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POSSIBLE FUTURE WORK ON INSOLVENCY LAW

Note by the Secretariat

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INTRODUCTION

1. The Commission, at its thirty-second session (1999), had before it a proposal by Australia (A/CN.9/462/Add.1) on possible future work in the area of insolvency law.[1/] The proposal referred to recent regional and global financial crises and the work undertaken in international forums in response to those crises. Reports from those forums stressed the need to strengthen the international financial system in three areas - transparency; accountability; and management of international financial crises by domestic legal systems. According to those reports, strong insolvency and debtor-creditor regimes were an important means for preventing or limiting financial crises and for facilitating rapid and orderly workouts from excessive indebtedness. The proposal before the Commission recommended that, in view of its universal membership, its previous successful work on cross-border insolvency and its established working relations with international organizations that have expertise and interest in the law of insolvency, the Commission was an appropriate forum to put insolvency law on its agenda. The proposal urged that the Commission consider entrusting a working group with the development of a model law on corporate insolvency to foster and encourage the adoption of effective national corporate insolvency regimes.

2. The Commission expressed its appreciation for the proposal. It noted that different work projects had been undertaken by other international organizations such as the International Monetary Fund, the World Bank and the International Bar Association on the development of standards and principles for insolvency regimes. It noted that the broad objective of those organizations, while differing in scope and working methods as a consequence of their respective mandates and membership, was to modernize insolvency practices and laws. The initiatives taken in those organizations were proof of the necessity of assisting States to re-assess their insolvency laws and practices. Those various initiatives, however, were also in need of strengthened coordination, where appropriate, so as to avoid inefficient duplication of work and achieve consistent results.[2/]

3. Recognition was expressed in the Commission for the importance to all countries of strong insolvency regimes. The view was expressed that the type of insolvency regime that a country had adopted had become a “front-line” factor in international credit ratings. Concern was expressed, however, about the difficulties associated with work on an international level on insolvency legislation, which involved sensitive and potentially diverging socio-political choices. In view of those difficulties, it was feared the work might not be brought to a successful conclusion. It was said that a universally acceptable model law was in all likelihood not feasible and that any work needed to take a flexible approach that would leave options and policy choices open to States. While the Commission heard expressions of support for such flexibility, it was generally agreed that the Commission could not take a final decision on committing itself to establishing a working group to develop model legislation or another text without further study of the work already being undertaken by other organizations and consideration of the relevant issues.

[1/] Possible future work in the area of insolvency law: Proposal by Australia, A/CN.9/462.Add.1.

[2/] Official Records of the General Assembly, Fifty-fourth Session, Supplement No. 17 (A/54/17), paras. 381-385.

4. To facilitate that further study, the Commission was invited by the Secretariat to consider the possibility of devoting one session of a working group to ascertaining what, in the current landscape of efforts, would be an appropriate product (such as a model law, model provisions, a set of principles or other text) and to defining the scope of the issues to be included in that product. Diverging views were expressed in response. One view was that more background work should be undertaken by the Secretariat and presented to the Commission at its thirty-third session for a decision as to whether substantive work of elaborating a uniform law or another text of a recommendatory nature should be undertaken. Another view was that the question could be referred to one session of a working group, for the purpose of exploring those various issues, with a report to be made to the Commission at its thirty-third session in 2000 on the feasibility of undertaking work in the field of insolvency. At that time, the Commission would have before it sufficient information to make a final decision on that issue. It was emphasized that preparatory work for the session of the working group would require coordination with other international organizations already undertaking work in the area of insolvency law, since the results of their work would constitute important elements in the deliberations towards recommending to the Commission what it might usefully contribute in that area. It was pointed out that the importance and urgency of work on insolvency law had been identified in a number of international organizations and there was wide agreement that more work was required in order to foster the development and adoption of effective national corporate insolvency regimes.

5. The prevailing view in the Commission was that an exploratory session of a working group should be convened to prepare a feasibility proposal for consideration by the Commission at its thirty-third session. Subsequently, after the Commission had discussed its future work in the area of arbitration, it was decided that the Working Group on Insolvency Law would hold that exploratory session at Vienna from 6 to 17 December 1999.

6. This note is intended to serve as a list of issues and approaches that might be covered by an instrument to be prepared by the Commission. It does not presume to be exhaustive, and it is anticipated that issues will be raised in the discussion that have not been addressed in the note.

7. The Working Group may wish to review this note topic by topic, with a view to considering firstly, whether future work on the topic of insolvency is desirable and feasible and, if so, which topics, if any, might be addressed in future work. In examining these topics, the Working Group might wish to consider the state of current discussions and whether the solutions presented in this note may offer an appropriate approach. Further, the Working Group might also wish to consider what form of work product (such as model law, model provisions, a set of principles or other text) might be appropriate for addressing relevant policy considerations and potential options for solution of the problems outlined in this note. This approach might assist the Working Group in reaching a working assumption on the form that any text might take. Such a working assumption might serve as a guide to any later deliberations of the Working Group and allow the form to crystallize as the work develops.

I. GENERAL BACKGROUND REMARKS

8. In the preparation of this note and the selection of issues referred to in it, the Secretariat has relied upon earlier efforts and reports. Chapter II of this note briefly introduces the current work of international organizations in the area of insolvency law. Chapter III outlines key principles or

objectives identified as important to an effective insolvency regime, while Chapter IV discusses in some detail the core features of an insolvency regime. These two parts are based upon the Key Principles and Features of Effective Insolvency Regimes set forth in the Report of the G22 Working Group on International Financial Crises[3/] and reports by the International Monetary Fund ("the IMF")[4/] and the Asian Development Bank ("the ADB").[5/] Chapter IV also includes the recommendations and proposals from those reports.
Chapter V of this note provides brief background information on the different types of text that might form the basis of future work. It addresses some of the considerations raised by these different work products, including the potential of each type of text to contribute to the goal of developing a harmonised framework for effective national corporate insolvency regimes.

9. Before proceeding with a consideration of issues, it may be useful to clarify how certain basic terms used in this note may be understood. Most legal systems contain rules on various types of proceedings that may be initiated when a debtor is unable to pay its debts, referred to by generic terms such as "insolvency proceedings". Two types of insolvency proceedings may be distinguished, for which uniform terminology is not always used.

10. In one type of proceedings (referred to here as "liquidation"), a public authority, typically a court acting through an officer appointed for the purpose (referred to here as the "liquidator") takes charge of the insolvent debtor's assets with a view to transforming non-monetary assets into a monetary form, distributing the proceeds proportionately to creditors, and liquidating the debtor as commercial entity. In some States this is the only type of proceedings used. Other terms used for this type of proceedings include bankruptcy, winding-up, faillite, quiebra, Konkursverfahren.

11. In the other type of proceedings (referred to here as "rehabilitation"), the purpose is not to liquidate the insolvent debtor, but to allow it to overcome its financial difficulties and resume normal commercial operations. These proceedings also are usually conducted under the supervision of a public authority, such as a court acting through an officer appointed for the purpose (referred to as an "administrator"). They are typically aimed at reaching an agreement between the debtor and its creditors about relief that should allow the debtor to reorganize its operations to restore its financial viability. Insolvency regimes may make provision for both liquidation and rehabilitation, as well as transfer from one process to the other in certain circumstances. Other terms used for this type of insolvency proceedings include rescue, reorganization, arrangement, composition, concordat préventif de faillite, suspensión de pagos, administración judicial de empresas, Vergleichsverfahren.

II. CURRENT ACTIVITIES IN INTERNATIONAL ORGANIZATIONS

[3/] Report of the G22 Working Group on International Financial Crises, October 1998 ("the G22 Report").

[4/] International Monetary Fund, Legal Department Report, Orderly and Effective Insolvency Procedures: Key Issues, May 1999 ("the IMF Report").

[5/] Asian Development Bank, Regional Technical Assistance Project, TA No: 5795-REG, Insolvency Law Reform: Preliminary Comparative Report, 1999 ("the ADB Report"); also Special Report: Insolvency Law Reform in the Asian and Pacific Region, Law and Development at the Asian Development Bank, 1999 ed., ("the ADB Special Report").

12. The international organizations whose work is mentioned in this part are not mainly concerned with the unification of legal rules. Their interest in insolvency laws and practices arises from their work in the international financial system and the growing recognition that effective insolvency regimes play a major role in strengthening a country's economic and financial system so as to prevent financial crises and, where the crisis has occurred, are an essential mechanism for responding to that financial situation. The value of strong national insolvency regimes has been emphasized by these organizations.

A. Asian Development Bank (ADB)

13. The ADB Regional Technical Assistance for Insolvency Law Reform (RETA) project is being carried out as a part of the Law and Development activities of the ADB and is designed to provide a regional forum for government officials and others concerned with insolvency law reform and administration to discuss common problems in insolvency law reform and administration and explore regional and international best practice. In the context of the RETA, the inter-relationship between corporate debt, debt recovery and corporate insolvency was studied in eleven Asian economies. The Preliminary Comparative Report of the study seeks to identify, observe upon and estimate similarities and differences in the eleven economies regarding those interrelationships, to develop key areas for discussion and critical evaluation and to suggest key components of a "best practices model" which would be suitable for the region to deal effectively with problems of corporate insolvency and debt recovery. The Report proposes that the basic components be determined by reference to well established and accepted policies and principles which are evident in the corporate insolvency regimes and related practices of many more fully developed countries. While the Report notes (1.6, p. 8) that there is a considerable degree of difference in the application and practice of these policies and principles among the various countries, it nevertheless underlines that there is, in these regimes, a reasonably basic degree of commonality of approach. It suggests that it is therefore possible to spell out a basic policy framework of a commercially acceptable insolvency regime which appears reasonably suited to application in a market economy.

14. The Report is based on an extensive survey of a number of aspects of the eleven economies, including forms and structures of business organizations (concentrating on large and medium size enterprises); the banking system and the availability of forms of financing for such enterprises, including secured financing and enforcement; unsecured financing and enforcement; attitudes towards financial difficulty and insolvency; informal processes; insolvency law regimes; foreign and cross-border aspects of insolvency law; the inter-relationship between lenders and borrowers; and a general assessment of various processes arising from these issues (pp. 6-7). The surveys were directed at the form and substance of the issues and processes, as well as the intangible or socio-political influences that might impact on the form and substance.

B. International Bar Association (IBA)

15. Committee J of the International Bar Association deals with insolvency and creditors' rights. A recent project is the Model Bankruptcy Code which is intended to harmonize substantive bankruptcy law by providing draft provisions on key components of bankruptcy law for those jurisdictions considering reform of their insolvency regimes. A first draft, dealing with liquidation proceedings, was completed in September 1997. It addresses topics such as tests for

insolvency, powers of the bankruptcy representative, invalid pre-bankruptcy transactions and priority of creditors' claims and contracts. A further draft of the Model Law is currently being prepared.

C. International Monetary Fund (IMF)

16. In May 1999, the Legal Department of the IMF completed an internal report entitled "Orderly and Effective Insolvency Procedures: Key Issues". The Report discusses the major policy choices that need to be addressed by countries when designing an insolvency regime. Based upon a comparative study of selected insolvency laws, the Report discusses issues that are of universal importance, and weighs the advantages and disadvantages of possible solutions. While it does express certain preferences with respect to some of the more important policy choices, it does not attempt to propose standards.

17. The Report makes it clear that the approaches adopted to these issues vary in a number of respects, being attributable not only to divergent legal traditions but also to different policy choices. Although some of these choices may be labelled as being "pro-creditor" or "pro-debtor" in approach, the Report (p. 2) warns that "the degree to which rules set forth in an insolvency law are perceived as fitting within one category or the other is ultimately less important than the extent to which the rules are effectively implemented by a strong institutional structure."

