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## Draft legislative guide on insolvency law

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## Part Two

### Core provisions for an effective and efficient insolvency law

80. Part Two of the Guide focuses on the content of the insolvency law and the core elements that are regarded as necessary for insolvency proceedings conducted under the law to be effective and efficient. As far as possible, the Guide addresses the core elements in a manner that corresponds to the sequence of proceedings.

81. Chapter I analyses application and commencement criteria. Chapter II considers the effects of commencement of insolvency proceedings on the debtor and its assets, including constitution of an insolvency estate, protection and preservation of the estate, use and disposal of assets, post-commencement finance, treatment of contracts, exercise of avoidance provisions, rights of setoff, and financial contracts and netting. Chapter III examines the roles of the debtor and the insolvency representative in insolvency proceedings and their various duties and functions, as well as mechanisms to facilitate creditor participation. While issues relevant to reorganization are considered throughout the Guide, chapter IV examines, in particular, issues relating to the reorganization plan and expedited reorganization proceedings. Chapter V addresses different types of creditor claims and their treatment, as well as establishment of priorities for distribution. Chapter VI deals with issues relating to the resolution of insolvency proceedings, including discharge and closure. [Chapter VII sets forth the UNCITRAL Model Law on Cross-Border Insolvency and its Guide to Enactment.]

#### I. Application and commencement

##### A. Eligibility and jurisdiction

###### 1. Eligibility: debtors to be covered by an insolvency law

82. An important threshold issue in designing an insolvency law focussed on debtors engaged in commercial activities (whether or not they are conducted for profit) is determining and clearly defining which debtors will be subject to the law. To the extent that any debtor is excluded from the law, it will not enjoy the protections offered by the law, nor will it be subject to the discipline of the law. This argues in favour of an all-inclusive approach to the design of an insolvency law, with limited exceptions. The design of eligibility provisions for an insolvency law raises two basic questions. Firstly, whether the law should distinguish between debtors who are natural persons and debtors which are some form of limited liability enterprise or corporation or other legal person, each of which will raise not only different policy considerations, but also considerations concerning social and other attitudes. Secondly, the types of debtors (regardless of the question of whether the debtor is a legal or natural person), if any, that should be excluded from the application of the law.

83. Countries adopt different approaches to defining the scope of application of their insolvency laws. Some insolvency laws apply to all debtors with certain specified exceptions, such as those discussed below. Other countries distinguish between natural person debtors and juridical or legal person debtors and provide

different insolvency laws for each. A further approach distinguishes between legal and natural persons on the basis of their engagement in commercial (or consumer) activities. Some of these laws address the insolvency of “merchants” which are defined by reference to engagement in commercial activities as an ordinary occupation, or companies incorporated in accordance with commercial laws and other entities that regularly undertake commercial activities. Some laws also include different procedures based on levels of indebtedness, and a number of countries have developed special insolvency regimes for different sectors of the economy, particularly the agricultural sector.

**(a) Individuals engaged in commercial activities**

84. Policies applicable to individual or personal debt and insolvency often evidence cultural attitudes that are not as relevant to commercial debtors and may include, for example, attitudes toward the incurring of personal debt; the availability of relief for unmanageable debt; the social effect of bankruptcy on the status of individuals; the need for counselling and educational assistance with respect to individual debt; and the provision of a fresh start for debtors through a discharge from debts and claims. Policies applicable to insolvency in the commercial sector, in comparison, are generally restricted to economic and commercial considerations such as the important role that business plays in the economy; the need to preserve and encourage commercial and entrepreneurial activity; and the need to encourage the provision of credit and protect creditors.

85. The interests of natural persons involved in commercial activity (including, for example, partnerships of individuals and sole traders) differ from those of consumer debtors, at least in some aspects of their indebtedness, but it is often difficult to separate an individual’s personal indebtedness from their commercial indebtedness for the purposes of determining how they should be treated in insolvency. Different tests may be developed to facilitate that determination, by focussing, for example, upon the nature of the activity being undertaken, the level of debt and the connection between the debt and the commercial activity. Indicators of involvement in commercial activity may include whether the business is registered as a trading or other commercial operation; whether it is a certain type of legal person under the commercial law; the nature of its regular activities; and information concerning turnover and assets and liabilities.

86. Many countries include natural person debtors involved in commercial activity within the scope of their commercial insolvency laws. The experience of other countries suggests that although business activities conducted by natural persons form part of commercial activity, these cases often are best dealt with under the regime for insolvency of natural persons because ultimately the proprietor of a personal business will conduct his or her activities through a structure that does not enjoy any limits on liability, leaving them personally liable, without limitation, for the debts of the business. These cases also raise difficult issues of discharge (release of the debtor from liability for part or all of certain debts after the closure of the proceedings—see chapter VI), including the length of time required to expire before the debtor can be discharged and the obligations which can be discharged or exempted from discharge. Debts which cannot be discharged often involve personal matters such as settlements in divorce proceedings or child support obligations. An additional consideration is that the inclusion of natural persons in the commercial



insolvency regime may have the potential, in some countries, to act as a disincentive to use of the commercial regime because of the social attitude towards personal insolvency, irrespective of its commercial nature. It is desirable that these concerns be considered in designing a law to address commercial insolvency, taking into account the manner in which commercial activity is generally conducted in a particular country and the existence and effectiveness of insolvency laws dealing with natural persons. In many countries, for example, commercial activity is conducted almost exclusively by individuals and to exclude them from the insolvency law would significantly limit its operation and effectiveness. In other countries, insolvency of natural persons engaged in commercial activity is specifically addressed by the personal insolvency law and they are excluded from the commercial regime.

87. This Guide focuses upon the conduct of commercial activities<sup>1</sup> by both legal and natural persons, irrespective of the legal structure through which those activities are conducted, and whether or not they are conducted for profit.<sup>2</sup> It identifies those issues where additional or different provisions will be required if natural person debtors are included in the insolvency law.

**(b) State-owned enterprises**

88. An insolvency law can apply to all forms of debtors engaged in commercial activities, both private and state-owned, especially those state-owned enterprises (SOE) which compete in the market place as distinct commercial or business operations and otherwise have to the same commercial and economic interests as privately-owned businesses. The discussion here is not intended to include states, sub-national governments, municipalities and other similar types of organization or public authority unless they are SOEs operating as commercial enterprises.

89. Government ownership of an enterprise may not, in and of itself, provide a sufficient basis for excluding the enterprise from the coverage of the insolvency law, although a number of countries do adopt that approach. Where the state plays different roles with respect to the enterprise not only as owner, but also as lender and largest creditor, normal commercial incentives will not apply, compromise solutions may be difficult to achieve and there is clear ground for conflicts of interest to arise. Inclusion of these enterprises in the insolvency regime therefore has the advantages of subjecting them to the discipline of the regime, sending a clear signal that government financial support for such enterprises will not be unlimited, and providing a procedure which has the potential to minimise conflicts of interest.

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<sup>1</sup> It is not intended that the Guide should define the phrase "commercial activities". However, should a definition be required, other UNCITRAL texts employing this phrase have adopted a broad interpretation so as to cover matters arising from all relationships of a commercial nature, whether contractual or not. Relationships of a commercial nature include, but are not limited to, the following transactions: any trade transaction for the supply or exchange of goods or services; distribution agreement; commercial representation or agency; factoring; leasing; construction of works; consulting; engineering; licensing; investment; financing; banking; insurance; exploitation agreement or concession; joint venture and other forms of industrial or business cooperation; carriage of goods or passengers by air, sea, rail or road.

<sup>2</sup> It would include, for example, commercial activity conducted for charitable purposes.

90. The need for exceptions to a general policy of inclusion of such enterprises in a general insolvency law may arise where the government has adopted a policy of extending an explicit guarantee in respect of the liabilities of such enterprises, where the treatment of state enterprises is part of a change in macroeconomic policy, such as a large-scale privatization program or where SOEs are involved in sensitive sectors of the economy, such as provision of key services or utilities (e.g. electricity and water). In these cases, independent legislation dealing with relevant issues, including insolvency, may be warranted. The Guide does not address issues specifically relevant to that independent legislation.

**(c) Debtors requiring special treatment**

91. Although it may be desirable to extend the protections and discipline of an insolvency law to as wide a range of debtors as possible, separate treatment may be provided for certain entities of a specialized nature, such as banking and insurance institutions, utility companies, and stock or commodity brokers. Exceptions for these types of debtors are widely reflected in insolvency laws and are generally justified on the basis of the detailed regulatory legal regimes to which these businesses are often subjected outside of the insolvency context. To address the insolvency of such debtors, regulatory regimes can include provisions particular to the type of business being regulated or special rules can be included in the general insolvency law. The special considerations arising from the insolvency of such debtors and consumer insolvency are not specifically addressed in the Guide.

**2. Jurisdiction**

92. In addition to possessing the necessary business or commercial attributes, a debtor must have a sufficient connection to the State to be subject to its insolvency laws. In many cases, no issue as to the applicability of the insolvency law will arise as the debtor will be a national or resident of the State and will conduct its commercial activities in the State through a legal structure registered or incorporated in the State. Where there is a question of the debtor's connection with the State, however, insolvency laws adopt different tests including that the debtor has its centre of main interests in the State, that the debtor has an establishment in the State or that the debtor has assets in the State.

**(a) Centre of main interests**

93. Although some insolvency laws use tests such as principal place of business, UNCITRAL has adopted, in the Model Law on Cross-Border Insolvency ("the UNCITRAL Model Law"), the test of "centre of main interests" of the debtor to determine the proper location for commencement of what is termed the "main proceedings" for that debtor. That test is also used in the Council (EC) Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings ("the EC Regulation"). The UNCITRAL Model Law does not define the term; the EC Regulation (13th Recital) indicates that the term should correspond to "the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties." An appropriate test would be the one provided in article 16(3) of the UNCITRAL Model Law and article 3 of the EC Regulation: the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the centre of main interests, unless it can be shown that the centre of

main interests is elsewhere. A debtor which has the centre of its main interests in a State should be subject to that State's insolvency law.

94. Notwithstanding the adoption of the "centre of main interests" test, a debtor which has assets in more than one State may find itself satisfying the requirements to be subject to the insolvency law of more than one State because of the different tests of debtor eligibility or different interpretations of the same test, with the resultant possibility of separate insolvency proceedings in those countries. In such cases, it will be appropriate to have in place legislation based on the UNCITRAL Model Law to address questions of coordination and cooperation.<sup>3</sup> In terms of the application of different tests, the Model Law focuses on the primacy of centre of main interests and main proceedings, but recognizes that other tests, such as presence of assets, can be used to commence local "non-main" proceedings to deal with local assets once the foreign main proceedings have been recognized.<sup>4</sup>

**(b) Establishment**

95. Some laws provide that insolvency proceedings may be commenced in a jurisdiction where the debtor has an establishment. The term "establishment" is defined in article 2 of the UNCITRAL Model Law to mean "any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services." Article 2 of the EC Regulation includes a similar definition but omits the reference to "services". Essentially, an establishment is a place of business which is not necessarily the centre of main interests. The definition, like the term "centre of main interests", is important to the overall structure of the UNCITRAL Model Law and its treatment of cross-border insolvency cases as a criterion for recognition of foreign insolvency proceedings and the application of measures for relief. In many countries, managers of an establishment that is unable to pay its debts will have personal liability to creditors unless they commence insolvency proceedings. Eligibility to commence proceedings on the basis of an establishment is therefore of relevance to a domestic insolvency regime and the treatment of that debtor's assets in a particular State.

96. The EC Regulation similarly provides that insolvency proceedings may be opened in a jurisdiction where a debtor has an establishment (termed "secondary proceedings"). Generally those proceedings will be restricted to liquidation proceedings covering the assets of the debtor situated in the territory of that State. Depending upon the nature of the debtor's business and the assets concerned, there may be limited situations where reorganization proceedings could be based upon establishment.

**(c) Presence of assets**

97. Some laws provide that insolvency proceedings may be commenced by or against a debtor that has or has had assets within a jurisdiction without requiring the debtor to have an establishment or centre of main interests in the jurisdiction. The UNCITRAL Model Law does not provide for the recognition of foreign proceedings commenced on the basis of presence of assets, although it does provide for local

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<sup>3</sup> The Model Law and Guide to Enactment are included as chapter VII of the Guide.

<sup>4</sup> UNCITRAL Model Law, article 28.

proceedings based on presence of assets to be commenced in a State recognizing foreign main proceedings in order to deal with those local assets.<sup>5</sup>

98. A distinction can perhaps be made between liquidation and reorganization proceedings commenced on the basis of presence of assets; while presence of assets may be an appropriate basis for commencement of liquidation proceedings involving specific assets located in a State, it may not be sufficient for the commencement of reorganization proceedings, particularly where proceedings commenced in the centre of main interests are liquidation proceedings or where the assets in question are limited. Although one country does provide that the presence of assets will be sufficient to commence reorganization proceedings (and that those proceedings can involve the assets of the debtor wherever located), this option is not widely available. Where proceedings are commenced on the basis of presence of assets against a multinational debtor, there generally will be a need to coordinate those proceedings with other jurisdictions where the debtor will have its centre of main interests and possibly establishments. The test of presence of assets may therefore raise multi-jurisdictional issues, including the possibility of multiple proceedings and questions of coordination and cooperation between proceedings that may implicate the UNCITRAL Model Law.

**(d) Competent courts**

99. An additional issue of jurisdiction is the court that is competent to commence insolvency proceedings and to resolve matters arising in the course of those proceedings. The competence for commencement and all later issues arising in the conduct of insolvency proceedings may lie with the same court of a State or different courts will have competence for different issues. To increase the transparency and ease of use of the insolvency law for the benefit of debtors, creditors and third parties (especially where they are from a foreign country), it should be made clear in the law which courts have jurisdiction for which functions. Although provisions specifying which courts have jurisdiction over insolvency proceedings may not always be included in the insolvency law, a reference to the provisions of other law which specifies court jurisdiction might usefully be included in the insolvency law.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on eligibility and jurisdiction is to establish:

- (a) the types of debtors that are subject to the law;
- (b) the types of debtors that may be excluded from the law;
- (c) the debtors that have sufficient connection to a State to be subject to the law; and
- (d) the courts that have jurisdiction over the commencement and conduct of insolvency proceedings.

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<sup>5</sup> UNCITRAL Model Law, article 28 and Guide to Enactment, paras. 184-187; see chapter VII.

