors' aggregate losses resulting from borrower non-performance by fostering cooperation among creditors when they are confronted by borrowers in financial difficulty. They seek to balance the rights and interests of affected parties by apportioning the burdens of insolvency in a manner consistent with a country's economic and social goals (such as the preservation of employment opportunities and the protection of members of the labour force). Insolvency laws also enhance corporate governance and corporate morality. They commonly allow for private creditors to replace the management of troubled firms and in this way create powerful incentives for prudent corporate behaviour. They permit an examination to be made of the circumstances giving rise to the insolvency and the conduct of officers of a company in its failure, perhaps revealing culpable behaviour on the part of those responsible for the company's failure, unfair dispositions of assets or property that is potentially recoverable.

5. The efficacy of insolvency laws and practices has been a recurring theme in, and major concern of, international forums, throughout the 1990s. The financial crisis in Asia and elsewhere has exposed weaknesses in the insolvency regimes and debtor-creditor laws of affected countries and in the structure of the international financial system. Effective insolvency regimes are increasingly being seen by international institutions and their members as an integral element of crisis prevention and an essential mechanism for responding to financial crises.

6. The world economy has changed beyond all recognition over the past 30 years. The growth and integration of global capital markets has created both enormous opportunities and new risks. The process of globalization and technological change has led to record growth in international monetary flows, an unprecedented expansion of investment and trade, an increased number and diversity of creditors and borrowers and increased economic interdependence. Globalization provides great opportunities for all countries to improve their standards of living. However, it can also generate new risks of instability which require all countries to pursue sound economic policies and structural reform. The soundness and credibility of insolvency laws and practices are central to the efforts of Governments and regulators to enhance the operation of the global financial system. Inefficient, antiquated or poorly designed insolvency laws and practices whose outcomes are uncertain, capricious, unfair or parochial threaten the benefits of globalization. They have the potential to seriously impede trade liberalisation and deter the international flow of capital.

Concerns about the International Financial System

7. The value of strong national insolvency regimes has been highlighted by a number of recent reports, including for example the *Report of the Working Group on International Financial Crises* prepared for the G22, a group comprising representatives from 22 systemically significant economies that met in Washington in April 1998 to examine issues related to the strengthening of the international financial architecture. This report considered the need to strengthen the international financial system in three areas - enhancing transparency and accountability; strengthening domestic financial systems and managing international financial crises. It concluded that strong insolvency and debtor-creditor regimes were an important means for preventing or limiting financial crises and facilitating rapid and orderly workouts from excessive indebtedness. They are essential to the orderly

resolution of payments crises, particularly when corporate indebtedness is a major source of strain on a country's macroeconomic stability. The Report commented that effective national insolvency regimes contribute to crisis prevention by providing the predictable legal framework needed to address the financial difficulties of troubled firms before the accumulated financial difficulties of the corporate sector spill over into an economy-wide payments crisis. Furthermore, the Report states that such a predictable framework is also essential to the orderly resolution of corporate financial difficulties, and thus is an essential element of any regime for orderly and cooperative crisis management. The Report endorsed eight key principles and features of insolvency regimes which were formulated in consultation with the International Federation of Insolvency Professionals (INSOL International).

Towards a Model National Insolvency Law

8. No specific recommendations were made in the *Report of the Working Group on International Financial Crises* about means of procuring adoption of insolvency regimes consistent with the endorsed principles and features. Rather, the Working Group envisaged that the enhanced international surveillance process under consideration in a number of forums would review national insolvency regimes, and technical assistance from the International Monetary Fund and the World Bank, together with scrutiny from capital markets, should help encourage improvements. Nevertheless, the Working Group urged that consideration be given in the relevant forums to the development of additional means and incentives for encouraging the adoption of effective regimes.