18. The Report notes that it does not address several issues - the application of insolvency laws to individuals; legal mechanisms that address the liquidity problems confronted by national or local governments; insolvency of financial institutions; the complex relationship between corporate governance and insolvency; the law on secured transactions; general features of an independent and competent judiciary and out-of-court rehabilitation.

D. Organisation for Economic Cooperation and Development (OECD)

19. Since 1992, the Privatisation and Enterprise Reform Unit of the OECD has been involved in a process of developing rules and policies for transition and emerging market governments in the area of legal reform, focusing on privatisation, insolvency and corporate law. The work on insolvency law has centred on the transition economies, examining the relationship between insolvency procedures and enterprise restructuring, providing comparative overviews of different legal and policy frameworks for insolvency, exploring policy implications of the use of insolvency or similar procedures in privatising state-owned assets. In the context of its special program for Asia and in cooperation with the World Bank and the ADB, the OECD has undertaken to develop a dialogue, involving member country experts and officials, policy makers and experts from emerging market economies, on the design and implementation of insolvency systems. A meeting will be held in November 1999 to discuss a number of reports, to review progress in insolvency reform in the Asian economies, to consider current efforts to develop a framework for international insolvency proceedings and to offer recommendations for future work.

E. Working Group on International Financial Crises (G22)

20. The Report of the Working Group, completed in October 1998, identifies a range of policies and institutional innovations that could help prevent international financial crises and facilitate the orderly resolution of crises that may occur in the future. In particular, it identifies for

consideration policies that could help reduce the frequency and limit the scope of future crises, improve creditor coordination, and promote the orderly, cooperative and equitable resolution of international financial crises that occur. 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).

21. No specific recommendations were made in the Report 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.

F. World Bank

22. As part of the wider effort to improve the future stability of the international financial system, the World Bank is leading an initiative to identify principles and guidelines for sound insolvency regimes and for the strengthening of related debtor-creditor rights. The initiative is to be undertaken in partnership with a number of international organizations (including the IMF, the ADB, UNCITRAL, the OECD, the International Finance Corporation, the African Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the International Bar Association and INSOL), which will provide guidance to the Bank and to a task force of experts.

23. The task force will prepare draft Principles and Guidelines on the basis of a series of working papers and an Insolvency Symposium (Washington, 13 and 14 September, 1999). The working papers will examine a number of issues including the legal framework for insolvency, the institutional framework, economics of insolvency, regulatory frameworks, business and financial sector concerns, rehabilitation and insolvency alternatives, systemic crisis situations, state-owned enterprise insolvencies, bank insolvencies and debtor-creditor regimes.

III. KEY OBJECTIVES

24. Although treated differently in the various reports mentioned in this note, there is broad agreement on the key objectives which are important to effective insolvency regimes.[6/]

A. Maximize value of assets

25. Insolvency law should provide for the possibility of rehabilitation of the debtor as an alternative to liquidation, where creditors would not involuntarily receive less than in a liquidation and the value of the debtor to creditors may be maximised by allowing it to continue.

[6/] This discussion is based on the principles outlined in the G22 Report, pp. 44-45.

B. Strike a balance between liquidation and rehabilitation

26. An insolvency regime 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 rehabilitation (often the preference of unsecured creditors).

C. Equitable treatment

27. An insolvency regime should treat similarly-situated creditors, including both foreign and domestic creditors, equitably. Equitable treatment recognises that creditors do not need to be treated equally, but in a manner that reflects the different bargains that they have struck with the debtor. The insolvency regime should address problems of fraud and favouritism that may arise in cases of financial distress.

D. Provide for timely, efficient and impartial resolution of insolvencies

28. Insolvencies should be resolved quickly and efficiently, avoiding undue disruption to the business of the debtor. To facilitate this, it may be useful to establish time limits in the law for the completion of certain matters and for the proceedings as a whole, to allocate responsibility for the process to the entity administering the debtor's assets, and possibly establish specialized courts or administrative tribunals to supervise the process.

E. Prevent premature dismemberment of the debtor's assets by creditors

29. The proceedings should be conducted in an orderly manner, and creditors should be restrained from prematurely dismembering the debtors assets by the imposition of a stay. This will enable a proper examination of the debtor's situation and facilitate both maximization of the value of the estate and equitable treatment of creditors.

F. Provide for a procedure that is predictable and transparent and which contains incentives for gathering and dispensing information

30. Relevant risk allocation rules should be clearly specified in the law and consistently applied to ensure that there is confidence in the process and that all participants are able to adopt appropriate measures to manage risk. Transparency is closely related to the objective of predictability and requires that participants in the process be given sufficient information to enable them to exercise their rights under the insolvency law. In addition, where the law provides for the exercise of discretion, it should also provide adequate guidance as to how that should be exercised.

G. Establish a framework for cross-border insolvency

31. To promote coordination among jurisdictions, insolvency laws should provide rules on cross-border insolvencies with recognition of foreign proceedings.

IV. IDENTIFICATION OF CORE FEATURES

32. The ADB and IMF Reports address a number of common issues to be addressed by an insolvency regime. In terms of the legal framework required to support the process, the Reports indicate that an insolvency regime should resolve a number of questions:

1. the types of debtors that will be subject to the law;
2. the relationship between liquidation proceedings and rehabilitation proceedings;
3. when insolvency proceedings can be commenced;
4. the extent to which the debtor should be displaced from management once proceedings have commenced;
5. the class of creditors whose actions are stayed or may not be commenced;
6. the extent to which liquidators and administrators should have authority to interfere with or nullify contracts entered into by the debtor prior to the commencement of proceedings;
7. limitations to be imposed upon the formulation of rehabilitation plans and requirements for their approval and implementation; and
8. in liquidations, ranking of creditors for the purposes of distribution.

33. In terms of the institutional framework, key issues include:

1. the extent to which the process is to be supervised by the courts or special administrative organs;
2. the discretion judges and designated officials should have in the exercise of their duties; and
3. the extent to which courts and designated officials should have the authority to make decisions on economic and business matters, even over the objections of creditors.

A. Application of the law - individuals and enterprises

34. An important threshold issue is determining which entities, as debtors, can be subjected to a general insolvency law. To the extent that any entity is excluded from the process, it will not enjoy the protections offered by the process, nor be subject to the discipline of the process. A general insolvency regime can apply to all forms of corporation, both private and state-owned, especially those state-owned entities which compete in the market place and are otherwise subject to the same commercial and economic processes as privately-owned corporations. In addition to general insolvency law, there may be a need for establishing special regimes for natural persons and highly regulated entities, such as financial and insurance institutions and utility companies.

35. The ADB Report (2.4, p. 14) tentatively proposes that all corporations, both private and state-owned (with the exception of banking corporations), should be subject to the same insolvency law regime.

36. The IMF Report (p. 17) concludes that, while the exclusion of an enterprise from any form of insolvency regime should be avoided, it is recognized that countries may wish to establish special regimes outside the scope of the general insolvency law for individuals or highly regulated entities, such as financial institutions. However, government ownership of an enterprise should not, in and of itself, provide a basis for excluding an enterprise from the coverage of the general insolvency law.

B. The relationship between liquidation and rehabilitation

37. Where a debtor is unable to discharge its liabilities as they fall due, there will usually be a number of competing claims on the assets which, in some cases, may best be satisfied by liquidation, even if creditors only receive a portion of the value of their claims. In other cases, liquidation will not be the best course of action and a restructuring of the debtor's debt structure and operations could take place to save the entity as a going concern and ensure that creditors are fully repaid or receive at least as much as they would have through liquidation. A key question in the design and evaluation of insolvency laws will be the way in which balance is achieved between a variety of social, political and economic interests and encouraging participation in the system.

38. The IMF Report suggests that the need for liquidation procedures can be viewed from different perspectives: first, as addressing inter-creditor problems and secondly, as a disciplinary force that is an essential element of a sustainable debtor-creditor relationship. With respect to the first issue, the Report (p. 10) points out that,

> "an orderly and effective liquidation procedure addresses the inter-creditor problem by setting in motion a collective proceeding that seeks to achieve equitable treatment among creditors and to maximise the assets to be distributed to creditors. [...] this is normally achieved by the imposition of a stay on the ability of creditors to enforce their rights against the debtor and the appointment of an independent liquidator whose primary duty is to maximize the value of the assets of the debtor prior to distribution to creditors."

39. Regarding the ongoing debtor-creditor relationship, the IMF Report points out that the orderly and predictable mechanism to enforce the rights of creditors, which is characteristic of liquidation procedures, can be seen as an important factor in determining the lending decisions of creditors. Viewed more broadly, liquidation procedures can be seen as "promoting the interests of all participants in the economy, since they serve to facilitate the provision of credit and the development of financial markets" (p. 11).

40. With regard to rehabilitation, the ADB Report (2.2(b), p. 12) discusses the economic theory (a more contemporary theory than the theory used to justify the liquidation process) which maintains that not all enterprises that fail in a competitive market should necessarily be liquidated. A corporation with a reasonable prospect for survival should be given that opportunity, especially since it can be demonstrated that there is greater value in keeping such corporations functioning.

41. In contrast to liquidation, rehabilitation allows time for a debtor to recover from liquidity problems, and to restructure its operations and relations with creditors and interested parties to determine how the value of the debtor's assets can best be maximised to satisfy all claims. The degree to which formal rehabilitation procedures are relied upon to achieve these goals differs, as does the focus of the procedure and the way in which the different interests are balanced. Some regimes focus, for example, upon saving the entity as a going concern and maintaining of the existing ownership structure, while others focus upon the claimants.

42. The IMF Report (pp. 11-12) notes that there are a number of reasons why formal rehabilitation procedures can provide a mechanism for enterprise rehabilitation that serves the interests of all participants in the economy. First, since out-of-court rehabilitation requires unanimity of creditors, recourse to formal rehabilitation procedures may assist in achieving restructuring where they 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. Secondly, the Report points to the fact that the modern economy has significantly reduced the degree to which an entity's value 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 which cannot be realised through liquidation. Thirdly, long term economic benefit is more likely to be achieved through rehabilitation procedures, since they encourage debtors to restructure before their financial difficulties become severe. Lastly, there are social and political considerations which are served by the existence of rehabilitation procedures which protect, for example, the employees of a troubled entity.

43. Commentators point to the particular importance of rehabilitation in transition economies where large scale liquidation of insolvent enterprises, especially large-scale state-owned enterprises, could produce structural and social problems of a magnitude that could negatively affect the social fabric of the country and jeopardize its political viability.[7/]

[7/] See, for example, Dr Manfred Balz, and Henry M. Schiffman, "Insolvency Law Reform for Economies in Transition - A Comparative Law Perspective" Part 1, ("Balz and Schiffmann Pt. 1"), Butterworths Journal of International Banking and Financial Law, Vol 11, No. 1 (January 1996), p. 19.

44. Although often treated as separate processes, there is significant overlap and interaction between liquidation and rehabilitation procedures and it may often be difficult to tell, at the time of commencement, whether the debtor should be liquidated or reorganized. One way of dealing with this issue is for an insolvency regime to include both processes, with the balance between the two to be determined by policy considerations. In some cases, for example, the law may presume that a company should be reorganized and liquidation procedures may only be commenced where that rehabilitation has failed. A different approach is the "unitary" proceeding, which provides that all insolvencies are conducted initially under the same rules, with proceedings only being separated into liquidation or rehabilitation once a determination has been made as to whether rehabilitation is possible.