## Contents of legislative provisions

### *Eligibility*

- (1) The law should govern insolvency proceedings against all debtors that engage in commercial activities, whether natural or legal persons, including State-owned enterprises,<sup>6</sup> and whether or not those commercial activities are conducted for profit.
- (2) Exclusions from the application of the law should be limited and clearly identified in the law.<sup>7</sup>

### *Jurisdiction*

- (3) The law should specify which debtors have sufficient connection to a State to be subject to its application. Different approaches may be taken to identifying appropriate connecting factors, but the grounds upon which a debtor can be subject to the law should include:<sup>8</sup>
  - (a) that the debtor has its centre of main interests in the State; or
  - (b) that the debtor has an establishment in the State.
- (4) The law should establish a presumption that, in the absence of proof to the contrary, a legal person's centre of main interests is in the State in which it has its registered office, and a natural person's centre of main interests is in the State in which it has its habitual residence.
- (5) The law should define "establishment" to mean "any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services".<sup>9</sup>
- (6) The law should clearly indicate (or include a reference to the relevant law which establishes) the court that has jurisdiction over the commencement and conduct of insolvency proceedings, including matters arising in the course of those proceedings.

## B. Commencement of proceedings

### 1. Introduction

100. The commencement standard is central to the design of an insolvency law. By providing the basis upon which insolvency proceedings can be commenced, this

<sup>6</sup> It is not intended that the legislative guide would apply to the insolvency of States, sub-national governments, municipalities and other similar types of organization, except to the extent that they are a "state-owned enterprise".

<sup>7</sup> Highly regulated organizations such as banks and insurance companies may require specialized treatment which can appropriately be provided in a separate insolvency regime or through special provisions in the general insolvency law. Some SOEs, such as those involved in sensitive sectors of the economy might also be excluded.

<sup>8</sup> This recommendation is intended to indicate minimum and non-exclusive grounds for commencing insolvency proceedings. Other grounds, such as presence of assets, are used in some jurisdictions: see the discussion in chapter I.A.2 (c). and paras. 184 -187 of the Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency, included in chapter VII.

<sup>9</sup> UNCITRAL Model Law on Cross-Border Insolvency art. 2(f).

standard is instrumental to identifying the debtors that can be brought within the protective and disciplinary mechanisms of the insolvency law and determining who may make an application for commencement, whether the debtor, creditors or other parties.

101. As a general principle it is desirable that the commencement standard is transparent and certain, facilitating access to insolvency proceedings conveniently, cost-effectively and quickly to encourage financially distressed or insolvent businesses to voluntarily commence proceedings. It is also desirable that access is flexible in terms of the types of insolvency proceedings available (reorganization and liquidation), the ease with which the proceedings most relevant to a particular debtor can be accessed and conversion between the different types of proceedings can be achieved. Restrictive access can deter both debtors and creditors from commencing proceedings, while delay can be harmful in terms of its effect on the value of assets and the successful completion of insolvency proceedings, particularly in cases of reorganization. Ease of access needs to be balanced with proper and adequate safeguards to prevent improper use of proceedings. Examples of improper use may include application by a debtor that is not in financial difficulty in order to take advantage of the protections provided by the law, such as the automatic stay, or to avoid or delay payment to creditors and application by creditors who are competitors of the debtor, where the purpose of the application is to take advantage of insolvency proceedings to disrupt the debtor's business and thus gain a competitive edge.<sup>10</sup>

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

## **2. Commencement standards**

### **(a) Liquidity, cash flow or general cessation of payments test**

103. A standard that is used extensively for commencement of insolvency proceedings is what is known as the liquidity, cash flow or general cessation of payments test. This requires that the debtor has generally ceased making payments and will not have sufficient cash flow to service its existing obligations as they come due in the ordinary course of business. Indicators of a debtor's general cessation of payments may include its failure to pay rent, taxes, salaries, employee benefits, trade accounts payable and other essential business costs. As such, this test puts the defining factors within the reach of creditors. Reliance on this test is designed to activate insolvency proceedings sufficiently early in the period of the debtor's financial distress to minimize dissipation of assets and avoid a race by creditors to grab assets that would cause dismemberment of the debtor to the collective disadvantage of all creditors. Allowing commencement of proceedings to take place only when the debtor can demonstrate balance sheet insolvency (when

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<sup>10</sup> This is discussed further in the context of denial of the commencement application and discontinuation of proceedings, part two, chapter I.B.5(d) and 8.

the debtor's balance sheet shows that the value of its liabilities exceed its assets — discussed below), may only serve to delay the inevitable and diminish recoveries.

104. One issue associated with the general cessation of payments test that needs to be considered is that the inability of the debtor to pay its debts as they become due may point to only a temporary cash flow or liquidity problem in a business that is otherwise viable. In today's competitive markets, competition may compel market participants to accept ever lower profits or even losses on a temporary basis in order to become competitive and maintain or gain market share. While it will be a question of fact in each case, it is desirable that an insolvency law provides guidance for the court in determining whether or not the commencement standard has been met in order to avoid a premature finding of insolvency.

**(b) Balance sheet test**

105. An alternative standard to general cessation of payments would be the balance sheet test, which is based on excess of liabilities over assets as an indication of financial distress. Since it relies on information under the control of the debtor, a practical limitation of the balance sheet test is that it is rarely possible for other parties to ascertain the true state of the debtor's financial affairs until after these difficulties have become a settled and often irreversible fact, and it thus may not easily form the basis for a creditor application. In addition, it may give a misleading indication of the debtor's financial situation because it focuses upon what is essentially an accounting question of how assets should be valued (e.g. a liquidation value as against a going concern value) and raises questions of whether a debtor's balance sheet is reliable and whether it gives a true indication of the debtor's ability to pay, particularly where accounting standards and valuation techniques give rise to results that do not reflect the fair market value<sup>11</sup> of a debtor's assets or where markets are not sufficiently developed or stable to enable that value to be established. This may be particularly true in the case of service businesses that under this test may technically be insolvent because of a lack of assets, even when the business is essentially viable. Alternatively a business may have a positive balance sheet without the cash flow necessary to sustain the business.

106. This test can also lead to delay and difficulties of proof as an expert would generally be required to review books, records and financial data<sup>12</sup> to reach a

<sup>11</sup> Fair market value is generally considered to be the value that reasonably can be expected to be obtained in an arm's length sale between a buyer and a seller, where neither party is under a compulsion to buy or sell. In the absence of a real sale, value may be somewhat speculative, as values are based on assumptions made regarding the conditions for the sale of the assets in question. To reduce the speculation, techniques have been developed to approximate value on the basis of sale of comparable businesses and assets, or on the basis of a multiple of the enterprises earnings potential. In markets where assets cannot be easily sold, because the market is saturated or because a market for the assets in question does not exist, value is difficult to measure.

<sup>12</sup> The book value of an asset is the amount for which the asset is shown for accounting purposes. It is usually derived from the original acquisition value which is adjusted for a combination of depreciation, amortization, revaluation to any lower current market price or, occasionally, revaluation upwards in accordance with accounting principles. Although there are generally accepted accounting principles ("GAAP") expounded by the International Accounting Standards Board, it is important to note that there are no universally agreed accounting guidelines that dictate the basis on which assets should be valued for accounting purposes. Furthermore, the

determination of the entity's fair market value. This will be especially difficult where those records are not properly maintained or readily available. For these reasons the balance sheet test often leads to proceedings being commenced after the possibilities of reorganization have disappeared, and can negatively affect the debtor's ability to deal collectively with its creditors when it maintains an operating business, thus circumventing the objective of maximization of value. It will thus not be sufficiently reliable to constitute the sole basis of that definition and it may be desirable to use it in conjunction with the cessation of payments test. When used in that manner, the balance sheet test can assist in defining insolvency by focusing on whether the assets, however valued, will be sufficient to satisfy the debtor's liabilities, including those obligations that are not yet mature.

**(c) Designing the commencement standard**

107. Insolvency laws use the general cessation of payments test and the balance sheet test in different combinations to establish a commencement standard. Some laws adopt a simple form of the general cessation of payments test, requiring that the debtor be unable to meet its obligations as they fall due. Other laws adopt that test but add further requirements, for example, that the cessation of payments must reflect a difficult financial situation that is not temporary, that the creditworthiness of the debtor must be at stake and that it be just and equitable for the debtor to be liquidated. The more elements are added to the commencement standard, the more difficult they will be to satisfy, especially where the elements included are subjective. This may lead to applications being contested, causing delay, uncertainty and expense. By contrast, tests that are relatively simple and straightforward may have a tendency to include more cases, but this may be balanced by the increased ease of application that results from such tests.

108. Another approach combines the cessation of payments test with the balance sheet test. One example requires that, in addition to having ceased making payments, the debtor must be overindebted, where overindebtedness is determined, for example, by the debtor's inability to satisfy its debts as they become mature because its liabilities exceed its assets. An approach that combines the two tests may support commencement where there is a lack of information as to the existence of a general default and provide a more complete picture of the debtor's present and prospective financial situation. The balance sheet test may facilitate, for example, consideration of immature debt that would not otherwise be considered under the cessation of payments test, but which will be very relevant, for example, to the likely success of reorganization.

109. An insolvency law may adopt a single standard for insolvency, in which case the cessation of payments test provides an efficient trigger for access to insolvency proceedings; the balance sheet test, as noted above, suffers from a number of disadvantages and should not be used as the single test. An insolvency law may also adopt a standard that contains both the cessation of payments test and the balance sheet test. Where this approach is followed, proceedings can be commenced if either of the tests can be satisfied.

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book value of assets for management account purposes may not be the same as the values for which the same assets are included in year-end audited financial statements. The result is that the book values of assets may bear little or no relationship to the amounts for which they could be realized to satisfy creditors.



*(i) Imminent insolvency (prospective illiquidity)*

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

*(ii) Types of proceedings that may be commenced*

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

**3. Liquidation****(a) Parties who may apply**

112. Insolvency laws generally permit an application for liquidation proceedings to be made by the debtor, by one or more creditors or a government authority, or by operation of law where the failure by the debtor to meet some statutory requirement (such as maintenance of a specified level of assets) automatically triggers insolvency proceedings.

**(b) Debtor application**

113. Many insolvency laws adopt a general cessation of payments test for debtor applications for liquidation. Since, as a matter of practice, an application by a debtor to commence liquidation proceedings will generally be a last resort in situations of severe financial difficulty, some laws allow a debtor to make an application either on the basis that it has ceased to repay its debts as they become due or, in the alternative, on the basis of a simple declaration of its financial condition, such as that it is unable or does not intend to pay its debts (in the case of a legal person the declaration may be made by the directors or other members of a governing body). At least one insolvency law dispenses with the need for the debtor to allege any particular financial state. In such cases, whatever burden of proof is placed on the debtor, the insolvency law should distinguish between, and provide for, on the one hand, situations where acceptance of the debtor's financial declaration can be

assumed provided no objections are raised by creditors and, on the other, situations where the debtor should be questioned as to its financial circumstances because there is some doubt regarding its financial situation or because creditors have raised objections to the commencement of proceedings. To some extent, these issues can be addressed by the procedure for commencement of proceedings. Where the court is required to make the commencement decision, for example it will have the opportunity to review the application and creditors can raise objections at that hearing. Where the application functions to automatically commence proceedings, creditors and other interested parties will still have the opportunity to raise objections, albeit after the commencement of proceedings (see 5(b) and 8 below). In both cases, attempts to misuse the application procedure can be reviewed.

(i) *Establishing an obligation for debtor to apply*

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

115. Establishing such an obligation may also raise difficult practical questions of how and when it should apply, particularly where a delay in applying for formal proceedings could lead to personal liability of members of the debtor, its governing body or its managers. In those circumstances it may operate to discourage the debtor from pursuing alternative solutions to its financial difficulties, such as an out-of-court reorganization agreement, which may be a more appropriate alternative in particular cases.<sup>13</sup> In addition, an obligation to apply will be of no effect where it is not combined with enforceable (and enforced) sanctions for the failure to comply. The adoption of incentives (such as the application of a stay to protect the debtor against enforcement and other actions—see chapter II.B) may be a more effective

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<sup>13</sup> This issue is discussed further in the context of expedited reorganization proceedings and the relevant commencement criteria, see part two, chapter IV.B

means of encouraging debtors to initiate proceedings at an early stage than the imposition of sanctions for failure to meet the obligation to apply.

**(c) Creditor application**

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

117. Creditors holding unmatured claims also have a legitimate interest in the commencement of insolvency proceedings. A particular concern may arise, for example, in the case of holders of long-term debt. Where the test is one of maturity of debt those creditors might never be eligible to seek commencement of proceedings, although it may be clear that the debtor will be unable to meet the relevant obligation when the time comes. One approach might be for an insolvency law to provide that the failure to pay an instalment of long-term debt could form the basis of a creditor application. However, developing a test that would allow an application in those circumstances may raise difficult issues of proof, particularly as to how the failure to make a single payment relates to the debtor's financial status. If an insolvency law were to permit applications to be made by creditors not holding mature debt, those issues of proof would need to be balanced against the objective of convenient, cost-effective and quick access to insolvency proceedings. These issues could be addressed by using a standard that contains both the cessation of payments and balance sheet tests.

118. In addition to the requirements for cessation of payments, maturity of the debt and that the claim be undisputed, some insolvency laws include other requirements, for example that the application be made by more than one creditor (each of which may be required to be an unsecured creditor holding an undisputed claim); and that creditors not only hold mature claims, but that their claims represent a specified composite value of claims (or a combination of both a specified number of creditors and a composite value of claims).

119. These requirements are often based upon the desire to minimise possible improper use by a single creditor who may seek to use the insolvency process as a substitute for a debt enforcement mechanism, particularly where the debt in question is small, or by a small number of creditors whose debt is only a fraction of the debtor's total indebtedness. The arguments in favour of such an approach may need to be balanced, however, against the objective of facilitating quick and easy access to the insolvency process. The concerns with improper use may be addressed by taking into account the value of the claim of the single creditor (although specifying a particular value for claims may not always be an optimal drafting technique as currency fluctuations may necessitate amendment of the law) or adopting a procedure which requires the debtor to provide information to the court that will enable the court to determine whether non-payment of a debt is the result of a dispute with a particular creditor or is, in fact, evidence of a lack of liquid assets. Concerns with improper use can also be addressed by focussing on discouraging improper use, rather than upon constructing a complex commencement standard to the potential detriment of all eligible debtors, and providing for certain consequences, such as damages for harm done to the debtor. These damages may relate not only to the costs and expenses incurred by the debtor, but also to disruption to the debtor's business.