9. Past efforts to address insolvency laws and policies through international forums at the global and even the regional level have met with mixed results. The harmonisation of insolvency laws is problematic for several reasons. Insolvency laws often interact with other national laws and policies. The application of insolvency laws are closely related to a country's other legal rules and statutory provisions governing property, contracts, companies, partnerships, mortgages and guarantees. In some jurisdictions they form a key part of other policy frameworks, such as protecting depositors in financial institutions, revenue collection, favouring certain categories of creditors over others (such as employees), and so on. Further, to be effective, insolvency laws must be supported by an appropriate and effective institutional framework for administration and enforcement (such as courts and tribunals, a professional and honest insolvency profession and regulators). They must be in harmony with the relevant legal, business and cultural frameworks in the local context.

10. Australia recognises that there are significant differences in the functions, national purposes and public policy objectives of insolvency laws. Variations exist also in the national legal systems for the validity, protection and priority of security interests. It is not possible to rationalise, unify or bridge such different legal systems or adopt, without modification, a legislative regime for insolvency which is successful in one jurisdiction and assume that it will work effectively in another.

11. Nevertheless, it should be possible to crystallise from successful insolvency regimes, basic essential principles that should be reflected in a country's insolvency laws. Australia believes it is possible to go further and outline the particular features that best give effect to the public and international policy objectives that countries seek to achieve through such laws. The development of

a model law on insolvency which is flexible in its application could be a valuable supplement to other forces driving nations to progress reforms in this area.

Features of Proposed Model Law

12. A model law or framework would not seek to harmonise insolvency laws across countries or establish uniform approaches or a 'firm' set of provisions. Rather, it would contain a menu of legislative measures on various matters (such as liquidations, compromises and reorganisations) which countries could select from and modify to suit their individual circumstances. A starting point for the development of a model framework could be the key principles and features of effective insolvency regimes identified in the G22's *Report of the Working Group on International Financial Crises*. The objective of the proposed UNCITRAL Working Group would be to 'flesh out' those principles and features by developing specific options for legislative and other measures which, if adopted, would be likely to contribute to the design of an effective insolvency regime.

13. It is envisaged that the model law would only deal with insolvency of commercial firms. It would not extend to the special rules and arrangements governing insolvency of financial institutions. There are significant policy considerations applying to the insolvency of such firms which demand special treatment.

Role of UNCITRAL in Developing a Model Law on Insolvency

14. Australia considers that UNCITRAL is eminently suited to carrying out a project of this complexity and wide-ranging significance and has a proven record in a related area. In May 1997, after less than two years in development (a comparatively short time frame for such a task), UNCITRAL adopted the Model Law on Cross-Border Insolvency.

15. In the course of developing the Model Law, UNCITRAL formed links with other key participants in the insolvency framework. UNCITRAL consulted heavily with practitioners and held joint colloquia with judges and State officials. Participants represented a broad cross-section of nations with different cultures and legal systems. The UNCITRAL Secretariat and members are therefore already familiar with many of the national policy issues connected with insolvency. These factors would tend to support the use of UNCITRAL as a forum for developing a framework for national insolvency laws.

16. An UNCITRAL Working Group to develop a model law would not only advance agreement on what technical content should be in national approaches to insolvency systems. The very existence of a Working Group, and its resultant product, would also heighten national awareness in developing economies of the importance of the topic. That could raise the national priority given to implementing insolvency law reforms. It would also give useful international prominence to an approach to insolvency laws which could become the benchmark for multilateral transparency reporting and surveillance. It could thus assist the international roll-out of better insolvency practice.

17. In conclusion, therefore, Australia urges UNCITRAL to establish a Working Group to develop a model law on corporate insolvency to foster and encourage the adoption of effective national corporate insolvency regimes.

Note

1. On 22 October 1998, the Prime Minister commissioned a Task Force, chaired by the Australian Treasurer, to advise on how Australia could contribute to international financial reform. The Task Force comprised senior representatives from the Australian banking and financial sector along with the heads of a number of Government Departments and the Governor of the Reserve Bank. The report of the Task Force was completed in December 1998.