45. The ADB Report (2.5, p. 14) points out that there are cost and efficiency advantages if both processes can be accessed under a single procedure. It cites, as an example, the corporation which, having sought formal rehabilitation and failed, could be automatically liquidated without the necessity of having to commence a new procedure for liquidation. The Report proposes that an insolvency regime should provide the possibility of accessing both the liquidation and the rehabilitation processes under a single procedure. The IMF Report (p. 14) suggests that the unitary approach offers procedural simplicity which may be of advantage where the capacity of the institutional infrastructure is limited. Since this approach, however, reflects a recent trend not yet adopted in the insolvency laws of many countries, the Report follows the twin-procedure model that still prevails.

46. This note considers formal liquidation procedures and rehabilitation procedures separately, identifying and discussing the core provisions of each process.

C. Liquidation procedures

47. The ADB Special Report (p. 11) identifies the common pattern of the liquidation process as follows:

1. an application to a court or other competent body either by the entity or the creditors;
2. an order or judgment that the entity be liquidated;
3. appointment of an independent person to conduct and administer the liquidation;
4. closure of the business activities of the entity;
5. termination of the powers of directors and employment of employees;
6. sale of the entity's assets;
7. adjudication of claims of creditors;
8. distribution of available funds to creditors (under some form of priority); and
9. dissolution of the entity.

1. Conditions for commencement of liquidation

48. While insolvency laws refer to different criteria for commencement, most use the liquidity or cash flow standard and require a general cessation of payments on liabilities as they become due. As the IMF Report (p. 18) points out, reliance on this standard, as opposed to a test requiring greater financial distress such as insolvency, is designed to activate proceedings

sufficiently early in the period of the debtor's financial distress to avoid a race by creditors to grab assets, causing dismemberment of the debtor to the collective disadvantage of creditors. Problems associated with this "preemptive" approach, such as the commencement of liquidation proceedings of a financially troubled, but nevertheless financially viable, enterprise, may be resolved by providing for the debtor to transform liquidation into rehabilitation.

49. In terms of access to the process, the ADB Report (2.6, p. 15) stresses the need for it to be convenient, inexpensive and quick. Restrictive access can deter both debtors and creditors, while delay can be harmful in terms of the dissipation of assets and the possibility of rehabilitation. Insolvency laws generally provide that liquidation proceedings can be initiated by either a creditor or a debtor. While the "general cessation of payments" requirement is often applied in both cases, in practice courts may be less demanding of evidence of insolvency in the case of a debtor application since this application will generally be as a last resort where the debtor is unable to pay its debts.8/ In the case of creditors, while they may be able to show that the debtor has failed to pay their own claim, providing evidence of a general cessation of payments may not be so easy. As the ADB Report (2.6, p. 15) notes, "although there should be a requirement of threshold proof, there is also a practical need for a creditor to be able to present proof, in relatively simple form, which establishes a presumption of insolvency on the part of the corporate debtor." Insolvency laws address this issue in a number of ways, including requiring the petition to be filed by more than one creditor or requiring the debtor to furnish information to the court to enable a determination of a general cessation of payments to be made. The ADB Report suggests that clear evidence of a failure of the corporate debtor to pay a matured debt is all that is required.

50. A matter related to debtor-initiated insolvency proceedings is the possible imposition of a duty on a debtor to commence proceedings at a certain stage of financial difficulty. Clearly there may be advantages in establishing an obligation to take early action. In the case of rehabilitation, the chances of successful rehabilitation are increased by early action and in the case of liquidation, creditors interests would be protected by preventing further dissipation of the debtor's assets. However, as the IMF Report (p. 20) suggests, such provisions may discourage management from pursuing an out-of-court restructuring agreement on the basis that delay in filing formal proceedings may lead to personal liability. Choosing not to rely on penalties to force a debtor to commence proceedings may require the adoption of incentives to encourage debtors to do so.

51. On the issue of commencement, the ADB Report (2.6, p. 15) tentatively proposes that:

> "Access to the process provided for under an insolvency law regime should provide for a quick, convenient and inexpensive procedure for both a corporate debtor and creditors, but with sufficient safeguards to protect against abuse of the process. Evidence should be provided of insolvency or financial difficulty of a corporate debtor."

52. The IMF Report (p. 20) concludes that:

8/ Balz and Schiffmann, Pt 1, p. 23.

"Where the law establishes separate liquidation and rehabilitation procedures, it should allow liquidation proceedings to be commenced on the basis of a petition filed by either a creditor or the debtor. When the petition is filed by a creditor, it is advisable that the principal commencement criterion be a demonstration that the debtor has ceased making payments generally. Various tests can be used as a means of determining whether, in fact, a cessation of payments is general. With respect to petitions filed by debtors, an important policy choice needs to be made as to whether the law should impose specific penalties on management for failure to commence proceedings upon a general cessation of payments. If it is decided that such penalties should not be imposed, it is advisable that, as an alternative, the law provide adequate incentives in the rehabilitation procedure to encourage debtors to utilize those procedures at a sufficiently early stage. In circumstances where the capacity of the judiciary is limited, it may be advisable to require that the court render a decision regarding the commencement of a proceeding within a specified period following the filing of a petition."

2. Effect of commencement

53. The issues to be considered under this heading relate to determining what constitutes the assets of the estate and to protecting those assets, both against the debtor and against creditors.

(a) Assets of the estate

54. The assets of the estate would generally include the property of the debtor as of the date the insolvency proceedings commence and assets acquired by the liquidator after that date.

55. Property in the first category would generally include both tangible and intangible assets owned by the debtor, whether or not in the possession of the debtor at the time of commencement. Assets not included in the estate would include those owned by a third party but in the possession of the debtor at the time of commencement and, in some cases, those assets being used by the debtor, but which are subject to a lease agreement where the lessor retains legal title. As the IMF Report (p. 22) points out, assets in the latter category may require special attention to ensure that the lease is not, in fact, a disguised lending arrangement. In such a case the lessor would be subject to the same restrictions as the secured lender.

56. Property in the second category would include assets acquired by the liquidator in continuing to operate the debtor's business prior to liquidation and those acquired by exercise of the avoidance powers.

(b) Protecting the estate

57. One of the principal goals of the insolvency process is to preserve the value of the estate. This will involve protecting it against the actions of both the debtor and the creditors, between the time a petition is filed and granted and after the proceedings have opened.

58. In respect of the first period, action may need to be taken to ensure that the debtor does not transfer assets out of the business or abscond from creditors and that the creditors do not take legal action which would have the effect of preempting the stay of actions against the debtor that will be imposed once the petition has been granted. The interim protective measures that can be

taken against such actions, either by the court or at the request of a creditor, could include appointing a preliminary liquidator, prohibiting the disposal of assets and suspending the enforcement of security interests against the debtor. Since these protective measures are of an interim nature, the court may require evidence that the measure is necessary before an order for the posting of a bond will be given, especially in cases where the application for interim measures is made by a petitioning creditor.

59. Once the liquidation proceedings have opened, protection of the estate may require that control of the business be removed from the debtor and transferred to an appointed liquidator. There may be situations, such as where the business of the debtor is to be sold as a going concern, that justify permitting the debtor to retain some control over the business, even though the liquidator has complete control by virtue of his or her appointment and would be liable for any wrongful acts of the debtor during this period. Such a step would generally require consultation with creditors.

60. Protection of the estate against creditors during the period of the proceedings may require the imposition of a stay on the ability of creditors to enforce their legal rights. That stay may need to be imposed immediately to maximize the benefit to the estate and ensure that a fair and ordered administration can be achieved. The terms and conditions of the stay will need to balance the interests of the liquidator in having adequate time to maximize the value of the assets and, if appropriate, sell the business as a going concern, against the extent to which insolvency law should interfere with accepted commercial practices and processes, particularly as they relate to secured creditors. The IMF Report (p. 24) points out that there is little debate regarding the necessity of imposing a stay on the ability of unsecured creditors to attach assets as a means of enforcing their contractual claims and precluding all creditors from initiating legal proceedings to recover debts that accrued before the proceedings were initiated. The coverage of secured creditors, however, raises a number of issues (see paras. 65-69 below).

61. The ADB Report (2.7, p. 17) tentatively proposes that:

> "If the debtor corporation has applied for liquidation or if it is determined that the debtor corporation is only suited to liquidation, the powers of the existing management should be removed and an independent administrator should be appointed to assume those powers and the conduct of the liquidation. Secondly, the stay or suspension of actions and proceedings against the property of the debtor corporation should be confined to unsecured creditors only."

62. The IMF Report (p. 24) concludes that:

> "Upon commencement of the liquidation proceedings, all assets in which the debtor has an ownership interest as of the date of commencement should be transferred to an independent, court appointed liquidator. The debtor should be required to disclose all assets and questionable transactions.
>
> "During the proceedings, all assets over which the liquidator exercises control should be protected by a "stay" on the ability of unsecured creditors to enforce legal remedies against the assets of the estate. Although the scope of the stay may vary among countries, it should,

at a minimum, preclude unsecured creditors from: (i) attaching, selling or taking possession of assets as a means of enforcing their claims or (ii) initiating legal proceedings to recover debts incurred before the liquidation proceedings were commenced.

"[...] the stay should apply to secured creditors for a limited period [...].

"Once a petition for commencement has been filed, it is advisable for the court to be given the authority to impose interim measures to protect the debtor's assets pending a determination of commencement by the court. The range of measures that should normally be available should include full or partial divestiture of the debtor's control over the assets, the appointment of an interim administrator and the imposition of a stay on the ability of creditors to attach assets."

3. The proceedings

General issues

63. A basic requirement of effective insolvency proceedings is that they be conducted in a timely, predictable and equitable manner, involving appropriate procedures for identification and collection of the assets of the estate, identification and verification of the liabilities of the estate, sale of the assets and distribution of the proceeds. These various stages of the liquidation process raise a number of issues.

(a) Verification of claims

64. Verification of the claims of creditors requires assessment of the legitimacy and amount of claims, as well as a determination of the category of the claim for distribution purposes. The burden of proving a claim generally lies with the creditor and to prevent delay, it may be appropriate to establish deadlines for the proof of claims. Where a regime allows challenges against a creditor's claims to be made, whether by the liquidator or other interested party, provision for dispute avoidance mechanisms, such as review by creditors of a final list of claims or some form of dispute resolution, could be included in the law.[9/]

(b) Encumbered assets and secured creditors

65. The application of any measure, such as a stay, against the ability of creditors to enforce their security must weigh the basic purpose of insolvency proceedings against the purpose of creditor security and the availability of affordable credit, as well as the basic principle that contractual obligations should be honoured. If security is to achieve the aim of protecting creditors' interests in the event that the debtor fails to repay, then the creditor should not be delayed or prevented from exercising its security. At the same time, as the IMF Report (p. 25) points out, it has become increasingly recognized that permitting secured creditors to freely separate their collateral from other assets in the estate can frustrate the basic objective of insolvency proceedings, particularly rehabilitation, but also liquidation. Failure to limit the actions of secured creditors may negatively effect maximization of the value of the estate prior to distribution, especially where the sale of the business as a going concern is an option. In that case,

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[9/] IMF Report (note 4), p. 37.

individual enforcement of securities may be against the interests of secured creditors as a whole, as the claims may be worth more when the business is sold as a going concern than when it is liquidated.