**(d) Application by a governmental authority**

120. Where the government is a creditor, it should have the same right as any other creditor to initiate liquidation proceedings. That right is generally given to a specific government (normally the public prosecutor's office or the equivalent) or other supervisory authority and the same commencement standard as applies in the case of applications by other creditors should generally apply.

121. Some countries provide an additional more broadly-based power for government or other supervisory authorities to use the insolvency regime to shut down a business in circumstances where the authority is not necessarily a creditor but closure of the business is considered to be in the public interest. In that case, a demonstration of illiquidity is not always necessary, enabling the government to terminate the operations of businesses that have been engaged in certain activities, generally of a fraudulent or criminal nature or involving serious breach of regulatory obligations or a combination of these. Given the potential for such a power to be misused in circumstances unrelated to insolvency and for public interests grounds to be very broadly defined, it is highly desirable that such powers be available only in very limited circumstances and only as a last resort in the absence of appropriate remedies under other laws. These limited circumstances may include the use of insolvency powers in conjunction with enforcement of laws, such as laws relating to money-laundering or regulation of securities, where a demonstration of insolvency may not be required. They may also include circumstances involving actual indications of insolvency where, for example, the authority is acting in the interests of a large number of small creditors, none of whom has a large enough debt to justify applying for proceedings, but who are nevertheless being harmed by the activities of the debtor.

122. Certain protections may also be required where the insolvency regime is to be used in these ways. For example, a preliminary investigation of the affairs of the debtor may be required; and preliminary measures, such as application of a stay and

appointment of an interim insolvency representative, may be granted to prevent the possibility of impropriety pending the court's determination as to what further action should be taken with respect to the business. The additional powers discussed above would generally only be available to commence liquidation proceedings, although there may be exceptional circumstances where liquidation could be converted to reorganization, subject to certain controls. These controls might include that the business activity is lawful and that management of the debtor's business is taken over by an insolvency representative or governmental agency.

#### **4. Reorganization**

##### **(a) Parties who may apply**

123. To a greater extent than with applications to commence liquidation proceedings, insolvency laws take different approaches to who may apply to commence reorganization proceedings, and a number of laws only permit debtor applications.

##### **(b) Debtor application**

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

125. It might be suggested that a relaxation of the commencement standard could invite abuse of insolvency proceedings. For example, a debtor that is not in financial difficulty might apply to commence proceedings and submit a reorganization plan that is designed to allow it to shed onerous obligations, such as labour contracts, to allow it to renegotiate its debt or to prevaricate and deprive creditors of prompt payment of debts in full. This situation should be distinguished from those situations in which debtors should be encouraged to apply because, for example, the payment of mature debts caused financial hardship which could lead to insolvency and the debtor could satisfy a test of imminent insolvency or prospective illiquidity (see chapter I.B.2(c)(i) above), even if it were not actually insolvent at the time of making the application. In other words, there is a financial basis for the application. Whether such improper use could arise is a question of how the elements of the reorganization procedure are designed, including the commencement standard,

requirements for preparation of the reorganization plan, debtor control of the business after commencement and sanctions for improper use of the process. As noted above, it may be desirable that the insolvency law focuses upon discouraging improper use rather than making commencement more difficult to the potential detriment of all eligible applicants. Improper use by the debtor could be addressed by providing, for example, that the relevant court has the power to deny the application and, in that event, that the debtor should be liable to creditors for their costs associated with resisting the application and for any harm caused by the application.

**(c) Creditor application**

126. Although insolvency laws generally provide for liquidation proceedings to be initiated by either a creditor or a debtor, there is no consensus as to whether reorganization proceedings can also be initiated by a creditor and, as noted above, a number of laws include provision only for debtor applications. Given that one of the objectives of reorganization proceedings is to enhance the value of assets and thereby increase the return to creditors on their claims through the continued operation and reorganization of the debtor's business, it is desirable that the ability to apply not be given exclusively to the debtor. A further reason for allowing creditor applications is that there will be cases where the debtor will not or can not apply for commencement because, for example, management has resigned. The ability of creditors to apply for reorganization is also central to the question of whether creditors can propose a reorganization plan (see chapter IV). A number of countries take the position that, since in many cases creditors are the primary beneficiaries of a successful reorganization, creditors should have an opportunity to propose the plan. If that approach is followed, it seems reasonable to provide that creditors can also make an application for commencement of reorganization proceedings.

127. In insolvency laws that permit creditors to apply for reorganization of a debtor, different approaches are taken to the commencement standard. One approach is those insolvency laws which adopt the same test, including prospective illiquidity, as applies in the case of a debtor application for reorganization. A different approach regards use of the same test as difficult to justify. This is not only because of the difficulties associated with creditors being able to prove that a standard of prospective illiquidity has been met by the debtor, but also because, as a general matter, it would seem unreasonable for any form of insolvency proceeding to be commenced against the debtor's will, unless creditors can demonstrate that their rights already have been impaired.

128. To address these issues with respect to creditor commencement of reorganization proceedings, some laws adopt commencement standard which require creditors to demonstrate certain factors in addition to insolvency. For example, that ongoing cash will be available to pay for the day to day running of the business, that the value of the assets will support reorganization and that the return to creditors in a reorganization is likely to exceed the return in liquidation. One clear disadvantage of such approaches is that they require creditors to have made, or be able to make, a thorough assessment of the business before making an application. That assessment may rely in turn upon obtaining information from the debtor that is relevant to that assessment and reliable enough to facilitate such

assessment. These concerns can be addressed by providing, for example, that on the making of an application by creditors, an assessment of the debtor's financial situation will be undertaken by an independent authority. Such a procedure may have the advantage of ensuring that proceedings are only commenced in appropriate cases. Care may be needed to ensure, however, that the additional requirements do not serve to complicate the application procedure, discouraging creditors from proposing reorganization, and promoting liquidation as an easier alternative or delaying commencement of the proceedings with consequences for maximization of value of the assets and affecting the likelihood of successful completion of the reorganization. Care should also be taken to ensure that the insolvency context is not used by a competitor of the debtor to obtain commercially sensitive or confidential information or to disrupt its business by imposing unjustifiable requirements with regard to assessment of its financial position.

129. Some insolvency laws adopt a variation of the cessation of payments test, and require the application to be made by a specified number of creditors or by creditors holding a specified value of matured claims, or both. Other laws require creditors, on making an application, to provide a bond or payment to cover the costs of the commencement proceedings.<sup>14</sup> These requirements might be said to suffer from the same disadvantages as noted above in respect of requirements that sufficient means are available to achieve a successful reorganisation.

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

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

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<sup>14</sup> Such a payment may also provide remuneration for the insolvency representative (see part two, chapter III.B, and see also the discussion on costs of the insolvency proceeding part two, chapter I.B.6).

**5. Procedural issues**

**(a) Making an application for commencement**

132. The insolvency law should specify how the insolvency proceedings could be commenced. Many insolvency laws require an application to be filed with a specified court, although there are other examples such as a law that provides for the proceedings to be initiated by lodgement of a declaration by the debtor with the corporate regulatory authority. This raises the question of the involvement of the court in the insolvency process, which is discussed in part one. Law other than the insolvency law may also affect the way in which the insolvency process is commenced, such as constitutional law (which may be relevant, for example, to the role of courts and administrative agencies, and to issues of competence), procedural law (including court rules) or company law.

**(b) The decision to commence insolvency proceedings**

133. A preliminary procedural issue relates to the manner in which the proceeding is commenced once the application has been made. In many countries the normal practice is for a court of competent jurisdiction to determine, on the basis of the application, whether the requisite conditions for commencement have been met. In some countries, that determination can also be made by the appropriate administrative agency or tribunal, where that agency plays a central supervisory role in the insolvency process. The central issue, however, is not so much who makes the decision to commence proceedings but rather what that body is required to do in order to approve an application and for proceedings to commence. Entry conditions which are designed to facilitate early and easy access to the insolvency process not only will facilitate the consideration of the application by the court or other body by reducing complexity and, where appropriate, assisting it to reach a decision in a timely manner, but also have the potential to reduce the cost of proceedings and increase transparency and predictability. Such entry conditions are also less likely to place a burden on systems which may lack institutional capacity or the expertise to undertake complex investigations requiring considerable commercial and business expertise. The issue of the costs and fees associated with accessing insolvency proceedings may be of particular importance in the case of small and medium size businesses. A further factor to be noted with respect to the commencement procedure is a recent trend in several insolvency laws of recognizing that the debtor has a fundamental right to be heard by the court or body that would determine an application for commencement of proceedings, whether the application was made by a debtor or by creditors.

134. In addressing requirements for commencement, some insolvency laws draw a distinction between an application by a debtor and an application by a creditor. In some laws, an application by a debtor functions as an acknowledgement of insolvency and leads to an automatic commencement of proceedings, unless it can be shown that the insolvency law is being abused by the debtor. In contrast, in the case of an application by a creditor under these laws, a court is required to consider whether the commencement criteria have been met before deciding to commence the proceedings. A primary reason is to avoid abuse by creditors or other interested parties. In some other laws, irrespective of whether the application is made by a debtor or creditors, the court is required not only to determine whether the entry



conditions have been met, but also to determine whether the type of proceedings applied for is appropriate to the particular circumstances of the debtor.

135. If the assessment to be made is complex there is a potential not only for delay between application and commencement, but also for further debts to be incurred in that period, as the debtor continues to trade and allows trade debts to increase in order to preserve cash flow, and for assets to be dissipated by the actions of creditors. Where the court is required to assess various issues before proceedings can be commenced, one means of reducing the potential complexity of the assessment is to provide, firstly, for the assessment to be made after commencement when the court can be assisted by the insolvency representative and other experts and, secondly, for conversion between liquidation and reorganization. Where this approach is adopted, an insolvency law may need to provide clear rules regarding the application of the stay (see chapter II.B), priority for repayment of debts incurred (see chapter V.C.1(b)) and the debtor's authority to dispose of assets during this period (see chapter II.A.2), as well as the treatment of unauthorized transactions occurring during the assessment period (see chapter II.F).

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

136. Where a court is required to make a decision as to commencement, it is desirable that that decision be made in a timely manner to ensure both certainty and predictability of the decision-making process and the efficient conduct of the proceedings without delay. This will be particularly important in the case of reorganization to avoid further diminution of value of the assets and to improve the chances of a successful reorganization. Some insolvency laws prescribe set time limits for the period after the application within which the decision to commence must be made. These laws often distinguish between applications by debtors and by creditors, with applications by debtors tending to be determined more quickly. Any additional period for creditor applications is to allow for prompt notice to be given to the debtor and to provide the debtor with an opportunity to respond to the application.

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

decision-making and provides guidance as to what is reasonable, but at the same time also recognizes local constraints and priorities.

**(d) Denial of the application to commence**

138. The preceding paragraphs refer to a number of instances where it will be desirable, in those cases where the court is required to make the commencement decision, for the court to have the power to deny the application for commencement, either because of questions of improper use of the insolvency law or for technical reasons relating to satisfaction of the commencement standard. The cases referred to include examples of both debtor and creditor applications. Principal amongst the grounds for denial of the application for technical reasons might be those cases where the debtor is found not to satisfy the commencement standard; where the debt is subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt; where the proceedings will serve no purpose because, for example, secured debt exceeds the value of assets; and where the debtor has insufficient assets to pay for the insolvency administration and the law makes no other provision for the administration of such estates.

139. Examples of improper use might include those cases where the debtor uses an application for insolvency as a means of prevaricating and unjustifiably depriving creditors of prompt payment of debts or of obtaining relief from onerous obligations, such as labour contracts. In the case of a creditor application, it might include those cases where a creditor uses insolvency as an inappropriate substitute for debt enforcement procedures (which may not be well developed); to attempt to force a viable business out of the market place; or to attempt to obtain preferential payments by coercing the debtor (where such preferential payments have been made and the debtor is insolvent, investigation would be a key function of insolvency proceedings).

140. As noted above, where there is evidence of improper use of the insolvency proceedings by either the debtor or creditors, the insolvency law may provide, in addition to denial of the application, that sanctions can be imposed on the party improperly using the proceedings or that that party should pay costs and possibly damages to the other party for any harm caused. Remedies may also be available under non-insolvency law.

**(e) Notice of application and commencement**

141. Giving notice of an application for commencement and of the commencement of insolvency proceedings is central to several key objectives of an insolvency regime. It ensures the transparency of the process and that all affected parties—the creditors in the case of a debtor application, and the debtor in the case of a creditor application—are equally well-informed

*(i) Debtor applications—notice to creditors*

142. In the event of a debtor application, creditors and other interested parties have a direct interest in receiving notice of the proceedings and an opportunity to dispute the presumptions of eligibility (perhaps within a specified time period to prevent the proceedings from being prolonged unnecessarily). The question arises, however, as to the time at which creditors should be notified—at the time the application is

made or the time the proceedings commence. The interests of creditors in knowing that the application has been made may need to be balanced, in certain circumstances, against the possibility, that if notice of the application is provided, the business position of the debtor may be unnecessarily affected where the application is ultimately rejected or creditors may be encouraged to take last minute action to enforce their claims. These concerns may be addressed by providing generally that creditors will be notified only of commencement of the proceedings. A further concern might relate to the consequences for creditors of a delay between the time of application by a debtor and the commencement of proceedings where they are only notified of the commencement. In that interim period, creditors will have an interest in being notified of the application in order to be able to make an informed decision concerning continuing provision of goods and services to the debtor to avoid the accumulation of further debt. Whilst it might be possible to adopt a flexible notice provision that would allow the court to provide notice in such circumstances, it might be better addressed in the insolvency law by reference to the timing of the commencement decision and the need to avoid delay.

(ii) *Creditor applications—notice to the debtor*

143. In the event of a creditor application for commencement of insolvency proceedings it is increasingly recognized that the debtor should have a fundamental right to immediate notice of the application and should have an opportunity to be heard and to dispute the applicants claims as to its financial position (see chapter III.A.3). Where the debtor has disappeared or is avoiding receiving personal notice, requirements for public notification might suffice, or notice could be served at the last known address of the debtor. Nevertheless, there may be exceptional circumstances where provision could be made, with the consent of the court, for personal notice to the debtor to be dispensed with on the basis that it may thwart the purpose of a particular application. These circumstances may include cases where giving notice of the application may lead to assets being placed by the debtor beyond the reach of the creditors or the insolvency representative. The counter-argument is that where the debtor is not notified, it could unknowingly continue to act to the detriment of the value of its assets and thus creditors. This concern may be better addressed in terms of provisional measures such as the imposition of a stay than by dispensing with notice of the application. However, where the law does permit the court to dispense with notice of the application, the debtor should nevertheless receive notice of commencement of proceedings as soon as possible.