66. The ADB Report (2.7(c), p. 17) questions the extent to which the insolvency law should intrude into and interfere with accepted commercial practices and processes. The Report suggests that some form of stay will be required in order to ensure a fair and ordered administration, and supports the use of an "automatic" stay which comes into effect once an application has been made. Where there is a genuine aim of rehabilitating the debtor, the extent of the stay should be very wide and all embracing on the basis that rehabilitation will fail unless the essential assets and component parts of the debtor corporation and its businesses are maintained. However, since the same rationale is not relevant in cases of liquidation, the stay should only be applicable to unsecured creditors.

67. The IMF Report (p. 25) suggests that it is essential that any stay on the ability of a secured creditor to enforce its rights be accompanied by measures that serve to protect the interests of these creditors during the liquidation process. One approach would be to apply the stay automatically, but for a limited period, to enable the liquidator to commence the task of identifying and assessing the estate, with any extension being subject to a demonstration of need by the liquidator. Another measure to protect the interests of secured creditors relates to preserving or maintaining the economic value of the secured claim during the period of the stay.

68. The IMF Report (p. 27) outlines two ways of protecting the value of the secured claim. The first approach is to protect the value of the collateral itself, by providing compensation for depreciation which could be by way of substitute collateral or by making periodic cash payments corresponding to the amount of depreciation; by paying interest during the period of the stay to the extent that the creditor is oversecured (the value of the collateral exceeds the value of the secured claim); by providing the creditor with substitute equivalent collateral; or by paying the full amount of the secured claim where the liquidator wishes to sell encumbered assets. A second approach is to preserve the value of the secured portion of the claim, by valuing the asset on commencement of proceedings and, by reference to that valuation, determining the value of the secured portion of the creditor's claim. This value is fixed and, on distribution following liquidation, the secured creditor is given priority to the extent of that value. During the proceedings, the creditor will also receive the contractual rate of interest on the secured portion of the claim as compensation for the delay in realizing the asset.

69. The IMF Report (pp. 27-28) concludes that:

> "As a general principle, an insolvency law should strike a balance between, on the one hand, preventing secured creditors from undermining the objective of maximizing the value of the assets of the estate and, on the other hand, protecting the interest of such creditors so that the value of their security - and, as a consequence, the availability of credit - is not eroded. As a means of implementing this principle, an insolvency law should normally provide for the following:
>
> "(a) For a brief - and specified - period following the commencement of the proceedings (eg. 30 or 60 days), the general stay on creditor enforcement should also apply to secured

creditors, thereby precluding them from enforcing their contractual rights upon the collateral during the period of the proceedings, subject to the qualifications described below. The stay should normally only be extended beyond this period by the court upon a demonstration by the liquidator that such an extension provides a necessary means of maximizing the value of the assets of the estate for the benefit of creditors generally (eg. because of the possibility of selling the enterprise or units of the enterprise as a going concern). It may be advisable for the law to impose a limit on the period of extension.

"(b) Exceptions to this stay may be appropriate with respect to those assets that are generally not necessary for a sale of the business as a going concern (eg. cash collateral).

"(c) During the period of the stay, a mechanism should exist that ensures that the interests of the secured creditor are adequately protected. Where this protection is provided by preserving the value of the creditor's collateral, these measures should include, for example, compensation for the depreciation of the collateral and, if the collateral is to be used or sold by the liquidator, the provision of replacement collateral. Countries may, as an alternative, protect the interests of the secured creditor by fixing the value of the collateral at the commencement of the proceedings and giving the secured creditor a first priority claim based on that value, plus a priority claim for regular payments of contractual default interest.

"Where the liquidator is unable to provide a secured creditor with the type of protection described above, the stay against the secured creditor should be lifted."

(c) Powers of avoidance

70. Since insolvency proceedings may commence at lengthy periods after a debtor first becomes aware that such an outcome cannot be avoided, there may be significant opportunities, as the IMF Report (p. 28) points out, to attempt to hide assets from creditors, incur artificial liabilities or make donations to relatives and friends. The result of such activities, in terms of the eventual insolvency proceedings, is to disadvantage general unsecured creditors, who were not party to such actions and do not have the protection of security, and to undermine the objective of equitable treatment of all creditors. The purpose of avoidance powers, therefore, is to restore creditor equality and undo unfair transactions or unilateral legal acts which can harm the future estate and its creditors.[10/]

71. The issue of avoidance powers is one that requires a balance to be struck between the value of strong powers to maximizing the value of the estate for the benefit of all creditors and the possible undermining of contractual predictability. The ADB Report (2.13, p. 22) suggests that "the debate over avoidance powers centres not so much on the policy behind the provisions, but on how effective in practice such provisions are and the somewhat arbitrary rules that are

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[10/] See, for example, Dr Manfred Balz and Henry M. Schiffman, "Insolvency Law Reform for Economies in Transition - A Comparative Law Perspective" Part 2, ("Balz and Schiffmann Pt 2"), Butterworths Journal of International Banking and Financial Law, Vol 11, No. 2 (February 1996), p. 66.

necessary to define, for example, time periods and the nature of the transactions themselves. There is some validity in the criticism that actual operation and enforcement of such provisions is not, in many cases, effective."

72. Notwithstanding possible criticisms, there appears to be general agreement that avoidance powers are important not only because they have an impact on maximizing the value of the estate for the benefit of creditors, but also because they contribute to establishing fair commercial conduct and are part of appropriate standards for corporate governance.[11/]

73. The issues to be considered include whether avoidance should be possible in both liquidation and rehabilitation; what acts should be voidable and what criteria should be used, including whether or not certain transactions should be automatically void or voidable.

74. In some jurisdictions, avoidance rules apply only to liquidation, not to rehabilitation. Some commentators suggest that this prevents the full potential of rehabilitation being realized and distorts the choice between liquidation and rehabilitation.[12/]

75. Avoidance rules may combine both objective and subjective elements. Objective criteria focus upon when the transaction took place in relation to the commencement of insolvency proceedings and the types of transactions at issue. Subjective criteria are based upon intent or knowledge which is specific to particular cases. While objective rules may be easy to apply, they may also lead to arbitrary decisions in cases where, for example, a legitimate transaction which falls within a specified period may be avoided, while a fraudulent transaction which occurred outside the specified period may be protected. Subjective criteria, on the other hand, may give rise to disputes and should be used only where really necessary. A balance needs to be reached between the two approaches.

76. The IMF Report (p. 29) points out that stricter rules should be applied to transactions and transfers made to insiders than to unrelated market parties, on the basis that insiders are more likely to be favoured and also tend to have the earliest knowledge of the debtor's financial difficulties. Categories of insiders would include those in a close corporate or family relationship, both past and present, with the debtor.

77. The IMF Report (pp. 29-30) identifies four categories of transactions that are most commonly covered by avoidance provisions: First, transactions and transfers made where there is evidence of the debtor's actual intent to defraud creditors by placing assets beyond their reach and where the counter-party knew of such an intent. These transactions would constitute actual fraud, since there is intent to defraud on the part of both parties. Many insolvency laws do not limit the period during which such transactions and transfers may be avoided. Secondly, transactions and transfers with a third party for inadequate consideration. An intent to defraud may be presumed whenever the transaction is unbalanced and does not appear to be made at "arms length". Some laws specify a maximum retroactive period calculated from the date of commencement, while others also require a finding of insolvency or imminent insolvency when

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[11/] ADB Report (note 5), 2.13, p. 22.

[12/] See Balz and Schiffmann, Pt 2, p. 66.

the transaction or transfer occurred. Thirdly, transactions and transfers to creditors that are "voluntary". These concern the problem of preferential treatment, where a benefit may be given to an individual creditor which has no entitlement to that benefit. This may include, for example, early payment of a debt or granting a security to a previously unsecured creditor. Some laws specify a maximum retroactive period calculated from the date of commencement, while others also require a finding of insolvency or imminent insolvency at the time when the transaction or transfer occurred. Finally, ordinary transactions and transfers with creditors. This covers transactions which are normal in every respect except that they took place within a very limited period before the commencement of the insolvency, suggesting that there may be some preferential treatment. The period is generally limited to 30-90 days and some laws also require that the creditor knew or should have known of the debtor's insolvency. Some exceptions are made where the transactions are part of the normal course of business, such as payment for goods that are regularly delivered and paid for.

78. While certain transactions and transfers may be rendered automatically void by an insolvency law, in other cases it may be appropriate only at the discretion of the liquidator. In those cases, the discretion should be subject to the obligation to maximize the value of the estate, taking into account the cost and delays of recovering transfers.

79. The ADB Report (2.13, p. 22) tentatively proposes that an insolvency regime should contain adequate provisions relating to avoidance of transactions which result in damage to creditors or conflict with the principle of equal treatment of creditors of the same class.

80. The IMF Report (p. 31) concludes that:

> "The liquidation procedure should set forth a mechanism that enables the liquidator to recapture assets that the debtor transferred prior to commencement, where such transfers prejudice creditors generally. The avoidance provision should specify the type of transactions and transfers that should be covered and the maximum "suspect period" prior to commencement during which these transactions and transfers will be subject to avoidance. Stricter rules should normally apply to transactions and transfers with insiders. At a minimum, it is advisable for the following types of transactions and transfers to be included:
>
> (a) Transactions and transfers made where there is evidence of the debtor's actual intent to defraud creditors by placing assets beyond their reach and where the counter party knew of such an intent. No maximum period need be specified in the insolvency law.
>
> (b) Transactions and transfers for inadequate consideration, including gifts, that took place when the debtor was insolvent or about to become insolvent, with a maximum period specified.
>
> (c) "Voluntary" transactions and transfers to creditors, where, for example, the debtor makes early payments on a debt or provides a security interest on an existing debt. A demonstration of actual or imminent insolvency may be necessary, with a maximum period specified.

> "In addition, it may be desirable - but is not necessary - to provide the liquidator with the authority to nullify transactions and transfers to creditors that are not in any way irregular but which occur during a very brief period (no longer than 90 days unless the creditor is an insider) and where there is evidence that the creditor knew or should have known of the insolvency. However, there may need to be exceptions for transactions and transfers made in the ordinary course of business."

(d) Treatment of contracts

81. It is a common feature of many insolvency laws that the liquidator may interfere in contracts which are not yet fully performed by both parties, electing to either reject or continue (and possibly subsequently assign) these contracts. As in the case of avoidance rules, the underlying rationale is maximization of the value of the estate. That objective must be balanced against competing interests, social concerns raised by some types of contracts, such as labour contracts, and the effect on the predictability of commercial and financial relations of the liquidator's ability to interfere with the terms of unperformed contracts.

82. Various approaches can be adopted to the termination or continuation of different types of contracts. Some contracts may be terminated at the discretion of the liquidator, while others may be terminated automatically when the proceeding is opened, without the right of the liquidator to continue them.[13/] Contracts may be continued at the discretion of the liquidator, with or without the agreement of the counter-party, subject to certain exceptions. Whether the liquidator elects to continue or terminate a contract, insolvency laws should require that, in order to provide certainty to the counter-party, notice be given within a specified period of time following initiation of the proceedings.

83. The rationale for rejecting contracts which are not yet fully performed is principally to "relieve the estate from intrinsically fair, but burdensome, contracts which the debtor may have concluded in the critical period preceding insolvency or which do not make sense any longer for the bankrupt enterprise and to enforce creditor equality against a party that only partially executed its obligations and gave the debtor credit for the latter's counter-obligation".[14/] Where a contract is terminated, the counter-party is excused from performing the remainder of the contract and becomes an unsecured creditor for the amount of damages caused by the termination.

84. In considering the question of continuation, an initial question is whether the contract under consideration gives a right of termination for default where insolvency proceedings are initiated. Where such a clause is included, the contract would generally be terminated, unless the liquidator sought continuation and the counter-party agreed or the liquidator elected to continue the contract over the objection of the counter-party. There are cases where continuation will be more advantageous than termination. One example may be a lease of the business premises of the debtor, where the business can be sold as a going concern. Continuation may also be

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[13/] Balz and Schiffman, Pt 2, p. 67.

[14/] ibid.

advantageous to the counter-party as payment under the contract may give priority for payment of services provided after commencement of the proceedings. In the event of continuation, the IMF Report (p. 32) points out that the interests of the counter-party can be protected by providing that costs of performance and any damage arising from a breach by the liquidator be treated as an administrative or priority expense. Since this will involve a risk for other creditors, a liquidator would generally only seek to continue contracts that would be beneficial to the estate.

85. The IMF Report (p. 34) identifies two general categories of exceptions to the power to continue contracts. The first is where the liquidator has the power to nullify termination provisions and specific exceptions can be made for certain types of contracts. These include short term financial contracts like swaps and futures agreements. The second is where, irrespective of whether the law allows nullification of a termination provision, the contract cannot be continued because it provided for the performance by the debtor or personal services.

86. Contracts which have been continued may subsequently be assigned for value. In some insolvency laws agreement of the counter-party or of all parties is required, while in others non-assignment clauses are made null and void by insolvency proceedings and the liquidator is free to assign the contract for the benefit of the estate. As the IMF Report (p. 33) notes:

> "While the ability of the liquidator to elect to continue and assign contracts in violation of the terms of the contract can have significant benefits to the estate, and therefore the beneficiaries of the proceeds of distribution following liquidation, this ability clearly undermines the contractual rights of the counter-party to the contract. Moreover, assignment raises issues of prejudice to the non-debtor party to the assigned agreement, especially where it has little or no say in the selection of the assignee."

87. As indicated above, some classes of contracts raise social concerns which may require special treatment under insolvency laws. One particular class is labour contracts, where the liquidator's ability to terminate may be limited by concerns that liquidation can be used as a means of expressly eliminating the protections afforded to employees by such contracts. This may be the case where the business is to be sold as a going concern and the elimination of onerous employment contracts could be beneficial to the sale price. Another class may be a lease agreement where the debtor is the lessee.

88. The IMF Report (p. 34) concludes that:

> "Liquidation procedures should give the liquidator the authority to terminate or continue contracts that have not been fully performed by both parties. Designing the scope of this power requires the making of important policy choices: while broader termination or continuation powers serve to maximize the value of the assets of the estate, they also cause greater interference with contractual relations. Moreover, these powers may need to be limited with respect to certain types of contracts.
>
> "(a) Termination - The liquidator should have the authority to terminate unperformed contracts. Upon termination, the counter party will become an unsecured creditor with a claim equal to the amount of damages caused by the termination. It is recognized that countries may choose to limit this power with respect to special contracts, such as labour contracts or lease agreements (where the debtor is the lessor), a limitation that will be

relevant in liquidation proceedings where there is an intent to sell the enterprise (or a business unit of the enterprise) as a going concern.

"(b) Continuation and assignment - The liquidator should normally have the power to choose to continue performance of the contract (including assignment of performance) in circumstances where such continuation is not precluded by the contract's terms. If such decision is made, the counter party should be afforded priority of payment (as an administrative expense) for any performance rendered after the commencement of the liquidation proceedings. If a country chooses to allow the liquidator to continue or assign a contract in contravention of its terms, it should require that the liquidator demonstrate that the contract can be adequately performed by the liquidator or the assignee. Exceptions to continuation powers will normally need to be made with respect to special contracts, such as financial and personal services contracts."

(e) Set-off

89. In the context of insolvency proceedings, recognizing a right of set-off would allow a creditor who is also a debtor to the estate to exercise that right after initiation of proceedings. The effect may be that, depending upon the amounts of the creditor's claim and the estate's claim against the creditor, the creditor may be paid in full. While this may appear to give an advantage to the creditor who is also a debtor to the estate, raising a potential issue about the equality of treatment among creditors, it can also be argued that it is unfair to refuse to pay a creditor while insisting on payment from that creditor. The IMF Report (p. 35) notes, in addition, that since many counter parties are banks, the right of set-off is particularly beneficial to the banking system and therefore, potentially, of general benefit to the economy. Banks which have lent to an entity against which insolvency proceedings have been commenced may also hold deposits of the debtor. A post-commencement right of set-off would allow the bank to offset its unpaid claims against those deposits, even where those claims are not yet due and payable.

90. The IMF Report (p. 35) also points to the interaction between a right of set-off and other provisions of insolvency law. It may, for example, be subject to avoidance provisions to the extent that the claim held by the debtor has been received by the creditor during the suspect period. It may also be limited by the liquidators' right to nullify termination clauses in a contract, unless the right to nullify is expressly limited to allow the creditor to terminate the contract and set-off mutual monetary claims.

91. The IMF Report (p. 36) concludes that:

"A pre-commencement right to set-off existing under general law should be protected during liquidation proceedings and generally should be exercisable by both the creditors and the estate. Moreover, the law should also permit post-commencement set-off if the mutual claims arise under the same transaction. In addition, countries may also wish to consider allowing for the exercise of set-off rights that arise under the general law after the

> insolvency proceedings commence, particularly with respect to mutual financial obligations."

(f) Disposition of assets

92. The manner of sale used by the liquidator should aim to maximize the value to the estate and follow a fair and transparent procedure. This may require that, for example, where the sale is conducted privately, it can be supervised, where appropriate, by the court, or creditors' approval is sought to avoid collusion.

93. The IMF Report (p. 38) concludes that:

> "The procedure for liquidating assets should be timely and efficient and should provide for a sale that maximizes the value of the assets being liquidated. To that end, the law should normally allow for both public auctions and private sales, with the requirement that, in the latter case, the sale is either supervised by the court or approved by the creditors, or both. Adequate notice of any sale should be given to creditors."

(g) Priorities

94. The establishment of a system of priorities for distribution of the proceeds of the estate is important not only for facilitating the provision of credit, and particularly secured credit, but also for ensuring the orderly and effective conduct of the proceedings. This includes making provision for payment of liquidators and ensuring that the objectives of the liquidation process can be achieved. Accordingly, insolvency laws may need to include rules which provide not only for distribution to creditors on the basis of the categorization of their claims (whether secured, unsecured, administrative or otherwise), but also deal with payment of liquidators and other administrative expenses.

95. Under such a system, secured creditors will have a first priority claim on the proceeds of the sale of the collateral to the extent of the value of the secured claim or to the general proceeds with respect to the value of the collateral, depending upon which method has been used to protect the secured creditor **(**see para. 68 above**)**. Where the secured claim is in excess of the value of the collateral or the value of the secured claim at commencement, the unsecured part of the claim will be treated for distribution purposes as an unsecured claim.

96. The first priority for distribution among unsecured creditors will generally be administrative expenses which cover court costs and fees of the liquidator, payments that were entered into or continued by the liquidator, and costs relating to collection, management, appraisal, and distribution of the assets of the estate. The rationale of this priority is in part to attract qualified professionals to liquidation work to ensure the orderly and effective conduct of insolvencies. Where secured creditors are involved in a liquidation, insolvency laws generally provide that secured claims should have priority over administrative claims. Some laws, however, provide that the expenses associated with preservation and sale of the collateral be deducted from the value of the collateral and the secured claims before secure creditors are paid, while another approach suggests that it may be reasonable to deduct those expenses from the administrative expenses of the estate. In some countries another expense that ranks with administrative expenses are claims for employee compensation that have accrued prior to commencement of proceedings.

97. Insolvency regimes vary considerably in the manner in which they treat distribution of remaining resources after the satisfaction of secured and administrative claims. Some laws identify different types of privileges which ensure the advancement in priority of certain classes of unsecured creditors. There may be a number of social and political reasons which justify the existence of privileges, such as the need to protect an economically less powerful class of claimants or the fact that certain classes of claimants, such as tort claimants, did not voluntarily extend credit on market terms, but are forced by the debtor or by law to "extend credit". The ADB Report (2.12, p. 21) points out that many insolvency regimes provide that debts such as tax debts and debts due to employees are to be paid in full, ahead of other creditors. Privileges, however, do have the potential to reduce the overall efficiency and effectiveness of the process and do establish an exception to the objective of creditor equality. In some cases privileges are said to be responsible for widespread disinterest in the proceedings on the part of general creditors and banks. For these reasons, the ADB Report notes that the modern approach is to endeavour to limit priority claims as much as possible.

98. Once the claims of privileged classes of creditors have been paid, the balance of the estate will be distributed to unsecured creditors on a pro-rata basis. This distribution will need to take account of subordinated claims. Some jurisdictions treat claims such as fines and penalties, gratuities, shareholder credits and post-petition interest on general unsecured claims as subordinate, while in other jurisdictions they are excluded or non-allowable claims.

99. The ADB Report (2.12, p. 21) tentatively proposes that:

> "An insolvency law regime should, as far as possible, preserve the principle of equal treatment for all creditors. Accordingly, the insolvency law should limit the number of priority claims to as few as possible."

100. The IMF Report (p. 41) concludes that:

> "The rules establishing the priority to be given to classes of creditors when distributing the proceeds of the sale of the estate's assets should pay due regard to contractual terms that provide for security or subordination. Thus, as a general rule, if the assets of the estate are encumbered, the proceeds of the sale of such assets should first be distributed to secured creditors to the extent of the value of their secured claim, plus any compensation arising from the stay that has not already been paid during the proceedings. Priority rules should also be designed to facilitate the effective functioning of the insolvency procedure. Accordingly, administrative expenses (including payment for the services of professionals, including the liquidator, and claims of post-petition creditors) should be given priority over unsecured claims. The inclusion of other statutory privileges, while they may be considered necessary for social or political reasons, should be limited to the extent possible since they generally undermine the effectiveness and efficiency of insolvency proceedings."

4. Discharge

101. Where claims remain outstanding once distribution has been completed, the question arises, with respect to certain enterprises, of whether the debtor should be discharged from those claims

or whether they will continue to exist as outstanding claims. This is relevant to individuals, partnerships and unlimited liability enterprises where personal liability for unsatisfied claims may continue. The IMF Report (p. 42) identifies two approaches to this issue. The first emphasizes the value of the debtor-creditor relationship, with the continued responsibility of the debtor after liquidation serving to moderate a debtor's financial behaviour and encourage creditors to provide finance. The debtor will remain liable for unsatisfied claims, subject to the statute of limitations. The other approach, based on the benefits of a "fresh start", allows the honest, non-fraudulent debtor a complete discharge immediately following the liquidation.

102. The IMF Report (p. 42) recommends that:

> "The discharge of individual debtors following the liquidation of their enterprise may provide an appropriate means of giving them a fresh start. However, it should not be available to those that have engaged in fraudulent behaviour or who have failed to disclose material information during the proceedings."

5. Foreign creditors

103. The IMF Report emphasizes the need for insolvency regimes to treat foreign creditors in the same way as domestic creditors. In addition, both the ADB (2.15, p. 23) and IMF Reports (p. 68) emphasize the need for insolvency laws to adopt a common framework for cooperation in multi-jurisdictional insolvencies, pointing to the UNCITRAL Model Law on Cross-Border Insolvency.