(iii) *Notice of commencement to parties other than creditors*

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

(iv) *Manner of giving notice*

145. In addition to the question of the time at which notice is to be given, an insolvency law may need to address, in order to ensure the effectiveness of the notice, the manner in which notice is given and the information to be included. The

manner of giving the notice could address both the party required to give the notice (e.g. the court or the party making the application for commencement) and how the information can be made available, with the key consideration being delivery or publication in a form that is generally likely to come to the notice of interested parties. For example, while individual notice may be provided directly to known creditors<sup>15</sup> (although in individual cases the effectiveness of this method will depend upon the state of the debtor's records), the need to inform unknown creditors has led legislators to adopt broad requirements such as publication in an official government publication or a commercial or widely circulated newspaper. That newspaper may be regional, national or local (by reference to the location of the debtor's business) depending upon the circumstances of the case and what will prove to be most cost effective. It may not always be necessary, for example, to require publication at considerable expense in a national newspaper when the debtor's business is based and conducted locally. To avoid the notification process becoming unwieldy and requiring in each case an investigation into what will prove to be the most effective means of giving notice, the obligation should refer to standard forms, with some flexibility for local conditions. Other options for achieving effective notification may include various forms of electronic communication and use of relevant public registries.

(v) *Content of the notice*

146. The information required in the notice may include the effect of the commencement of proceedings (especially as to the application of the stay—see chapter II); the time for submission of claims; the manner in which claims should be submitted and the place at which they should be submitted; the procedure and any form requirements necessary for submitting a claim; advice as to which creditors should make claims (i.e. whether secured creditors need to submit a claim—see chapter V.A); consequences of failure to make a claim or to make a claim in the prescribed manner; and information concerning verification of claims and meetings of creditors.

**6. Debtors with insufficient assets**

147. Many debtors that would satisfy the criteria for commencement of insolvency proceedings are never formally liquidated, either because creditors are reluctant to initiate proceedings where it appears that the debtor has no, or insufficient, assets to fund the administration of insolvency proceedings, or because debtors in such a position will rarely take steps to commence proceedings. Some insolvency laws provide that where an application for commencement is made in these circumstances, it will be denied on the bases of an assessment of insufficiency of assets by the court, while others provide a mechanism for appointment and remuneration of an insolvency representative (see chapter III.B.3). Some other laws provide for a surcharge on creditors to pay for the administration of estates (see Fees below).

148. There are a number of reasons, particularly of a public interest nature, for devising a mechanism to enable the administration of a debtor with apparently few

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<sup>15</sup> This will be facilitated by reference to the list of creditors to be provided by the debtor in cooperation with the insolvency representative see chapter IIIA.4(b) and III.B.4. See also art. 14, UNCITRAL Model Law on Cross-Border Insolvency.

or no assets under a formal proceeding. Where an insolvency law does not provide for exploratory investigations of insolvent companies with few or no assets, it does little to ensure the observance of fair commercial conduct or to further standards of good governance of commercial entities. Assets can be moved out of companies or into related companies prior to liquidation with no fear of investigation or the application of avoidance provisions or other civil or criminal provisions of the law. A mechanism for administration will assist in overcoming any perception that such abuse is tolerated, may provide a return for creditors where antecedent transactions can be avoided, as well as a means of investigating the conduct of the management of such debtors and may encourage entrepreneurial activity and responsible economic risk-taking through a discharge and fresh start for entrepreneurs and others engaging in commercial activities—the punitive and deterrent aspects of insolvency laws will be less appropriate where the debtor is honest.

149. Mechanisms for pursuing the administration of such estates may include, as noted above, levying a surcharge on creditors to fund administration; establishing a public office or utilising an existing office to administer insolvent debtors; establishing a fund out of which the costs may be met; appointing a listed insolvency professional on the basis of a roster or rotation system, which is designed to ensure a fair and ordered distribution of all insolvency cases, whether with insufficient assets or otherwise, where the insolvency representative will be paid a prescribed stipend by the State or the costs will be borne directly by the insolvency representative and cross-subsidised by their clients generally (since, where they are a professional, their remunerative rates can be adjusted to take into account unremunerative work—this approach could not be taken where the insolvency representative is a government official). Where such a mechanism is included in an insolvency law, consideration may also need to be given to defining those debtors to which the provisions will apply, such as by reference to a debtor having available less than a prescribed value of unencumbered assets and no regular source of revenue that would otherwise enable the liquidation to proceed.

## **7. Fees for insolvency proceedings**

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

151. Applications by both debtors and creditors for commencement of insolvency proceedings may be subject to the payment of fees. Different approaches may be taken to the level of fee imposed. One approach might be to set a fee that can be used to help defray the costs of the insolvency system. Where the resultant fee is high, however, it could operate as a deterrent and run counter to the objective of convenient, cost effective and quick access to the insolvency process. A very low fee, on the other hand, might not be sufficient to deter frivolous applications and it

is therefore desirable that a balance between these objectives be reached. Some insolvency laws require the creditors making an application to guarantee the payment of the costs of the proceedings up to a certain fixed amount, to pay a certain percentage of the total of claims or a fixed amount as a guarantee for costs. In some laws where a payment as security for costs is required, that amount may be refunded from the estate if there are sufficient assets, and certain creditors, such as employees, are exempted from providing the required security. Other laws require, as a condition of commencement, that the unencumbered assets of the estate must be sufficient to cover the costs of the proceedings. Where they are insufficient, the insolvency law generally provides for the application to be denied or for it to be treated in accordance with provisions on estates with few or no assets (see above). A further approach establishes the fees that may be levied as a fixed percentage of the value of the assets of the estate. In large cases, this may result in significant fees being paid out of the estate, discouraging both creditor and debtor applications.

#### **8. Dismissal of proceedings after commencement**

152. In addition to circumstances where the application to commence proceedings might be denied as discussed above (chapter II.B.5(d)), there will also be instances where, after proceedings have already commenced, an insolvency law should permit them to be dismissed. A dismissal procedure will be relevant irrespective of whether an application by the debtor functions to automatically commence proceedings and no opportunity exists for the application to be challenged by creditors and other interested parties at the time of commencement, or the decision to commence is made by the court. The grounds for dismissal would be essentially the same as those for denial, that is, that there is improper use of the insolvency law, either by the debtor or creditors, or that the debtor did not satisfy the commencement criteria at the time of commencement.

### **Recommendations**

#### **Purpose of legislative provisions**

The purpose of provisions on commencement of insolvency proceedings is to:

- (a) facilitate access for debtors and creditors to the remedies provided by the law;
- (b) establish commencement criteria that are transparent and certain;
- (c) enable applications for insolvency proceedings to be made and dealt with in a speedy, efficient and cost effective manner;
- (d) establish safeguards to protect both debtors and creditors from improper use of the application procedure;
- (e) establish requirements for effective notification of commencement of proceedings.

#### **Contents of legislative provisions**

(7) The law should include provisions addressing both reorganization and liquidation of a debtor.

**Commencement standard***- Persons permitted to apply*

(8) The law should specify the parties permitted to make an application for commencement of insolvency proceedings which should include the debtor and any of its creditors.<sup>16</sup>

*- Debtor application*

(9) The law should specify that insolvency proceedings can be commenced on the application of a debtor if the debtor can show either that:

- (a) it is or will be generally unable to pay its debts as they mature; or
- (b) its liabilities exceed the value of its assets.<sup>17</sup>

*- Creditor applications*

(10) The law should specify that insolvency proceedings can be commenced on the application of a creditor if it can be shown that either:

- (a) the debtor is generally unable to pay its debts as they mature; or
- (b) the debtor's liabilities exceed the value of its assets.

*Presumption that the debtor is unable to pay*

(11) The law may establish a presumption that, if the debtor fails to pay one or more of its mature debts, and the whole of the debt is not subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt claimed, the debtor is generally unable to pay its debts.<sup>18</sup>

*Commencement on debtor application*

(12) The law should specify that where the application for commencement is made by the debtor:

- (a) the application for commencement will automatically commence the insolvency proceedings; or

<sup>16</sup> This would include a government authority that is a creditor of the debtor.

<sup>17</sup> The intention of this recommendation and the recommendation on creditor applications is to allow legislators flexibility in developing commencement standards, based on a single or dual test approach. Where the law adopts a single test, it should be based on the debtor's inability to pay debts as they mature (cessation of payments test) and not on the balance sheet test. Where the law contains both tests (cessation of payments and balance sheet tests) proceedings can be commenced if one of the tests can be satisfied.

<sup>18</sup> Where the debtor has not paid a mature debt and the creditor has obtained a judgement against the debtor in respect of that debt, there would be no need for a presumption to establish that the debtor was unable to pay its debts. The debtor could rebut the presumption by showing, for example, that it was able to pay its debts; that the debt was subject to a legitimate dispute; or that the debt was not mature. The recommendations on notice of commencement provide protection for the debtor by requiring notice of the application for commencement of proceedings to be given to the debtor and providing the debtor with an opportunity to rebut the presumption.

(b) the court will promptly determine its jurisdiction and whether the debtor is eligible and the commencement standard has been met and if so, commence insolvency proceedings.

*Commencement on creditor application*

(13) Where the application for commencement is made by a creditor the law generally should specify that:

(a) notice of the application promptly be given to the debtor;<sup>19</sup>

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

(c) the court promptly determine its jurisdiction and whether the debtor is eligible and the commencement standard has been met and if so, commence insolvency proceedings.<sup>20</sup>

*Denial of an application to commence proceedings*

(14) The law should specify that, where the decision to commence proceedings is to be made by the court, the court may deny the application to commence and, where appropriate, impose costs or sanctions against the applicant, if it determines:

(a) that it does not have jurisdiction, the debtor is ineligible or does not meet the commencement standard; or

(b) that the application is an improper use of the law.

(15) Where the application was made by a creditor, the law should specify that the debtor promptly be given notice of the decision to deny.

*Notice of commencement of proceedings*

(16) The law should establish procedures for giving notice of the commencement of insolvency proceedings.

*- General notice*

(17) The law should specify that the means of giving notice of the commencement of insolvency proceedings must be appropriate<sup>21</sup> to ensure that the information is likely to come to the attention of interested parties.<sup>22</sup> The law should specify the party responsible for giving that notice.

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<sup>19</sup> Where the debtor's whereabouts is unknown and it cannot be contacted, the general law may provide relevant rules concerning the giving of notice in such circumstances.

<sup>20</sup> A determination that the commencement standard has been met may involve consideration of whether the debt is subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt (see also chapter II.B.5 (d)).

<sup>21</sup> The question of what is appropriate in a particular case will also involve considerations of cost effectiveness and the insolvency law should not require, for example, expensive publication in a national newspaper, when publication in a local paper will suffice.

<sup>22</sup> General notice would generally be provided by way of making the information available in a publication such as an official government gazette, a widely circulated national, regional or local newspaper, through electronic means, or through relevant public registries.



*- Notice to creditors*

(18) The law should specify that notice of the commencement of proceedings is to be given to creditors individually, unless the court considers that, under the circumstances, some other form of notice would be more appropriate.<sup>23</sup>

*- Content of notice*

(19) The law should specify that the notice of commencement of insolvency proceedings include:

(a) information concerning submission of claims, including the time and place for submission;

(b) the procedure and form requirements for the submission of claims;

(c) the consequences of failure to submit a claim in accordance with paragraphs (a) and (b); and

(d) information concerning verification of claims, application of the stay and its effects, and meetings of creditors.

*Debtor with insufficient assets*

(20) The law should specify the treatment of debtors whose assets and sources of revenue are insufficient to meet the costs of administering the insolvency proceedings. Different approaches may be taken including:

(a) denial of the application, except where the debtor is an individual who would be entitled to a discharge; or

(b) commencement of the proceedings, where different mechanisms for appointment and remuneration of the insolvency representative may be available.<sup>24</sup>

*Dismissal of insolvency proceedings*

(21) The law should permit the court to dismiss proceedings if, after commencement, the court determines, for example, that:

(a) the proceedings constitute an improper use of the insolvency law; or

(b) the debtor was ineligible or did not meet the commencement standard at the time of commencement.

(22) The law should specify that where proceedings are dismissed, the court may impose costs or sanctions, where appropriate, against the applicant for commencement of the proceedings.

(23) The law should require notice of a decision to dismiss proceedings to be given.

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<sup>23</sup> The obligation to prepare the list of creditors to be given notice is dealt with under obligations of the insolvency representative and the debtor (see chapter III).

<sup>24</sup> See chapter III.B.

## **II. Treatment of assets on commencement of insolvency proceedings**

### **A. Assets constituting the insolvency estate**

#### **1. Introduction**

153. Fundamental to insolvency proceedings is the need to identify, collect, preserve and dispose of assets that belong to the debtor. Many insolvency systems place these assets under a special regime sometimes referred to as the insolvency estate, over which the insolvency representative will have specified powers, subject to certain exceptions.

154. This Guide uses the term “estate” in its functional sense to refer to assets of the debtor that are controlled by the insolvency representative and are subject to the insolvency proceedings. There are some important differences in the way in which the concept of the insolvency estate is understood in various jurisdictions. In some countries, the insolvency law provides that legal title over the assets is transferred to the designated official (generally the insolvency representative). In other countries, the debtor continues to be the legal owner of the assets, but its powers to administer and dispose of those assets are limited, because the insolvency representative will have complete control of the assets or because the debtor will only be able to deal with assets in the ordinary course of business, and use or disposal of assets outside of the ordinary course of business, including by the creation of security interests, will require the consent of the insolvency representative or, in some cases, the court.

155. Irrespective of the applicable legal tradition, an insolvency law will need to clearly identify the assets that will be subject to the insolvency proceedings and therefore included within the concept of the estate and indicate how they will be affected by those proceedings, including clarifying the relative powers of the various participants. Identification of assets and their treatment will determine the scope and conduct of the proceedings and, particularly in reorganization, will have a significant bearing on the likely success of those proceedings. The inclusion in an insolvency law of clear and comprehensive provisions on these issues will ensure transparency and predictability for both creditors and the debtor.