D. Rehabilitation

1. Essential features

104. The ADB Report (2.2(b), p. 12) points out that despite the fact that the rehabilitation process has not been as universal as that of liquidation, and may not therefore follow such a common pattern, there are a number of key or essential elements that can be determined:

(a) voluntary submission by an entity to the process, which may or may not involve judicial proceedings and judicial control or supervision;
(b automatic and mandatory stay or suspension of actions and proceedings against the property of the entity affecting all creditors for a limited period of time;
(c) continuation of the business of the entity, 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 entity itself will be treated;
(e) consideration of, and voting on, acceptance of the plan by creditors;
(f) possibly, the judicial sanction of an accepted plan; and
(g) implementation of the plan.

These issues are addressed in the following sections.

2. Commencement requirements

105. One of the objectives of a rehabilitation regime is to establish a process which will encourage debtors to take action to address their financial difficulties in a timely manner. Accordingly, the same commencement criterion as for liquidation (a general cessation of payments) should not apply, at least in the case of debtor-initiated proceedings. Some laws do not apply substantive criterion to commencement, while others adopt a criterion such as prospective illiquidity. As both the ADB and IMF Reports (2.5, p15; p. 45) note, however, there may be a need for safeguards to ensure that the rehabilitation process is not abused, either as a shelter or delaying tactic on the part of an entity which has no real prospect of rehabilitation or by allowing a debtor which is not in financial difficulty to propose a rehabilitation plan which would involve shedding onerous obligations, such as to employees.

106. Since a creditor is unlikely to be in a position to know of the prospective illiquidity of the debtor, a general cessation of payments would be a reasonable criterion to apply to creditor-initiated rehabilitation proceedings.

107. On the issue of commencement, the IMF Report (p. 46) concludes that:

> "The law should allow for rehabilitation proceedings to be initiated by the debtor or by a creditor. As a means of encouraging a debtor to commence rehabilitation proceedings early, thereby increasing the chances of a successful rehabilitation, the commencement criterion should not require a demonstration of a general cessation of payments. However, such a demonstration should normally be relied upon in the case of a petition filed by a creditor. The law should also provide for commencement of rehabilitation proceedings through a conversion from liquidation proceedings."

108. As noted above **(**para. 105**)**, there may be a need for safeguard provisions to prevent abuse of the rehabilitation process by the debtor. The ADB Report (2.5, p. 15) proposes that this issue could be addressed by requiring an early assessment of whether there is some real prospect of rehabilitation. Where the debtor fails that assessment, it could automatically be transferred to the liquidation process. The power to recommend or request such a transfer could be exercised by the administrator (other than management, the party most likely to have an understanding of the debtor's business) or the creditors' committee, or it could be given to the court. Reliance upon supervision by the court could be avoided by imposing time limits or giving greater leverage to creditors.

109. The ADB Report (2.5, p15; 2.12, p. 21) tentatively proposes that:

> "An insolvency regime should provide, as part of the rescue process, for an independent investigation and report of the affairs and financial position of the corporation. It should also provide for an independent assessment of any rescue proposal in respect of the corporation. If the corporation fails that or any subsequent assessment it should automatically be transferred to the liquidation process."

110. The IMF Report (p. 50) concludes that:

"As a means of ensuring that rehabilitation proceedings are not abused by the debtor, it is critical that there be provisions that allow for the conversion of rehabilitation proceedings to liquidation proceedings. Such provisions should include a mechanism that allows the court to immediately convert the proceedings on its own motion, or upon a recommendation by the administrator or the creditors, when it is clear that rehabilitation is not feasible or when there is evidence that the debtor is acting in bad faith. To strengthen such a conversion mechanism, countries should also consider specifying in the law that rehabilitation proceedings may not, under any circumstances, exceed a specified period. Such time limits may be of particular importance in countries where the capacity of the judiciary is limited."

3. Consequences of commencement

111. While commencement of rehabilitation proceedings raises similar issues as a liquidation concerning the stay on the ability of creditors to enforce their legal remedies against the debtor and the control by the debtor of the estate, the approaches adopted in rehabilitation proceedings differ.

(a) The stay

112. The reason for limiting the ability of creditors to enforce their remedies in liquidation is to avoid a premature dismemberment of the debtor and allow the liquidator to maximise the value of the estate. This is even more important in the case of rehabilitation to ensure that there is a debtor which can be rehabilitated and to provide an incentive to encourage debtors to attempt rehabilitation as early as possible. As in liquidation proceedings, the question arises of whether the stay should apply to secured creditors and, if so, the duration of its application. As in the case of liquidation, where the stay does apply to secured creditors, measures may be needed to ensure the preservation and protection of the collateral, such as allowing the creditor to request relief from the stay or imposing time limits on the duration of rehabilitation proceedings.

(b) Control of the debtor's business

113. Where the debtor is normally removed from a position of control of the business under liquidation and the assets transferred to the liquidator, there is no agreed approach on the extent to which this should occur in rehabilitation proceedings. As the IMF Report (p. 47) points out, "if rehabilitation proceedings mirrored liquidation proceedings in terms of the degree of control that the debtor is given over the enterprise, such an approach would clearly undermine any incentive for the debtor to voluntarily make use of rehabilitation proceedings." The extent to which the debtor is allowed to retain control must be weighed in terms of the longer term benefits to the business (since the debtor is the party likely to have the best understanding of the business) and any negative effects, such as on the confidence of creditors. One approach is to allow the debtor to retain full control of the business, without the appointment of an independent administrator. As noted above in respect of commencement of rehabilitation proceedings (para. 105), however, there may need to be safeguards to ensure that the debtor is not simply using rehabilitation to delay the inevitable and allow the assets of the business to be dissipated, undermining the chances of rehabilitation and prejudicing the interests, and confidence, of creditors.

114. Sometimes the solution to this issue may depend upon whether the rehabilitation is voluntary or involuntary. One approach is to establish a sharing arrangement between the debtor and the administrator, where the latter supervises the activities of the debtor and approves significant transactions. In order to ensure that independent parties can ascertain the limits imposed upon the debtor and also be certain as to how the rehabilitation proceedings will operate, the division of powers between the debtor and administrator may need to be clearly defined and not left subject to broad discretion on the part of the administrator.

115. The ADB Report (2.7, p. 17) tentatively proposes that:

"In the case of a genuine rescue attempt, [...] it is suggested that the existing management might continue but with overall supervisory and ultimate power in an independent administrator. Secondly, the stay or suspension of actions and proceedings against the property of the debtor corporation should apply to all creditors (secured or otherwise) for a reasonable length of time, but subject to applications by affected creditors for relief from the stay."

116. The IMF Report (pp. 48-49) concludes that:

"It is important that the rehabilitation procedure provide for a stay on the ability of creditors to enforce legal remedies against the assets of the debtor once rehabilitation procedures are commenced. The scope of the stay should be at least as comprehensive as the minimum requirement outlined under Liquidation Procedures [...]. [...] the stay should also apply to secured creditors.

"[...] a stay on the ability of secured creditors to exercise their rights against the collateral during the entire period of the proceedings is of critical importance. However, this does not reduce the need to provide such creditors with adequate protection (including relief from the stay when such protection cannot be given) and, in that context, this provides an additional reason for imposing time limits on the duration of the proceedings.

"Total displacement of the debtor from the management of the enterprise will eliminate the incentive for debtors to avail themselves of rehabilitation procedures at an early period and may undermine the chances of successful rehabilitation. On the other hand, allowing the debtor to retain full control over the enterprise creates a number of risks, including the risk that the assets of the debtor will be dissipated to the detriment of creditors. For the above reasons, it is preferable for the law to provide for an arrangement whereby the debtor continues to operate the enterprise on a day-to-day basis, but under the close supervision of an independent, court-appointed administrator. However, the court should have the authority to displace debtor's management entirely in circumstances where there is evidence of gross mismanagement or misappropriation of assets."

4. The proceedings

(a) Preparation and content of the rehabilitation plan

117. In some jurisdictions the plan for rehabilitation of the debtor is prepared by the existing management of the debtor; in others it is prepared by an independent administrator, but in conjunction with existing management or ownership.

118. The rationale for allowing the debtor to prepare the plan is to foster utilization of rehabilitation procedures by debtors with financial difficulties and, as the IMF Report (p. 51) suggests, to take advantage of the debtor's knowledge of the business and of the steps that may be necessary to make the business viable, enhancing the chances of achieving a successful rehabilitation. To ensure, however, that the plan prepared by the debtor will be accepted by creditors, it may be necessary to provide for some supervision or assessment of the preparation of the plan by the administrator. One approach to maximizing the debtor's potential involvement in

preparation of the plan would be to provide an initial period during which the debtor has the exclusive right to propose a plan. Where the debtor fails to do so, either the creditors or the administrator (or both) could be given the right to do so. However, a situation which may involve a number of plans being proposed by different parties should be avoided as it may lead to unnecessary complexity and potential delays to the negotiation process. The manner in which this option is managed may depend upon whether or not the plan requires the approval of creditors and whether that approval can be overruled by the court.

119. Third parties, such as government agencies and labour unions, may also be given the option of providing their opinion on the plan.

120. The IMF Report (p. 50) concludes that:

> "As a means of encouraging debtors to utilize rehabilitation procedures, the law should normally provide the debtor with the opportunity to prepare a plan. This opportunity should not be given exclusively to the debtor. The administrator and/or the creditors should also be given the opportunity to prepare a plan, possibly after the expiration of an initial 'exclusivity' period. For purposes of enhancing the efficiency and effectiveness of the negotiation process, it is preferable that the law limit the ability of different parties to propose their respective plans at the same time."

121. In dealing with the content of the plan, the IMF Report (p. 52) points out that "virtually all countries have laws requiring, to a greater or lesser extent, that the rehabilitation plan should adequately and clearly disclose to all parties information regarding both the financial condition of the company and the transformation of legal rights being proposed by the proponent of the plan." Beyond the statement of general principle, the content of the plan is closely linked to the process and effect of approval, as well as to the relevance of other laws. To the extent, for example, that company law precludes certain dealings, such as debt-for-equity conversions, a rehabilitation plan including such conversions could not be approved unless the prohibition were removed. The application of other laws, such as those relating to foreign investment, may be more problematic. The IMF Report (p53) gives the example of limits on foreign direct investment which may affect the chances of rehabilitation where a number of creditors are non-residents. Equally, the financial difficulties of the debtor may provide an opportunity for foreign investors to obtain a controlling interest, which for policy reasons may not be desirable in certain circumstances. The same considerations apply to the case of labour laws and derogations that may need to apply in the case of rehabilitation.

122. The IMF Report (p. 53) concludes that:

> "With respect to the permissible contents of a plan, an insolvency law should normally only impose those constraints necessary to protect creditors that may be bound by the terms of a plan that impairs their rights without their consent."

(b) Approval of the plan

123. The ADB Report (2.11, p. 20) makes the point that, although an insolvency regime is a collective process, it cannot accord equality to different, competing interests, nor depend upon the need for unanimity within different interest groups for its application. Accordingly, the manner in which an insolvency regime deals with approval and effect of a rehabilitation plan will require a balance between the extent to which the process involves an impairment of the rights of creditors without their consent and the means by which the plan can be imposed, despite the dissent of a minority of creditors.

124. To the extent that the law provides protection for secured creditors and ensures that an approved plan does not interfere with the exercise of their rights, there may be no need for secured creditors to vote on the plan. That approach, however, may reduce the chances of success of the rehabilitation, especially where a secured asset may be central to the success of the plan. Unless, as the IMF Report (pp. 53-54) points out, the secured creditor is bound by the plan or the plan provides for full satisfaction of the secured creditor's claims, the exercise of that creditor's rights may render the plan impossible to perform.