#### **2. Assets included in the insolvency estate**

##### **(a) General definition of the insolvency estate**

156. The estate may be expected to include all assets of the debtor including rights and interests in property wherever located, whether or not in the possession of the debtor at the time of commencement, and including all tangible (whether movable or immovable) and intangible assets. It would also include the debtor’s rights and interests in assets subject to a security interest and in third party owned assets (where the continued use of those assets by the estate may be subject to other provisions of the insolvency law (see chapter II.C). Generally, assets acquired by either the debtor or the insolvency representative after commencement of the insolvency proceedings (subject to specific exclusions that would apply in the case of natural person debtors (see below)) and assets recovered through avoidance or other actions would also be included. Some of these assets may be freely sold or exchanged while others may be subject to limitations that arise from contract or

other law (e.g. a non-assignable government licence or a customer list that is subject to privacy restrictions) or involve mediating problems that can arise with respect to other rights in those assets. Notwithstanding such limitations, it is desirable that these assets be included in the estate.

157. Tangible assets should be readily found on the debtor's balance sheets, such as cash, equipment, inventory, works in progress, bank accounts, accounts receivable and real estate. The assets to be included within the category of intangible assets may be defined differently in different States, depending upon the national law, but may include intellectual property, securities and financial instruments, policies of insurance, contract rights (including those relating to assets owned by third parties), and rights of action arising from a tort<sup>25</sup> to the extent of the debtor's interest. The inclusion of some intangible assets in the estate may give rise to conflicts with other laws, such as laws restricting transferability or laws relating to privacy protection. In the case of natural persons, the estate may also include assets such as inheritance rights in which the debtor has an interest or to which the debtor is entitled at the commencement of the insolvency or which come into existence during the insolvency proceedings, as well as the debtor's interest in assets owned jointly by the debtor and another person, including the debtor's spouse.

158. Notwithstanding the desirability of a broad definition of the estate, the inclusion of a number of types of assets can be controversial. Some assets can be included in the estate without difficulty, such as assets belonging to the debtor and that are unencumbered, assets that are not disputed by a third party, and assets recovered by the insolvency representative, whether through claims against a third party or through avoidance actions. Other assets can be excluded from the estate without difficulty, such as assets belonging to a third party in which the debtor has no interest and assets belonging, with full ownership rights, to the debtor's spouse. Assets such as encumbered assets, joint assets, assets located abroad, some intangible assets and third party owned assets in which the debtor has an interest can raise difficult questions. These are discussed in the following sections.

**(b) Encumbered assets**

159. One question of some importance is whether the insolvency law includes encumbered assets as part of the insolvency estate. Insolvency laws adopt different approaches to the treatment of assets subject to security interests. Many laws provide that encumbered assets are included in the insolvency estate, with the commencement of proceedings giving rise to different effects, such as limiting the exercise of security rights held by creditors or third parties by application of a stay and other effects of commencement. Including encumbered assets in the estate and thus limiting the exercise of rights by secured creditors may assist not only in ensuring equal treatment of creditors, but may be crucial to the proceedings where the encumbered asset is essential to the business. For example, where manufacturing equipment or a leased factory building is central to the debtor's business operations, reorganization or sale of the business as a going concern cannot take place unless

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<sup>25</sup> Where the debtor is a natural person, some jurisdictions exclude torts of a personal nature such as defamation, injury to credit or reputation or personal bodily injury, where the debtor remains personally entitled to sue and to retain what is recovered on the basis that the incentive to vindicate wrongdoing otherwise would be diminished, but may not be entitled to sue for any loss of earnings associated with those causes of action.

the equipment and the lease can be retained for the proceedings. There will be advantages particularly in reorganization and where the business is to be sold as a going concern in liquidation, in having all assets of the debtor available to the insolvency estate from the time of commencement.

160. Where the encumbered assets are included in the insolvency estate, they may also be subject to certain protections such as those relating to maintaining the value of the encumbered asset or the secured portion of a creditor's claim and to specified situations where the encumbered asset may be separated from the estate (see for example chapter II.C). An insolvency law should make it clear that such an inclusion will not deprive secured creditors of their property rights in the encumbered assets, even if it does operate to limit the exercise of those rights (for example, postponement by operation of the stay).

161. Other insolvency laws provide that the security right is unaffected by insolvency proceedings and secured creditors may proceed to enforce their legal and contractual rights. Recognizing that there will be cases where encumbered assets may be crucial to the proceedings, there are examples of laws which provide that even where those assets are unaffected by the insolvency, the debtor, with the insolvency representative's consent, can ask the court to prevent enforcement where the asset is necessary for the business to continue operating. Exclusion of encumbered assets may have the advantage of generally enhancing the availability of credit because secured creditors would be reassured that their interests would not be adversely affected by the commencement of insolvency proceedings. It is increasingly recognized, however, that this general advantage to an economy is outweighed by the advantages to be derived from including encumbered assets in the insolvency estate and restricting the exercise of secured creditors' rights as noted above.

**(c) Third party owned assets**

162. Some jurisdictions permit assets in which a creditor retains legal title or ownership (for example, a retention of title or a lease arrangement) to be separated from the insolvency estate on the basis that the insolvency law should respect the creditor's legal title in the asset. In some jurisdictions the separation of the asset may be subject to the provisions of the insolvency law relating to treatment of contracts. The estate will generally include, however, as indicated above in the general definition of the estate, any rights that the debtor might have in respect of those third party owned assets. There will be cases where the third party owned assets, may be crucial, like encumbered assets, to the continued operation of the business, whether in reorganization or sale as a going concern in liquidation. In those cases, it will be advantageous for the insolvency law to include a mechanism which will permit third-party owned assets to remain at the disposal of the insolvency proceedings, subject to protecting the interests of the third party owner and to the right of the third party to dispute that inclusion. These issues are discussed further in chapter II.C.

163. If the economic terms of the transaction demonstrate that it is a device to finance the acquisition of an asset, although structured, for example, as a lease, some laws treat the arrangement as a secured lending arrangement and in insolvency the lessor will be subjected to the same treatment as other secured creditors. A transaction will be a financing device where, at the end of the term of the lease, either the debtor can retain the asset for the payment of a nominal sum or the

remaining value of the asset is negligible. The insolvency law may regard the debtor's rights as part of the insolvency estate and permit the asset to be used by the insolvency representative subject to certain conditions as described in chapter II.C.

164. Where the interest in assets that is claimed by the debtor is disputed by a third party, it will be desirable for the insolvency law to enable those assets to be protected on an interim basis to ensure their preservation pending decision by the court as to ownership. Where the decision is that the assets do not form part of the estate, the law may also address issues of damage to the third party arising from the debtor's retention. The issue of damages may also be relevant where a third party withholds assets that are found to form part of the estate.

**(d) Foreign assets**

165. Whether the debtor's assets outside the country where the proceedings are taking place will become part of the estate raises issues of cross-border insolvency. This may be of particular importance in reorganization, where the exclusion of foreign assets could significantly affect the success of the proceedings. Some insolvency laws take the approach that there should be a single insolvency proceeding, based in the country where the debtor has its head office or place of registration or incorporation (centre of main interests), that will apply to the debtor's assets wherever situated (the universal approach). This approach includes the idea that the State adopting it will accept the same claim made under the insolvency law of another State. Other insolvency laws are based upon an approach that limits the applicability of the insolvency law to the geographical area governed by the jurisdiction enacting the legislation (the territorial approach). This approach requires different proceedings to be commenced in each jurisdiction in which the debtor has assets or in which different branches or establishments of the debtor are located. Another approach is a modified version where a State claims universal application of its own law, but does not recognize the same universal application of the laws of other States.

166. The existing diversity of approaches to this issue creates considerable uncertainty and undermines the effective application of national insolvency laws. However, as the differences between insolvency laws increasingly narrow and greater convergence emerges, there are fewer reasons for maintaining the territorial approach. It is increasingly desirable that an insolvency law provides for the insolvency estate to comprise all assets of the debtor wherever located. However, since divergence is likely to remain for some time, the UNCITRAL Model Law on Cross-Border Insolvency establishes a regime for effective cooperation in cross-border insolvency cases through recognition of foreign decisions and access for foreign insolvency representatives to local court proceedings. The regime is intended to be compatible with all legal systems and is discussed in more detail in chapter VII.

**(e) Recovered assets**

*(i) Avoidance proceedings*

167. Assets that will be subject to the proceedings will include any assets or their value recovered by the insolvency representative through avoidance proceedings where the transaction resulted in preferential treatment to some creditors or were

prejudicial to the insolvency estate or made in an effort to defeat the collective rights of creditors (see chapter II.F).

(ii) *Unauthorized post-application and post-commencement transactions*

168. Many insolvency laws adopt measures intended to limit the extent to which a debtor subject to insolvency proceedings can deal with its assets, whether encumbered or not, without the authorization of the court or the insolvency representative (see chapter II.B.8(b) and 9). These restrictions generally will apply after the commencement of insolvency proceedings, but may also apply after an application for commencement of proceedings in those cases where the powers to deal with assets of the estate are given to an interim insolvency representative. Some insolvency laws treat transactions which are not authorized as invalid and unenforceable as against the insolvency estate, and enable any assets transferred to be reclaimed, except in some cases where the counterparty gave value or can prove that the transaction did not impair creditors' rights. Other insolvency laws achieve the same result by addressing unauthorized contracts in terms of avoidance provisions, depending upon how the suspect period is calculated (see chapter II.F.3).

**3. Assets excluded from the insolvency estate**

**(a) General exclusions**

169. The insolvency law may specify the exclusion of certain assets from the estate. Insolvency laws adopt different approaches to this issue. Assets excluded from the estate may include, for example, certain assets owned by a third party that are in the possession of the debtor when the proceedings commence, such as trust assets and assets subject to an arrangement (whether contractual or otherwise) that does not involve a transfer of title but rather use of the assets and return to the owner once the purpose for which they were in the possession of the debtor has been fulfilled.<sup>26</sup> Assets excluded from the estate may also include assets subject, under some laws, to reclamation, such as goods supplied to the debtor before commencement, but not paid for and recoverable by the supplier (subject to identification and other applicable conditions).

**(b) Where the debtor is a natural person**

170. In the case of insolvency of a natural person, the insolvency law may provide that the estate should exclude certain assets such as post-application earnings from the provision of personal services by the debtor, assets that are necessary for the debtor to earn a living and personal and household assets, such as furniture, household equipment, bedding, clothing and other assets necessary to satisfy the basic domestic needs of the debtor and its family. Such exclusions generally would not be available to legal person debtors. Where an insolvency law provides exclusions in respect of the assets of a natural person, they should be clearly identified and their number and value limited to the minimum necessary to preserve the personal rights of the debtor and allow the debtor to lead a productive life. In identifying these exclusions, consideration might need to be given to applicable human rights obligations, including international obligations, which are intended to protect the debtor and relevant family members and may affect the exclusions that

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<sup>26</sup> Such an arrangement may be known as a bailment or depositum.

should be made.<sup>27</sup> A further consideration may be the economic effects of exclusions; some research suggests that the full or substantial exemption of personal assets from insolvency proceedings may have a positive effect on entrepreneurship and risk-taking.

*Joint assets*

171. Where the debtor is a natural person and personal assets are owned jointly by the debtor and the debtor's spouse, different approaches to the treatment of these assets are adopted, whether by the insolvency law or other law, such as that relating to matrimonial property or property ownership. In some federal jurisdictions this issue may involve questions of both state and federal law. The relationship between those other laws and the insolvency law may determine how certain provisions of the insolvency law, for example, avoidance provisions, will apply.

172. One approach to the treatment of joint assets is to completely exclude those assets from the estate. Another approach provides that where the proceedings are opened against the assets of one spouse, the part of the mutual assets belonging to that spouse can become part of the insolvency estate if, under the general law other than the insolvency law, the assets can be divided for purposes of execution (where division of the assets will be conducted outside of the insolvency law and proceedings). The choice between these approaches therefore may depend upon the operation of law other than the insolvency law and factors such as the ease with which the assets may be divided (see chapter II.C.2).

**4. Time of constitution of the insolvency estate and collection of assets**

173. The insolvency law should specify the date by reference to which assets will be considered to be part of the estate to provide certainty for the debtor and for creditors. Some insolvency laws refer to the date of commencement of proceedings, while others refer to the date of the application for commencement or to an act of insolvency that forms the basis of the application. The significance of the difference between these dates relates to the treatment (and most importantly the protection) of the debtor's assets in the interim period between application and commencement. For that reason, some laws constitute the estate from the date of application. Other laws, for reasons of clarity and certainty, constitute the estate from the date of commencement, but also contain provisions that restrict the debtor's powers to dispose of property during the period following the making of the application. Assets disposed of in that period can be reclaimed by the insolvency representative. A further consideration with respect to protection of assets between application and commencement is the application of avoidance provisions and the date from which the suspect period is calculated (see chapter II.F.6).

174. Whichever date is chosen, the estate may be expected to include the assets of the debtor as at that date as well as assets acquired by the insolvency representative and the debtor after that date, whether in the exercise of avoidance powers (see chapter II.F) or in the normal course of operating the debtor's business.

175. Once the assets to be included in the estate are identified, they must be collected. To achieve this, the insolvency law may include powers enabling the

<sup>27</sup> In Europe, for example, the European Convention on Human Rights 1950 is relevant.

insolvency representative to establish control over assets determined to part of the estate, as well as obligations to ensure that the debtor and other relevant parties assist and cooperate with the insolvency representative in that regard. Where assets are located in a foreign country, additional measures will be required, such as those set forth in the UNCITRAL Model Law on Cross-Border Insolvency.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions relating to the insolvency estate is to:

- (a) identify those assets that will be included in the estate formed on commencement of proceedings, including the debtor's interests in assets subject to a security interest and in third party-owned assets;
- (b) identify the assets, if any, that will be excluded from the estate.

### **Contents of legislative provisions**

#### *Assets constituting the estate*

(24) The law should identify the assets that will constitute the estate, including:

- (a) assets of the debtor [owned<sup>28</sup> by the debtor] including the debtor's interest in assets subject to a security interest and in third party-owned assets as at [the time of application for commencement] [commencement] of insolvency proceedings;
- (b) assets acquired after commencement of the insolvency proceedings; and
- (c) assets recovered through avoidance and other actions.

(25) In the case of insolvency proceedings commenced where the debtor has its centre of main interests, the law should specify that the estate includes all assets of the debtor wherever located.<sup>29</sup>

#### *Assets excluded from the estate where the debtor is a natural person<sup>30</sup>*

(26) The law should specify the assets, if any, that are excluded from the estate where the debtor is a natural person.

## **B. Protection and preservation of the insolvency estate**

### **1. Introduction**

176. An essential objective of an effective insolvency system is the establishment of a protective mechanism to ensure that the value of the insolvency estate is not diminished by the actions of the various parties and allow the insolvency

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<sup>28</sup> Ownership would be determined by reference to the relevant applicable law.