125. One solution to this problem is to allow secured and priority creditors to vote on the plan as separate classes, where the plan might otherwise adversely affect the value of their claims or seriously impair their right to enforce the security. Where a majority of each of these classes votes in support of the plan, all secured and priority creditors can be bound by the plan. A measure which can be adopted to protect dissenting secured or priority creditors is to provide that they receive at least as much as they would have under liquidation. For some secured and priority creditors, including employees, support of the plan may mean weighing an immediate impairment of the value of their claims against the future of the entity and its long-term prospects.

126. A number of mechanisms can be used to deal with voting of general unsecured creditors. The first step is to identify the minimum threshold of support of general unsecured creditors required to bind that class of creditor and the means by which that threshold is to be attained. Whatever level of "majority" is required to establish support for the plan, the means of determining the majority may include reference to whether votes actually cast (as opposed to a potential number of those entitled to participate) represent the majority percentage of the value of the debt, the majority of the number of creditors or a combination of both. Although combining the requirements may make it more difficult to achieve the support required for approval, there may be circumstances where use of this system ensures a fair and equitable result as amongst creditors. One example cited by the IMF Report (p. 54) is where a single creditor holds a majority of the value of the debt; this rule would prevent it from imposing its support of the plan on all other creditors.

127. In some jurisdictions, general unsecured creditors are divided into classes. Such a division may be justified on the basis that unsecured creditors may have different economic interests and

different aims in terms of what they want to receive from the rehabilitation plan. Some creditors might be more interested in the long term prospects of the business and be prepared for a continuing relationship, while others are more concerned to receive immediate cash payments and have no further dealings with the business. An additional justification for creating classes relates to approval of the plan and the means by which the support of one class can be used to impose the plan on other classes.

128. Where different classes of creditors are required to indicate their approval of a plan by vote, rules may be required that allow the plan to be imposed on those minority creditors who oppose it ("cram-down" provision), but at the same time ensure that those creditors' interests are protected and priority interests respected. Laws which protect the rights of those creditors on whom the plan is imposed also apply a rule which provides that a dissenting class of creditors cannot be forced to accept less than the full value of their claims if creditors of a junior class receive any value ("absolute priority rule"). The IMF Report (p. 56) points out that the creation of classes of creditors and the application of such rules complicate the law and its application by the court and the administrator. Such complexity may be justified where institutional structures are sufficiently developed to deal with it, as it may enhance the chances of successful rehabilitation. In other cases, since the development of a complex system of classes and voting of creditors requires the exercise of discretion to make classification and voting mechanism choices, the burden placed on institutional structures may actually undermine the rehabilitation process.

129. Where the corporate form, capital structure or membership of the debtor entity may be affected by a plan, some laws provide for approval by shareholders. Where the plan is proposed by management, approval by shareholders may already have occurred, especially if required by the rules or laws governing the entity. The IMF Report (p. 56) suggests that this is particularly the case when the plan involves debt-for-equity conversions, either through the transfer of existing shares or the issuance of new shares.

130. The ADB Report (2.11, p. 21) draws attention to the need to ensure that, under any system of voting, voting powers are not manipulated and that the interests of genuine creditors are neither interfered with nor prejudiced by the voting powers of persons who are connected to the corporation (insiders).

131. Courts may have a number of powers with respect to approval and implementation of a plan. Many countries enable the courts to enforce the plan against creditors who may have dissented in the approval process; courts may also have the power to reject a plan, notwithstanding that it has been approved by the requisite majority of creditors on the basis that it does not adequately protect the interests of dissenting creditors or there is evidence of fraud in the approval process or that it is not feasible. The IMF Report (p. 56) notes that the plan may not be feasible because, for example, it does not bind secured creditors and does not provide for full satisfaction of the secured claims of those creditors. Exercise by those secured creditors of their rights would then make the plan impossible to perform.

132. The IMF Report (p. 57) concludes that:

"(a) It is important for the law to provide a means by which a plan can be imposed upon a minority of dissenting creditors while, at the same time, providing a mechanism that serves to protect the interests of such creditors to the extent that their interests are impaired. At a minimum, a dissenting creditor should not be bound by a plan if it does not provide it with at least as much as it would have received under liquidation.

"(b) As a means of enhancing the chances of rehabilitation, consideration can be given to allowing secured creditors and priority creditors to vote - but only as separate classes - and to enable the court to divide unsecured creditors with different economic interests into different classes. In addition, consideration can also be given to providing the court the authority to utilize the support of one class to make the plan binding on other classes. If this approach is adopted, rules such as the absolute priority rules should be applied so as to ensure that the dissenting classes of creditors are treated equitably in terms of priority ranking that applies in liquidation. The implementation of such an approach normally requires the exercise of discretion by the institutional infrastructure. Accordingly, in circumstances where the capacity of the institutional infrastructure is limited, the establishment of classes and cram-down authority may undermine confidence in the law and, therefore, its inclusion will require careful consideration.

"(c) If the requisite majority of creditors have approved the plan and it is also endorsed by the administrator, it is recommended that the law only give the court the authority to reject the plan in limited circumstances, such as where dissenting creditors have not been treated fairly or where there is evidence of fraud in the voting process."

133. The ADB Report (2.11, p. 21) tentatively proposes that:

"An insolvency law should make proper provision for the involvement of creditors as part of the liquidation or rescue process. In particular:

(a) the insolvency law should clearly define the voting rights of creditors and should describe minimum requirements for the approval of a plan of rescue;
(b) provision should be made for voting by classes of creditors, particularly secured creditors, if the rescue proposal is required to bind such classes;
(c) the law should also provide protection against manipulation of the voting system and, in particular, should ensure that a court or other tribunal is empowered to set aside the results of voting which are obtained by the exercise of votes of insiders or persons who are related to the corporation, its shareholders or directors; and
(d) the effect of a vote of the requisite majority of a class should be made binding on all creditors of that class."

(c) Powers of avoidance

134. The issues relating to costs and benefits of avoidance powers identified in respect of liquidation (paras. 70-80 above) apply equally to rehabilitation. One issue which does not arise in liquidation relates to avoidance of pre-commencement transactions where the debtor retains control of the entity during rehabilitation. In that situation, the debtor may be reluctant to seek to avoid a transaction for a number of reasons, particularly where there has been lending amongst related entities or the debtor may have a conflict of interest. In such a situation, creditors may need to have the power to seek avoidance of the transaction. The IMF Report argues that this is a reason for appointment of an administrator, especially where there is potential for this situation to arise.

135. The IMF Report (p. 59) concludes that:

> "The existence of avoidance provisions is a critical component of rehabilitation proceedings. The application of such proceedings may be more effective in circumstances where an independent administrator has been appointed."

136. The ADB Report proposal is set out at para. 79 above.

(d) Treatment of contracts

137. The issues concerning treatment of contracts which arise in the context of liquidation, especially where the business is to be sold as a going concern, also arise in a rehabilitation. The IMF Report (p. 59) points to specific difficulties in cases where the insolvency law does not provide for the nullification of contract termination clauses in the event of commencement of rehabilitation proceedings. This is especially important where the contract in question is crucial to the rehabilitation of the entity, such as a lease agreement.

138. The IMF Report (p. 59) concludes that:

> "The policy choices regarding the breadth of the power to interfere with contractual terms become particularly important in the context of rehabilitation procedures. Broad powers to continue or terminate contracts will significantly enhance the possibility of rehabilitation, but some countries may be concerned that the aggressive application of this power may undermine predictability. As under liquidation, if the administrator is given the authority to nullify termination provisions and/or the law does not provide for set-off of independent monetary claims, it is important that exceptions to these rules be made to allow for the netting of financial contracts."

(e) Post-commencement financing

139. While provision of on-going funding may arise in liquidation where a business has to be run for a short period of time prior to sale as a going concern, it is of critical importance where a genuine prospect of rehabilitation of the business exists. Insolvency regimes address this need by giving the administrator the power to obtain funding, either on a secured or unsecured basis, and subject in some cases to approval by creditors or the courts. Where the provision of security on

unencumbered property or a second priority security interest on encumbered property are not sufficient to raise the necessary credit, some insolvency laws allow the administrator to give a "super priority" (priority over all creditors) or "super administrative priority" (priority over other administrative creditors).

140. The ADB Report (2.7, p. 17) tentatively proposes that:

> " [...] legislation should both sanction and provide a "super priority" (ahead of all creditors) for funding of necessary on-going and urgent business needs of the debtor corporation."

141. The IMF Report (p. 60) concludes that:

> "Given the importance of new financing for an enterprise during rehabilitation, it is important that the law give the administrator adequate powers to obtain such financing. This should normally include the power to give a post-petition creditor administrative priority or a security interest on unencumbered assets. Where necessary, consideration may also be given to granting a creditor priority over other administrative creditors. In contrast, permitting the granting of priority over secured creditors is not recommended as it runs the risk of severely undermining the value of security."

(f) Pre-packaged and pre-negotiated rehabilitation

142. These techniques allow negotiation and voting for the plan to take place before commencement of the rehabilitation procedure, with court approval sought immediately after commencement. An alternative approach is for negotiation for the plan to occur before commencement, with formal voting taking place after commencement. The IMF Report (p. 61) outlines a number of advantages of these procedures. It combines the benefits and efficiencies of an informal process with the ability to impose a plan upon dissenting creditors, an important advantage of the form rehabilitation process. It provides certainty to the debtor with respect to control of the enterprise, as well as minimizing disruption of the business. Where the institutional infrastructure is limited, shortening the formal portion of the proceedings will be beneficial. One point to be noted, however, is that the debtor will not have protection from the actions of creditors during negotiations with those creditors.

143. The IMF Report (p. 61) concludes that:

> "As a means of enhancing the efficiency of the rehabilitation process, the law should allow for the approval by the court of rehabilitation plans that have been voted upon (or, at a minimum, negotiated) prior to the commencement of the rehabilitation proceedings."

E. Involvement of creditors

144. Both the ADB and IMF Reports (2.11, pp. 20-21; p. 62) underline the importance of the active participation of creditors as decision makers in a number of key areas of the insolvency process. Although their involvement in the liquidation process will generally be more limited than in a rehabilitation, creditors in liquidation proceedings may nevertheless have the power to dismiss the liquidator, approve the temporary continuation of the business by the liquidator and approve a private sale of the assets of the estate. Such involvement suggests that creditors need to be kept informed of the progress of the liquidation.

145. In rehabilitation proceedings, creditors would generally have the authority to dismiss the administrator, to propose and approve a rehabilitation plan and to request or recommend action from the court, such as conversion of proceedings from rehabilitation to liquidation. To facilitate creditors' participation in the process, a creditors' committee which represents the interests of different classes of creditors can be created to act on behalf of the creditors. While only performing an advisory function, the committee can facilitate the decision-making process by making recommendations on key matters for decision to both the court and to creditors. It can provide a forum in which differences between creditors can be resolved and serve as a vehicle for providing information to creditors.

146. The ADB Report (p. 21) tentatively proposes that an insolvency law should make proper provision for the involvement of creditors as part of the liquidation or rescue process.

147. The IMF Report (p. 63) concludes that:

> "The law should enable creditors to play an active role in the insolvency proceedings. To that end, it should allow for the formation of a creditors' committee, with the cost of such a committee being an administrative expense."

F. Liquidators and Administrators

148. The IMF Report (pp. 63-65) identifies a number of issues in respect of the qualifications, appointment, dismissal, remuneration and liability of liquidators and administrators that need to be considered in insolvency laws. As court-appointed officials, both the liquidator and the administrator have an obligation to ensure that the law is applied effectively and impartially, and they will have to interact with the courts in a number of matters that are likely to arise in the course of the proceedings.