<sup>29</sup> Where the law adopts a universal approach as recommended here, the law should also address the issue of recognition of foreign proceedings, see UNCITRAL Model Law on Cross-Border Insolvency (chapter VII).

<sup>30</sup> Exclusions generally are not provided for legal person debtors. On assets that may be excluded in respect of natural persons see chapter II.3(b).



proceedings to be administered in a fair and orderly manner. The parties from whom the estate needs the greatest protection are the debtor and its creditors.

## **2. Protection of the estate by application of a stay**

177. With regard to creditors, one of the fundamental principles of insolvency law is that insolvency proceedings are collective proceedings, which require the interests of all creditors to be protected against individual action by one of them. Many insolvency laws provide for the imposition of a mechanism that not only prevents creditors from enforcing their rights through legal remedies during some or all of the period of the liquidation or reorganization proceedings, but also suspends actions already underway against the debtor and prevents the commencement of new actions. This mechanism is variously termed a moratorium, suspension or stay, depending on the effect of the mechanism. For the purposes of this Guide, the term “stay” is used in a broad sense to refer to both suspension of actions and a moratorium on the commencement of actions.

### *(i) Liquidation*

178. As a general principle, the emphasis in liquidation is on selling the assets, in whole or in part, so that creditors claims can be satisfied from the proceeds of realization of the estate as quickly as possible. Maximizing value is an overriding objective. The imposition of a stay can ensure a fair and orderly administration of the liquidation proceedings, providing the insolvency representative with adequate time to avoid making forced sales that fail to maximize the value of the assets being liquidated, and also an opportunity to see if the business can be sold as a going concern, where the collective value of assets may be greater than if the assets were to be sold piecemeal. A stay also allows the insolvency representative to take stock of the debtor’s situation, including actions already pending, and provides time for all actions to be fully considered, increasing the possibility of achieving a result that is not prejudicial to the interests of the debtor and creditors. The balance that is difficult to achieve in liquidation proceedings is between the competing interests of secured creditors, who will often hold security in some of the most important assets of the business, and unsecured creditors.

### *(ii) Reorganization*

179. In reorganization proceedings, the application of a stay facilitates the continued operation of the business and allows the debtor a breathing space to organize its affairs, time for preparation and approval of a reorganization plan and for other steps such as shedding unprofitable activities and onerous contracts, where appropriate. As in liquidation, it also provides an opportunity to consider actions pending against the debtor. Given the goals of reorganization, the impact of the stay is greater and therefore more crucial than in liquidation and can provide an important incentive to encourage debtors to initiate reorganization proceedings. At the same time, the commencement of proceedings and the imposition of the stay give notice to all those who do business with the debtor that the future of the business is uncertain. This can cause a crisis of confidence and uncertainty as to how the insolvency proceedings will impact upon suppliers, customers and employees of the debtor’s business.

180. The immediate benefits that accrue to the debtor by having a broad stay quickly imposed to limit the actions of creditors will need to be balanced against the longer-term benefits that are derived from limiting the degree to which the stay interferes with contractual relations between debtors and creditors, especially secured creditors.

### **3. Scope of application of the stay**

#### **(a) Actions to which the stay will apply**

181. Some countries adopt the approach that to ensure the effectiveness of the stay, it must be very wide, applying to all remedies and proceedings against the debtor and its assets, whether administrative, judicial or self-help and restraining both unsecured and secured creditors from enforcing their rights, as well as governments from exercising priority rights. Examples of the types of actions and acts that may be stayed could include the commencement or continuation of actions or proceedings against the debtor or in relation to its assets; the commencement or continuation of enforcement proceedings in relation to assets of the debtor, including the execution of a judgement and perfection or enforcement of a security interest; recovery by any owner or lessor of property that is used or occupied by, or is in the possession of, the debtor; payment or provision of security in respect of a debt incurred by the debtor prior to the commencement date; the right of the debtor to transfer, encumber or otherwise dispose of any assets (in reorganization, this might be limited to transfer, encumbrance or disposal outside the ordinary course of business); the right of a counterparty to terminate a contract with the debtor (except where the contract provides a termination date that happens to fall after commencement);<sup>31</sup> and termination, suspension or interruption of supplies of essential services (for example, water, gas, electricity and telephone) to the debtor. Article 20 of the UNCITRAL Model Law on Cross-Border Insolvency (see chapter VII), for example, provides that commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities and execution against the debtor's assets are stayed. The types of individual actions referred to above should cover those commenced both in the courts and before an arbitral tribunal.<sup>32</sup>

182. One of the reasons for including continuation of proceedings within the scope of the stay is that the need for the insolvency representative to become involved in ongoing cases (where the debtor is divested of control) can distract and divert resources away from its task of administering the estate. A default judgement, for example, could be entered against the debtor and form the basis of a creditor's claim in the proceedings when, on a proper adjudication, the action might have been dismissed or judgement entered for a smaller amount. Since most insolvency laws include a mechanism to process claims—addressing submission, verification, and approval—and to make distributions, most proceedings with respect to those claims being conducted outside of the insolvency case are rendered superfluous. Nevertheless, some insolvency laws provide that, where legal proceedings against

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<sup>31</sup> To give the insolvency representative time to assess the contract's importance to the proceedings and what action should be taken with respect to continuation or rejection. See chapter II.E.

<sup>32</sup> It may not always be possible, however, to implement an automatic stay of arbitral proceedings, such as where the arbitration takes place in a foreign State rather than in the State in which insolvency proceedings are commenced.

the debtor (including both commencement and continuation of those proceedings) are within the scope of the stay, those proceedings can be commenced or continued at the discretion of the court if it is considered necessary to preserve a claim or establish the quantum of a claim.<sup>33</sup>

183. Other insolvency laws allow the commencement or continuation of legal proceedings (without leave of the court), but the application of the stay prevents enforcement of any resulting order. Some insolvency laws limit the actions that may be pursued and only specific actions, such as employee actions against the debtor, can be commenced or continued, but any enforcement action resulting from those proceedings will be stayed. In some insolvency laws a distinction is made between regulatory and pecuniary actions. Some laws allow claims of both a regulatory and pecuniary nature to be continued, others only regulatory claims, such as those that are not designed to collect money for the estate but to protect vital and urgent public interests, restraining activities causing environmental damage or activities that are detrimental to public health and safety.

**(b) Exclusions from application of the stay**

184. To ensure transparency and predictability, it is highly desirable that an insolvency law clearly identify the actions that are to be included within and specifically excluded from the scope of the stay, irrespective of who may commence those actions, whether unsecured creditors (including preferential creditors such as employees, legislative lienholders or governments), third parties (such as a lessor or owner of property in the possession or use of the debtor or occupied by the debtor), secured creditors or others. Exclusions might include: set-off rights and netting of financial contracts (see chapter II.G); actions to protect public policy interests, such as to restrain environmental damage or activities detrimental to public health and safety; actions to prevent abuse, such as the use of insolvency proceedings as a shield for illegal activities; actions commenced in order to preserve a claim against the debtor; and actions against the debtor for personal injury or family law claims.<sup>34</sup> With respect to claims against the debtor that have the potential for very large compensation awards, such as mass tort claims, it is desirable that they be included within the scope of the stay.

**(c) Secured creditors**

185. The scope of rights that are affected by the stay varies considerably among insolvency laws. There is little debate regarding the need for the stay to apply to suspend or prevent the commencement of actions by unsecured creditors against the debtor or its assets. The application of the stay to secured creditors, however, is potentially more difficult and requires a number of competing interests to be balanced. These include, for example, respecting the pre-insolvency priorities of secured creditors as regards their rights over the encumbered assets; minimizing the

<sup>33</sup> Article 20(3) of the UNCITRAL Model Law on Cross-Border Insolvency, for example, provides that the application of the stay to commencement or continuation of individual actions or proceedings against the debtor is not to affect the right to commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor.

<sup>34</sup> Some jurisdictions, for example, will exclude from the application of the stay the performance of obligations of the debtor that do not affect the estate, e.g. to give parental access in a family law situation.

effect of the stay on the value of encumbered assets; and, in cases of reorganization, ensuring that all assets necessary for the successful reorganization of a viable debtor are available to the proceedings.

186. Creditors generally seek security for the purpose of protecting their interests in the event that the debtor fails to repay. If security is to achieve this objective, it can be argued that, upon commencement of insolvency proceedings, the secured creditor should not be delayed or prevented from immediately enforcing its rights against the encumbered asset. The secured creditor has, after all, bargained for security in exchange for value that reflects the reliance on the security interest. For that reason, the introduction of any measure that will diminish the certainty of the secured creditor's ability to recover debt or erode the value of security interests, such as applying the stay to secured creditors, may need to be carefully considered. Such a measure may ultimately undermine not only the autonomy of the parties in their commercial dealings and the importance of observing commercial bargains, but also the availability of affordable credit; as the protection provided by security interests declines, the price of credit may need to increase to offset the greater risk. Some of the insolvency laws that exclude secured creditors from the stay focus, as an alternative to the stay, on encouraging pre-commencement negotiations between the debtor and creditors to achieve agreement on how to proceed.

(i) *Reorganization*

187. A growing number of insolvency laws recognize, however, that in many cases permitting secured creditors to freely enforce their rights against the encumbered asset can frustrate the basic objectives of the insolvency proceedings, particularly in reorganization, and for that reason they are included within the scope of the stay, subject to certain protections. It may be worth noting that the increasing acceptance by banks and other financial institutions of moratoriums in voluntary restructuring negotiations conducted pursuant to such rules as the "London Approach" (see part one, chapter II) may be responsible in part for the growing acceptance by secured creditors of the application of the stay to them in proceedings under the insolvency law.

188. Insolvency laws take different approaches to the application of the stay to secured creditors in liquidation proceedings. As a general principle, where the insolvency representative's function is to collect and realize assets and distribute proceeds among creditors by way of dividend, the secured creditor may be permitted to freely enforce its rights against the encumbered asset to satisfy its claim without affecting the liquidation of other assets. Some insolvency laws thus exclude secured creditors from the scope of the stay on the basis that where the assets are to be liquidated the balance will weigh in favour of allowing secured creditors to enforce their rights. Where that approach is adopted, however, some flexibility may be needed in cases where the insolvency representative may be able to achieve a better result that maximizes the value of the assets for the collective benefit of all creditors if the stay is applied to secured creditors. This may be particularly relevant where the business can be sold as a going concern in the context of the liquidation proceeding. It may also be true in some cases where even though assets are to be sold in a piecemeal manner, some time is needed to arrange a sale that will give the highest return for the benefit of all unsecured creditors.

189. Where secured creditors are included within the scope of the stay, an insolvency law can adopt measures that will ensure the interests of the secured creditor are not diminished by the stay. These measures may relate to the duration of the stay, protection of the value of the encumbered assets, payment of interest and provision of relief from the stay where the encumbered assets are not sufficiently protected or where they are not necessary to the sale of the entire business or a productive part of it.<sup>35</sup>

#### **4. Discretionary or automatic application of the stay**

190. A preliminary question on application of the stay is whether it should apply automatically (by operation of the insolvency law) or at the discretion of the court. Local policy concerns and factors such as the availability of reliable financial information and the ability of the debtor and creditors to access an independent judiciary with insolvency experience may affect the decision on this issue. Application of the stay on a discretionary basis may allow the stay to be tailored to the needs of the specific case (as regards the debtor, its assets and its creditors and the time of application of the stay) and avoid both unnecessary applications of the stay and unnecessary interference with the rights of secured creditors. This approach, however, has the potential to cause delay while the court considers the relevant issues; does not create a predictable situation for those creditors and third parties to whom the stay ultimately may apply; and may create a need for some mechanism, such as provisional measures, to address the period before the court decides on the application of the stay, as well as requiring the giving of notice as to application of the stay. An alternative approach which minimizes delay, will assist the achievement of the maximization of the value of the assets and ensure that the insolvency process is fair and ordered as well as transparent and predictable, might be to provide for the stay to apply automatically to specified actions (either on application or commencement of proceedings), with the possibility of extension of the stay to other actions at the discretion of the court. This approach is adopted in the UNCITRAL Model Law on Cross-Border Insolvency: article 20 specifies the types of actions that will be stayed automatically upon recognition of foreign main proceedings, while article 21 indicates examples of additional relief that may be ordered upon recognition, at the discretion of the court. The automatic stay is a feature of many modern insolvency law regimes and can be combined with provisions permitting relief in specified circumstances.

#### **5. Time of application of the stay**

191. A further concern related to application of the stay is the time at which it will apply in both liquidation and reorganization proceedings. There are essentially two approaches. Under the first, the stay applies from the time of the making of an application for commencement of proceedings and under the second, from the time of the commencement of proceedings, with provisional measures being available to cover the period between application and commencement.

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<sup>35</sup>Where a secured transactions regime provides a grace period for perfection of a security interest, whether the insolvency law should recognize that grace period and include an exception to application of the stay to secured creditors to permit perfection in the applicable circumstances also will need to be considered (see UNCITRAL Legislative Guide to Secured Transactions).

**(a) Specifying the exact time of effect of the stay**

192. As a preliminary issue, regardless of whether an automatic stay is to be applicable by reference to the time of application or commencement, it is important that an insolvency law address the question of the exact time at which the stay will become effective to ensure protection of the estate, especially in relation to payments. Different approaches are taken to this issue. In some laws, the stay becomes effective as of the time of the court's decision to commence proceedings, in others when the decision as to commencement becomes publicly available, while in yet other laws the stay has effect retroactively from the first hour of the day of the commencement order. A similar diversity of approaches is taken where the stay has effect upon the making of the application for commencement of proceedings. Whichever approach is adopted, the insolvency law should contain a clear rule.

**(b) Application of the stay from the time an application for commencement is made**

193. With respect to the point at which the stay should take effect, one approach applies the stay from the making of an application for either liquidation or reorganization proceedings, irrespective of whether it is a debtor or creditor application. This approach may avoid the need to consider the availability of interim or provisional measures of protection to cover the period between the making of the application and the commencement of proceedings, but will require the application of the stay at a time when a number of factual matters are not necessarily clear, in particular whether the debtor will satisfy the commencement criteria. To balance against the risk of abuse in this situation, it is desirable if this approach is followed, that clear procedures for seeking relief from the application of the stay on an expedited basis be included in the insolvency law.

**(c) Application from commencement**

194. The most common approach to application of the stay is for it to apply on commencement of the proceedings, when issues of eligibility, jurisdiction and satisfaction of the commencement criteria will have been resolved and it is clear that proceedings should be commenced rather than the application be denied.

*(i) Provisional measures*

195. In some insolvency laws, the application of the stay on commencement is complemented by provisional measures to address the period between application and commencement to protect the assets of the debtor and the collective interests of creditors. Even where the commencement decision is made quickly, there is the potential in that period for the debtor's business situation to change and for dissipation of the debtor's assets—the debtor may be tempted to transfer assets out of the business, and creditors, on learning of the application, may take remedial action against the debtor to pre-empt the effect of any stay that may be imposed upon commencement of the proceedings. The unavailability of provisional measures in such circumstances could frustrate the objectives of the insolvency proceedings. As with most provisional measures, the need for relief generally must be urgent and must outweigh potential harm resulting from such measures.

196. Where an insolvency law permits provisional measures to be granted, it is important that it also make provision for periodic review and, if necessary, renewal

of provisional measures by the court and address what happens to those measures on commencement of the insolvency proceedings. In many instances there will be no need for provisional measures to continue to apply after the commencement of proceedings, as they will be superseded by the measures automatically applicable on commencement. If, however, provisional relief of a particular kind is not provided by the measures automatically applicable on commencement, and that type of relief is still required after commencement, the court in appropriate circumstances may extend the application of that provisional measure.

(ii) *Types of provisional measures*

197. Provisional measures may be available on the application of the debtor, creditors, or third parties or be ordered by the court on its own motion. They may include: appointing an interim insolvency representative or other person (not including the debtor) to administer or supervise the debtor's business and to protect assets and the interests of creditors; prohibiting the debtor from disposing of assets; taking control of some or all of the debtor's assets; suspending enforcement by creditors of security rights against the debtor; staying any action by creditors against the debtor's assets, such as by a secured creditor or retention of title holder; or preventing the commencement or continuation of individual actions by creditors to enforce their claims. Where an insolvency representative is appointed as a provisional measure, it may not have powers as broad as those of an insolvency representative appointed on commencement of proceedings and its functions may be limited to protecting assets and the interests of creditors. It may be given, for example, the power to use and dispose of the debtor's assets in the ordinary course of business and to realize those assets in whole or in part in order to protect and preserve the value of assets that, by their nature or because of other circumstances are perishable, susceptible to devaluation or otherwise in jeopardy. In any event, it may be necessary to determine the balance of responsibilities between the insolvency representative and the debtor with respect to the operation of the debtor's business, bearing in mind that at that point no determination as to commencement of insolvency proceedings has yet been made. Where proceedings are not commenced, significant harm to the debtor's business or to the rights of creditors may result. In general, the debtor would continue to operate its business and to use and dispose of assets in the ordinary course of business, except to the extent restricted by the court.

(iii) *Evidentiary requirements*

198. Since these measures are provisional in nature and are granted before the court's determination that the commencement criteria have been met, the law may require the court to be satisfied that there is some likelihood that the debtor will satisfy the commencement requirements. Where a party other than the debtor applies for the measure, the applicant may be required by the court to provide evidence that the measure is necessary to preserve the value or avoid dissipation of the debtor's assets. In that case, some form of security for costs, fees or damages, such as the posting of a bond, may also be required in case proceedings are not subsequently commenced or the measure sought results in some harm to the debtor's business. Where provisional measures are improperly obtained, it may be appropriate to permit the court to assess costs, fees and damages against the applicant for the measure.

(iv) *Notice of application and orders for provisional measures*

199. The insolvency law may also need to consider the question of provision of notice, both in respect of the application for provisional measures and of an order for provisional measures (including the time at which those measures become applicable), and the parties to whom that notice needs to be given. As a general principle, the debtor should be given notice of an application for provisional measures and an opportunity to challenge the application. Only in exceptional circumstances is it desirable that notice to the debtor be dispensed with and the application proceed on an ex parte basis. While many laws allow ex parte applications for provisional measures, they generally do so on the basis that the applicant provides security for costs and damages and can demonstrate requisite urgency, i.e. that irreparable harm will result if the applicant is required to seek the requested measure under customary procedures requiring many days' notice.<sup>36</sup> Nevertheless, once an order for provisional measures has been made on an ex parte basis, the debtor would generally be entitled to notice of the order and an opportunity to be heard. Bearing in mind the need to avoid unnecessary damage to a debtor against whom insolvency proceedings are not subsequently commenced, notice of an order for provisional measures may need to be given only to parties directly affected by the order.

(v) *Relief from provisional measures*

200. Relief from the application of provisional measures, such as modification or termination, may be appropriate in cases where the interests of the persons to whom the measures are directed are being harmed by their application. Examples of situations where relief might be appropriate would include those involving perishable goods, actions relating to preservation or quantification of a claim against the debtor and secured creditors (see para 206 below). The granting of such relief may need to be balanced against potential detriment to the interests of creditors generally or to the debtor's assets. Such relief might be available on the application of the affected party, the insolvency representative or on the motion of the court itself, and would generally require notice to be given to the person or persons affected by the modification or termination and an opportunity to challenge the modification or termination.

**6. Duration of application of the stay**

**(a) Unsecured creditors**

201. Many insolvency laws provide for the stay to apply to unsecured creditors throughout both liquidation and reorganization proceedings. In liquidation, this would generally mean when the liquidation of the assets had been completed and the proceedings closed. In reorganization, some laws provide that the proceedings will end when the reorganization plan is approved and effective, while others delay closure until the plan is fully implemented. Application of the stay until that later time may be unnecessary on the basis that the reorganization plan should address the claims of unsecured creditors who would be bound by the approved plan.

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<sup>36</sup> See UNCITRAL work on interim measures in support of arbitration: document A/CN.9/WG.II/WP.119 [Yearbook 2001, Part two].



202. Relief from the application of the stay may be provided to unsecured creditors in particular instances such as those noted above with respect to quantification or preservation of a claim (see chapter II.B.3(a) above).

**(b) Secured creditors**

*(i) Reorganization*

203. [91] It may be desirable for the stay to apply to secured creditors for a sufficient period of time to ensure that the reorganization can be conducted in an orderly manner without the possibility of assets being separated before the reorganization can be finalised. To avoid delay and encourage a speedy resolution of the proceedings, there may be advantage in limiting the application of the stay to the time that it may reasonably take for a reorganization plan to become effective to avoid application of the stay for an uncertain or unnecessarily lengthy period, provided that the period is not allowed to continue for years without a plan being proposed and approved. Such a limitation may also have the advantage of providing secured creditors with a degree of certainty and predictability as to the duration of the period of interference with their rights and the treatment of those rights in the plan. Alternatively a fixed time period might be specified. The difficulty with establishing a fixed time limit, however, is that it may not always be sufficiently long, depending on the size and complexity of the reorganization and the plan required, and may be difficult to enforce. Solutions may include establishing clear time limits, with the possibility of extension (see below), or providing for relief from the stay in certain circumstances (see below). It is important that the overall design of the insolvency law encourages speedy and efficient progress of the proceedings, enabling the period for application of the stay to secured creditors, particularly in reorganization, to be minimized.

*(ii) Liquidation*

204. Insolvency laws adopt different approaches in respect of application of the stay to secured creditors in liquidation. Of those laws applying the stay to secured creditors, some adopt the approach that the stay automatically applies upon commencement of liquidation proceedings but only for a brief period, such as 30 or 60 days. This period is to allow the insolvency representative to assume its duties and take stock of the assets and liabilities of the estate and to determine the best means of achieving liquidation of the assets. In those cases where the encumbered asset is essential to the sale of the business as a going concern, some laws provide that application of the stay may be extended beyond the specified period. Where the encumbered asset is not required for the sale of the business, however, the stay could be lifted (see below). Another approach extends the stay to secured creditors for the duration of the liquidation proceedings, subject to a court order for relief where it can be shown that the value of the encumbered asset is being eroded and cannot be maintained.

**7. Extension of the duration of the stay**

205. Where the stay applies for a specified period, the law may include provision for extension of the stay. Experience in some countries suggests that extension of the stay has been treated as a routine matter with the result that stays have been extended for periods of up to several years, ultimately defeating the purpose of the

proceedings and destroying any value that may have been available for creditors at the outset. To avoid this situation, it is desirable that an insolvency law provide clear rules on the availability of extensions, limiting the parties that may apply and the grounds upon which an extension should be granted. An extension may be available, for example, on the application of the insolvency representative when it can be demonstrated that an extension is required in order to maximize value (e.g. there is a reasonable possibility that the debtor, or business units of the debtor, can be sold as a going concern) provided that it is not detrimental to the interests of secured creditors. To provide additional protection and avoid the stay being applied for an uncertain or unnecessarily lengthy period, it is desirable that an insolvency law limit the period for which the stay can be extended and, possibly, the number of times an extension is available.

#### **8. Protection of secured creditors**

206. As noted above, where secured creditors are included in the scope of the stay, the insolvency law can adopt certain measures to protect their interests. In addition to limiting the duration of the stay, these measures may include providing for the stay to be lifted and adopting measures to ensure, where the value of the secured claim is more than or close to the value of the encumbered asset, that the value of the encumbered asset is protected against diminution, either as a result of the use of the asset or because of the application of the stay. Since these measures are interrelated, it is desirable that an insolvency law adopt a coherent approach. Where the length of the application of the stay is short, for example, there may be no need for the law to require protection of the value of the encumbered assets. Where the stay applies for a long time, however, lifting of the stay may be a more cost effective remedy than providing protection for the value of the asset, provided the asset is not required for the proceedings. The interests of secured creditors can, of course, also be protected more generally, by consulting them on the use and sale of the encumbered assets; the payment of interest as far as the proceeds of the asset allow; and taking over the asset where the asset is worth less than the secured claim. These measures are discussed in the following sections. The desirability of approaches that provide protection for the value of the encumbered asset may need to be weighed against the potential complexity and cost of those measures and the need for the court to be able to make difficult commercial decisions on the question of protection. Where protection is provided, it may be desirable for an insolvency law to provide guidance to determine when and how creditors holding some type of security interest over the debtor's assets would be entitled to the types of protection described below.

##### **(a) Relief from the stay**

207. In liquidation and reorganization proceedings, circumstances may arise where it is appropriate to provide relief from the stay. The secured creditor may be permitted to apply to the court for that relief or the insolvency representative (without the approval of the court) may be permitted to release the security. Relevant circumstances may include where the value of the secured creditor's claim exceeds the value of the encumbered asset; where the secured creditor is not receiving protection for the erosion of the value of the encumbered asset; where the provision of protection may not be feasible or would be overly burdensome to the estate; where the encumbered asset is not needed for the reorganization or sale of

the business as a going concern in liquidation; where relief is required to protect or preserve the value of assets, such as perishable goods; or where, in reorganization, a plan is not approved within any applicable time limit.

208. Where relief from the stay is granted, the insolvency law may provide for the encumbered asset to be turned over to the secured creditor in which case the asset will cease to be part of the estate and the secured creditor will be free to enforce its rights. Under some laws the insolvency representative may be required to decide whether the asset should be turned over to the secured creditor or whether the asset can be relinquished. The difference between these options may have cost implications for the estate. For example, where the asset is a large piece of equipment, turning it over to the creditor may require expenditure by the estate for transport, while relinquishment places the costs of removal on the creditor.

209. While provisions on relief from the stay principally address the interests of secured creditors, there are examples of insolvency laws which provide that relief from the stay may be granted to an unsecured creditor. This may be relevant, for example, where goods are perishable and in those cases where the insolvency law does not allow commencement or continuation of claims, to allow a claim to be determined in another forum where litigation may be well advanced and it would be efficient for it to be completed, or a claim against an insurer of the debtor to be pursued.

**(b) Protection of value**

210. Some insolvency laws adopt provisions specifically designed to address the negative impact of the stay on secured creditors by maintaining the economic value of secured claims during the period of the stay (in some jurisdictions referred to as “adequate protection”).

*(i) Protecting the value of the encumbered asset*

211. Where the estate is able to maintain the value of encumbered assets, it can be approached in several ways. One approach is to protect the value of the encumbered asset itself on the understanding that, upon liquidation, the proceeds of sale of the encumbered asset will be distributed directly to the creditor to the extent of the secured portion of their claim. This approach may require a number of steps to be taken.

212. During the period of the stay it is possible that the value of the encumbered asset will diminish. Since, at the time of eventual distribution, the extent to which the secured creditor will receive priority will be limited by the value of the encumbered asset, such a depreciation can prejudice the secured creditor. Some insolvency laws provide that the insolvency representative should protect secured creditors against any diminution either by providing additional or substitute assets or making periodic cash payments corresponding to the amount of the diminution in value. This approach is only necessary where the value of the encumbered asset is less than the amount of the secured claim. If the value exceeds the claim, the secured creditor will not be harmed by the erosion of value until that value becomes insufficient to pay the secured claim. Some countries that preserve the value of the encumbered asset as outlined also allow for payment of interest during the period of the stay to compensate for delay imposed by the proceedings. Provision of interest

may be limited however to the extent that the value of the encumbered asset exceeds the value of the secured claim. Otherwise, compensation for delay may deplete the assets available to unsecured creditors. Such an approach may encourage lenders to seek security that will adequately protect the value of their claims.

*Valuation of encumbered assets*

213. Central to the notion of protecting the value of encumbered assets is the mechanism for determining the value of those assets in order to enable the court to determine whether and how much to provide to secured creditors as relief against the erosion of the value of encumbered assets during the proceedings. This is a potentially complex issue and involves questions of the basis on which the valuation should be made (e.g. going concern value or liquidation value), the party to undertake the valuation and the relevant date for determining value, such as the date of commencement, with provision for ongoing review. One approach is for the valuation assessment, at least in the first instance, to be determined through agreement by the parties (being the debtor, or insolvency representative, and the secured creditor). Other laws provide different court-based approaches. For example, rather than undertaking the valuation itself, the court may specify a mode of determining the value, which might be carried out by appropriate experts. This could be supported by clearly stated principles in the insolvency law upon which the valuation might be based. An alternative approach is for the court, possibly following an initial estimate or appraisal of value by the insolvency representative, to determine the value on the basis of evidence, which might include a consideration of markets, market conditions and expert testimony. Some laws require a market valuation of an asset through sale, whereby the highest price available in the market for the asset is obtained via tender or auction. This valuation technique is less applicable to protection of either the value of the encumbered asset or the secured claim (see below) than it is to disposal of assets of the estate by the insolvency representative. Valuation is also relevant for the process, at commencement, of registering all assets and liabilities, and preparing a net balance of the debtors position (see chapter V.A.3(b)(iii)).