149. Given the potential complexity of both liquidation and rehabilitation proceedings, persons appointed to these positions will need to have adequate experience with commercial and financial matters and a knowledge of the law. To the extent that specialized advice is required to facilitate either process, that can be obtained by engaging specialists. Consideration needs to be given to how the official is appointed - such as from a list of eligible specialists - and whether the appointment should be made by the court.

150. As to dismissal, either official could be dismissed on the basis of a decision taken by the majority of unsecured creditors, or by the court, either of its own motion or at the request of any interested party. In the case of dismissal by creditors, consideration may need to be given to whether grounds for dismissal are required and, if they are not, whether any time limits should be imposed for dismissal without justification.

151. Whatever basis is chosen for remunerating liquidators and administrators, disputes with creditors can be avoided by adopting a transparent method which is explained to creditors at the beginning of the proceedings and which avoids the exercise of exclusive discretion by the courts.

152. The liability of the liquidator or administrator is another issue requiring consideration. Where they are appointed by the court, they will owe a duty of care to all interested parties and will be liable for breach of that duty. In determining what standard of care should apply to liquidators and administrators, regard should be had to the potential difficulty of the duties they undertake, the need to attract suitably qualified professionals and the means by which that liability can be reduced, for example, by obtaining the approval of creditors before taking any key decision.

153. The IMF Report (p. 65) contains the following conclusions on these issues:

> "(a) Given the central role that a liquidator and an administrator play in insolvency proceedings, it is important that they have an adequate knowledge of the law and sufficient experience in commercial and financial matters. To ensure that these officials have adequate integrity and expertise, countries may wish to consider establishing some form of self-regulatory licensing system.
>
> "(b) The court should have the authority to appoint the liquidator or administrator. The law should determine the conditions under which these officials can be dismissed by either the court or a majority of unsecured creditors.
>
> "(c) While a variety of methods can be used for determining the remuneration of a liquidator or administrator, it is important that the method chosen be transparent and that creditors be made aware of this method from the beginning of the proceedings.
>
> "(d) As court-appointed officials, liquidators and administrators have an obligation to ensure that the law is applied effectively and impartially. Accordingly, they owe a duty of care to all parties in interest and should be personally liable to all these parties for violation of this duty. As a general matter, the duty of care should only be considered violated in cases of negligence."

G. The Court

154. Both the ADB and IMF Reports (2.8, p. 18; p. 66) address issues of administration of both liquidation and rehabilitation proceedings that concern the supervisory role of the court. The ADB Report (2.8, p. 18) notes that an insolvency law requires adequate administration and supervision to function effectively, both in respect of the initiation of the process and its orderly progression. It suggests that "the experience in most jurisdictions is that a specialist court or other administrative body (or, certainly, experienced judges or officials) is often required to deal

with the initial processing of insolvency cases and then be available to exercise a general supervisory capacity to ensure that the administration takes its course and that the system is not abused." The IMF Report (p. 66) also notes that an insolvency law will only be effective if the judiciary has sufficient capacity to implement it, underlining the importance of the relationship between the capacity of the judiciary and the design of an insolvency law.

155. The ADB Report (2.8, p. 18) tentatively proposes that:

"The insolvency legislation should provide for swift and strict time limits for the initial processing of an insolvent corporation. The court or other tribunal system must be properly resourced to enable the process to be implemented.

"The longer term administration of an insolvent corporation which is being liquidated may be conducted through a special government agency but with provision to enable more difficult and complex cases of liquidation to be administered by an outside independent specialist insolvency administrator. The government agency must be properly resourced to enable it to perform its functions efficiently.

"Cases of rescue should be administered by an independent specialist administrator.

"All cases of liquidation or rescue should be subject to supervision by the appropriate court or tribunal."

156. The IMF Report (p. 67) concludes that:

"(a) As a means of ensuring that an insolvency law is applied with predictability, the law should provide adequate guidance with respect to how the court should exercise its discretion, particularly when the court's decision involves an assessment of economic and commercial issues.

"(b) Since the insolvency proceedings give rise to a dynamic process, it is important that procedures be put in place to ensure that court hearings are held quickly and that decisions, including appeals, are rendered soon thereafter. During the period of appeal, the lower court's decisions should normally continue to be binding.

"(c) Given the need to ensure efficiency and the proper exercise of discretion, countries may wish to consider the establishment of specialized courts, either in the form of bankruptcy courts or commercial courts. Whether or not a specialized court system is adopted, it is important that the judges have adequate training and experience in commercial and financial matters."

H. Informal insolvency procedures

157. Informal insolvency procedures have been developed in a number of countries over the last decade and provide alternatives to formal insolvency procedures that offer a greater degree of flexibility and early pro-active response from creditors than is normally possible under formal

regimes. The ADB Report (pp. 25-27) describes the necessary conditions for informal procedures, as well as the main processes and practical problems. It also notes (p. 63) that, since the commercial culture of many of the countries studied for the Report are conditioned toward non-confrontational dispute resolution, there may be a relatively firm basis upon which to promote and build the elements necessary to structure an informal negotiated approach to the problems of insolvent or financially troubled debtors.

158. The ADB Report (p. 24) points to a number of well-defined initial premises that are required for informal processes to be effective. These include significant debts owed to a number of different creditors, usually banks or other financial institutions; a preference for negotiating an arrangement for financial difficulties of the debtor; availability of relatively sophisticated refinancing, security and other commercial techniques that can be used to rearrange or restructure the debts; the sanction of resort to insolvency law if the informal process breaks down; and the prospect of greater benefit for all through negotiation rather than formal processes.

159. The process of informal workout includes a number of steps: creation of a forum in which debtor and creditors can explore and negotiate an arrangement to deal with the debtor's financial difficulties; appointment of a "lead" bank creditor to organize and manage the process; establishment of a "steering" committee of creditors; an agreement to suspend adverse actions by both creditors and the debtor which may be compared to the stay of actions and proceedings in formal proceedings; and the provision of information on the debtor's situation, including its activities, current trading position and so on.

160. The ADB Report (pp. 25-27) raises a number of issues that may need to be resolved in developing an informal process. These include identifying which party may initiate the process and the tools that may be used to ensure the progress of that process; the extent to which independent experts and advisors should be involved in the process; the means of resolving differences between creditors, particularly with respect to competing priority rights; dealing with dissenting creditors and creditors that it may not be possible to actively engage in the process because of the sheer number of creditors; the provision of ongoing funding to the debtor entity and the establishment of priorities to secure that funding.

IV. FORM OF POSSIBLE FUTURE WORK

161. Should the Working Group consider that further work by the Commission on all or any of the above issues is desirable and feasible, the Working Group might also like to consider what, in the current landscape of efforts, would be an appropriate product, such as a model law, model provisions, set of principles or other text. The following paragraphs address some of the considerations raised by these different work products, including the potential of each type of text to contribute to the goal of developing a harmonized framework for effective national corporate insolvency regimes.

A. Model law or model provisions

162. A model law is a legislative text that is recommended to States for adoption as part of their national law. In incorporating the text of the model law in its system, a State may tailor the text of the law to its needs and, if appropriate, modify or leave out some of its provisions. It is precisely

this flexibility which, in a number of cases, may ensure greater acceptance of a model law than of a convention dealing with the same subject matter. However, notwithstanding the flexibility of a model law, States may be invited (e.g. by a resolution of the General Assembly) to make as few changes as possible in incorporating the model law into their legal systems, in order to increase the likelihood of achieving a satisfactory degree of unification and to provide certainty about the extent of unification.

163. A model law is an appropriate vehicle for modernization and unification of national laws when it is expected that States will wish or need to make adjustments to the uniform text to accommodate local requirements that vary from system to system, or where strict uniformity is not necessary. For example, in unifying the law of procedure, a uniform text may require, owing to different structures of the judicial system or on account of different procedural traditions, various modifications before the State can enact it as a national law. A model law would also be appropriate when the purpose of the uniform text is, on the one hand, to establish a standard of a modern law in an area where national systems are widely disparate, undeveloped or outdated and, on the other hand, to provide an incentive for a movement towards unification. An additional consideration that might favour a model law approach is the greater ease of negotiation over an instrument that contains obligations that cannot be altered.

164. Recent model law texts completed by UNCITRAL have included a guide to enactment, while previous ones have included an explanatory note. The purpose of the guide to enactment or explanatory note is to set out background and explanatory information relevant to the text which may assist Governments and legislators in using the text. The guide might include, for example, information that would assist States in considering what, if any, provision of the model law might have to be varied to take into account particular national circumstances, as well as information relating to discussions in the Working Group on policy options and considerations. In addition, matters not addressed in the text of the model law may be included in the guide by way of further explanation and guidance to States enacting the model law.

165. Within the category of model laws prepared by UNCITRAL, two texts, the Model Law on International Commercial Arbitration and the Model Law on Electronic Commerce, illustrate the flexibility of the form. The Model Law on International Commercial Arbitration, which could be described as a procedural instrument, provides a discrete set of inter-dependent articles. It is recommended that, in adopting the Model Law, very few amendments or changes are required. Deviations from the Model Law text have, as a rule, very rarely been made by countries adopting enacting legislation, suggesting that it has been widely accepted as a coherent model text.

166. The Model Law on Electronic Commerce, on the other hand, is a more conceptual text. Legislation adopting or proposing to “enact” the Model Law largely reflects the principles of the text, but may depart from it in terms not only of drafting, but also in the combination of provisions adopted or proposed for adoption. As such, and so far as it is appropriate to distinguish between a model law and model provisions, the Model Law on Electronic Commerce perhaps can be regarded as establishing a set of model principles, which are drafted in the form of legislative provisions to facilitate consideration by legislators and assist in the development of laws. Those principles do not necessarily form a discrete set in the same way as the Model Law on International Commercial Arbitration, but address a number of existing rules which may be scattered throughout various parts of different national laws in a typical enacting State.

Accordingly, an enacting State may not necessarily incorporate the text as a whole into a free-standing law, but may adopt appropriate provisions into existing legislation. Nevertheless, the Model Law on Electronic Commerce does address the legal issues relevant to the establishment of a basic legal framework for electronic commerce, and while the model provisions do not purport to address all legal issues relevant to electronic commerce, they do provide an internationally negotiated set of principles which can guide legislators when considering and dealing with the issues covered.

B. Legislative principles or recommendations

167. It is not always possible to draft specific uniform provisions in a suitable form, such as a convention or a model law, for incorporation into national legal systems. One reason may be, for example, that national legal systems use widely disparate legislative techniques and approaches for solving a given issue, or that States are not yet ready to agree on a common approach or a common rule. A further reason may be that not all States perceive a sufficiently urgent need to find a uniform solution to a particular issue.

168. In such a case, it may be appropriate not to attempt to elaborate a text in the form of a model statute, but to limit the action to a set of principles or legislative recommendations. The purpose of these principles or legislative recommendations would be to assist Governments and legislative bodies in reviewing the adequacy of laws, regulations, decrees and similar legislative texts in a particular field. In order to advance the objective of harmonisation, and offer a legislative model, the principles or recommendations would need to do more than state general objectives. These principles or recommendations would set out a number of issues often addressed in national laws and regulations and address the desirability of dealing with those issues in legislation. The text would provide a set of possible legislative solutions on certain issues, but not necessarily a single set of model solutions for the issues considered. It may be appropriate to include variants, depending upon applicable policy considerations. The text would assist the reader to evaluate different approaches available and to choose the one suitable in the national context.

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