214. In some liquidation cases the insolvency representative may find it necessary to use or sell encumbered assets (see chapter II.C) in order to maximize the value of the estate. For example, in liquidation to the extent that the insolvency representative is of the view that the value of the estate can best be maximized if the business continues to operate for a temporary period, it may wish to sell inventory that is partially encumbered. In reorganisation proceedings also, it may be in the best interests of the estate to sell encumbered assets of a similar nature to provide needed working capital. Thus, in cases where secured creditors are protected by preserving the value of the encumbered asset, it may be desirable for an insolvency law to allow the insolvency representative the choice of providing the creditor with substitute equivalent security, such as a replacement lien over another asset or the proceeds of the sale of the encumbered asset, or paying out the full amount of the value of the assets that secure the secured claim either immediately or through an agreed payment plan. Other approaches focus on the use of the proceeds of the sale of the encumbered assets (see chapter II.C). One method is for the court to prevent current or future use of those proceeds by the insolvency representative. Other laws grant secured creditors relief from the stay to pursue individual remedies regarding such proceeds, or where use of the proceeds is not authorised by either the secured

creditor or the court, hold the debtor, its management or the insolvency representative personally liable for the amount of the proceeds, or make such debt non-dischargeable.

(ii) *Protecting the value of the secured portion of the claim*

215. A second approach to protecting the interests of secured creditors is to protect the value of the secured portion of the claim. Immediately upon commencement, the encumbered asset is valued and, based on that valuation, the amount of the secured portion of the creditor's claim is determined. This amount remains fixed throughout the proceedings and, upon distribution following liquidation, the secured creditor receives a first-priority claim to the extent of that amount. During the proceedings, the secured creditor could also receive the contractual rate of interest on the secured portion of the claim to compensate for delay imposed by the proceedings.

**9. Limitations on disposal of assets by the debtor**

216. In addition to measures designed to protect the insolvency estate against the actions of creditors and third parties, insolvency laws (as noted above, see chapter II.A.2(e)) generally adopt measures which are intended to limit the extent to which the debtor can deal with the assets of the estate. These measures generally will apply after proceedings have commenced, but may in some cases also apply between the time of an application for commencement and commencement itself. For example, where an interim insolvency representative is appointed as a provisional measure before commencement of the proceedings, the debtor may be subject to supervision or control of that insolvency representative, and generally have limited powers to deal with its assets. Under some insolvency laws, this period will only occur in the case of a creditor application because a debtor application will function to automatically commence the proceedings.

217. Where an insolvency representative is appointed on commencement of the insolvency proceedings, many insolvency laws provide that the debtor will lose either all control of the insolvency estate and will not be able to enter into any transactions after commencement, or will have continuing, but limited, powers in relation to the day-to-day conduct of the business and can enter into transactions only in the ordinary course of business. Transactions that do not fall into that category, such as the sale of significant assets, may require authorization by the insolvency representative, the court or in some cases, the creditors.<sup>37</sup>

218. Where the debtor enters into an unauthorized transaction, whether between application and commencement or after commencement, the effect generally would be that any property transferred should be returned to the insolvency representative and any obligations created would be unenforceable against the estate. There may be concerns, however, about the counterparty to the transaction, especially where that party entered into the transaction in good faith and gave value for what was received. For that reason, some insolvency laws provide for those transactions to be valid in certain circumstances. These might include, for example, situations where the transfer was of an immovable and was made before the commencement of the insolvency was notified in the relevant registry or where a third party holding certain assets of the debtor transferred them to another party in good faith and

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<sup>37</sup> Further aspects of these transactions are discussed in chapters II.A.2(e), II.C and II.E.7.

without any knowledge of the commencement of insolvency proceedings. While operating to protect an innocent third party, the inclusion of such a provision will operate to reduce the assets potentially available to creditors. For that reason, it is desirable that if any such provision is to be included in an insolvency law, it be narrowly framed. Because the delay between commencement and notification of commencement can be central to the occurrence of these transfers, it is essential that the requirements for giving notice of commencement result in early and effective notification (see chapter I.B).

219. Some insolvency laws address contracts entered into and transactions implemented by the debtor between application and commencement that are not authorized, whether by the insolvency law, the insolvency representative, the court or creditors (as required), in terms of the avoidance provisions (see chapter II.F), and apply the suspect period retrospectively from commencement of proceedings.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on the protection and preservation of the estate is to:

- (a) establish measures to ensure the value of the estate is not diminished by the actions of the debtor, creditors or third parties;
- (b) determine the scope of those measures and the parties to whom they apply;
- (c) establish the method, time and duration of application of those measures;
- (d) establish the grounds for relief from those measures.

### **Contents of legislative provisions**

#### *Provisional measures*<sup>38</sup>

(27) The law should specify that the court may grant relief of a provisional nature, at the request of the debtor, creditors or third parties, where relief is needed to protect and preserve the value of the assets of the debtor<sup>39</sup> or the interests of creditors, between the making of an application to commence insolvency proceedings and commencement of the proceedings,<sup>40</sup> including:

- (a) staying execution against the assets of the debtor, including [perfection] [actions to make security interests effective against third parties] or enforcement of security interests;

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<sup>38</sup> These articles follow the corresponding articles of the Model Law on Cross-Border Insolvency, see Art. 19 UNCITRAL Model Law on Cross-Border Insolvency.

<sup>39</sup> The reference to assets in paragraphs (a) to (c) is intended to be limited to assets that would be part of the insolvency estate.

<sup>40</sup> The law should indicate the time of effect of an order for provisional measures e.g. at the time of the making of the order, retrospectively from the commencement of the day on which the order is made or some other specified time.

(b) entrusting the administration or supervision of the debtor's business, which may include the power to use and dispose of assets in the ordinary course of business, to an insolvency representative or other person<sup>41</sup> designated by the court;

(c) entrusting the realization of all or part of the assets of the debtor to an insolvency representative or other person designated by the court, in order to protect and preserve the value of assets of the debtor that, by their nature or because of other circumstances, are perishable, susceptible to devaluation or otherwise in jeopardy; and

(d) any other relief of the type applicable automatically on commencement of proceedings.

*Indemnification in connection with provisional measures*

(28) The law may provide the court with the power to:

(a) require the applicant for provisional measures to provide indemnification and, where appropriate, to pay costs or fees; or

(b) impose sanctions in connection with an application for provisional measures.

*Balance of rights between debtor and insolvency representative*

(29) The law should clearly specify the balance of the rights and obligations between the debtor and any insolvency representative appointed as a provisional measure. Between the time of an application for commencement of insolvency proceedings and commencement of those proceedings, the debtor is entitled to continue to operate its business and to use and dispose of assets in the ordinary course of business, except to the extent restricted by the court.

*Notice*

(30) The law should specify that, unless the court limits or dispenses with the need to provide notice, appropriate notice be given to those parties in interest affected by:

(a) an application or court order for provisional measures (including an application for review and modification or termination); and

(b) a court order for additional measures applicable on commencement, unless the court limits or dispenses with the need to provide notice.

(31) The law should specify that where the debtor or other party in interest affected by a provisional measure is not given notice of the application for that provisional measure, [within a specified number of days] [upon urgent application] [within a reasonable period of time] [promptly]<sup>42</sup> the debtor or other party in interest affected by the provisional measures has the right to be heard on whether the relief should be continued.

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<sup>41</sup>The term "other person" in recommendation (27)(b) and (c) is not intended to include the debtor.

<sup>42</sup> Any time limit included in the law should be short in order to prevent the loss of value of the debtor's business.

*Modification or termination of provisional measures*

(32) The law should specify that the court, at its own motion or at the request of the insolvency representative, the debtor, a creditor or any other person affected by the provisional measures, may review and modify or terminate those measures.

*Termination of provisional measures on commencement*

(33) The law should specify that provisional measures terminate when the measures applicable on commencement take effect, unless the court continues the effect of the provisional measures.

*Measures applicable on commencement*

(34) The law should specify that, on commencement of insolvency proceedings:<sup>43</sup>

(a) commencement or continuation of individual actions or proceedings<sup>44</sup> concerning the assets of the debtor, and the rights, obligations or liabilities of the debtor are stayed;

(b) [perfection] [actions to make security interests effective against third parties] or enforcement of security interests are stayed;<sup>45</sup>

(c) execution or other enforcement against the assets of the estate is stayed;

(d) the right of a counterparty to terminate any contract with the debtor is suspended;<sup>46</sup> and

(e) the right to transfer, encumber or otherwise dispose of any assets of the estate is suspended.<sup>47</sup>

*Exceptions to the application of the stay*

(35) The law may permit exceptions to the application of the stay or suspension under recommendation (34) and where it does so, those exceptions should be clearly stated. Paragraph (a) of recommendation (34) should not affect the right to

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<sup>43</sup> These measures would generally be effective as at the time of the making of the order for commencement.

<sup>44</sup> See Art. 20 UNCITRAL Model Law on Cross-Border Insolvency. It is intended that the individual actions referred to in paragraph (a) of recommendation (34) would also cover actions before an arbitral tribunal. It may not always be possible, however, to implement the automatic stay of arbitral proceedings, such as where the arbitration does not take place in the State but in a foreign location.

<sup>45</sup> Where a secured transactions regime provides a grace period for perfection of a security interest, whether the insolvency law should recognize that grace period and include an exception to application of the stay to secured creditors to permit perfection in the applicable circumstances will need to be considered (see UNCITRAL Legislative Guide to Secured Transactions).

<sup>46</sup> See chapter II.D(2)(a). This recommendation is not intended to preclude the termination of a contract if the contract provides for a termination date that happens to fall after the commencement of insolvency proceedings.

<sup>47</sup> The limitation on the right to transfer, encumber or otherwise dispose of assets of the estate may be subject to an exception in those cases where the continued operation of the business by the debtor is authorised and the debtor can transfer, encumber or otherwise dispose of assets in the ordinary course of business.



commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor.<sup>48</sup>

*Additional measures available on commencement*

(36) The law should specify that the court may grant relief additional to the measures applicable on commencement.<sup>49</sup>

*Duration of measures automatically applicable on commencement*

(37) The law should specify that the measures applicable on commencement of insolvency proceedings remain effective throughout the insolvency proceedings until:

- (a) the court grants relief from the measures;<sup>50</sup>
- (b) in reorganization proceedings, a reorganization plan becomes effective;<sup>51</sup>
- (c) in the case of secured creditors in liquidation proceedings, a fixed time period specified in the law expires,<sup>52</sup> unless it is extended by the court for a further period on a showing that:
  - (i) an extension is necessary to maximize the value of assets for the benefit of creditors; and
  - (ii) the secured creditor will be protected against the erosion of the value of the encumbered asset.

*Relief from measures applicable on commencement*

(38) The law should specify that a secured creditor may request the court to grant relief from the type of measures applicable on commencement on grounds that may include that:

- (a) the encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business;
- (b) [where the value of the secured claim exceeds the value of the encumbered asset] the value of the encumbered asset is eroding and the secured creditor is not protected against the erosion of that value;
- (c) in reorganization, a plan is not approved within any applicable time limits.

<sup>48</sup> See Art. 20(3), and paras. 151-152 of the Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency. Where an issue arises as to quantification of a claim, the court may be requested to consider whether relief from the stay can be provided to enable an action or proceeding to be commenced for that purpose.

<sup>49</sup> The additional relief that may be available will depend upon the types of measures available in a particular jurisdiction and what measures, in addition to the measures applicable on commencement, might be appropriate in a particular insolvency proceeding.

<sup>50</sup> Relief should be granted on the grounds included in recommendation (38).

<sup>51</sup> A plan may become effective upon approval by creditors or following confirmation by the court, depending upon the requirements of the law (see recommendations in chapter V.A).

<sup>52</sup> It is intended that the stay should apply to secured creditors only for a short period of time, such as between 30 and 60 days, and that the law should clearly state the period of application.

*Protection from erosion of the value of the encumbered asset*

(39) The law should specify that a secured creditor may request the court to grant protection. Where the value of the encumbered asset does not exceed the secured claim or will be insufficient to meet the secured claim if the value of the encumbered asset erodes during the imposition of the measures applicable on commencement, protection may include:

- (a) cash payments by the estate;
- (b) provision of additional security; or
- (c) such other means as the court determines.

## **C. Use and disposal of assets**

### **1. Introduction**

220. Although as a general principle it is desirable that an insolvency law not unduly interfere with the ownership rights of third parties or the interests of secured creditors, the conduct of insolvency proceedings will often require assets of the insolvency estate, and assets in the possession of the debtor being used in the debtor's business, to continue to be used or disposed of (including by way of encumbrance) in order to enable the goal of the particular proceedings to be realized. This will be especially important in reorganization, but also in liquidation where the business is to be sold as a going concern. It may also be relevant in some cases of liquidation where the business needs to be continued for a short period to enable the value of the assets to be maximized even if they are to be sold off piecemeal. For these reasons, it is desirable that an insolvency law include provisions on the use, or disposal of assets of the insolvency estate (including encumbered assets), and third party-owned assets, addressing the conditions upon which those assets may be used or disposed of and the provision of protection for the interests of third party owners and secured creditors. It may be important to note, in designing such provisions, that other laws may affect the use of these powers in insolvency. In particular, laws prohibiting or restricting foreign ownership in certain sectors of the economy may operate to limit the price that can be obtained for certain assets and in turn affect distributions to creditors.

### **2. Assets of the insolvency estate**

#### **(a) Ordinary course of business**

221. With respect to use and disposal of assets of the insolvency estate, some insolvency laws draw a distinction between the exercise of these powers in the ordinary course of conducting the business of the debtor and their exercise in other circumstances in terms of who may exercise those powers and the protections that are required. For example, decisions as to use and disposal of property in the ordinary course of business may be taken by the insolvency representative<sup>53</sup> without

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<sup>53</sup> The exercise of these rights by the insolvency representative depends upon the functions of that position under the insolvency law and may be restricted, for example, where the insolvency representative's role is that of a trustee or supervisor and also upon the relative roles assigned to the debtor and insolvency representative (see chapter III.A and B) after commencement of

requiring notice to be given to creditors or a hearing of the court, while use and disposal outside the ordinary course of business may require approval of the court or of the creditors. Some laws extend these rights of use and disposal to a debtor under the supervision or control of an insolvency representative, or to a debtor-in-possession.

222. Any concerns with respect to the exercise of powers of use and disposal by the insolvency representative and the possibility for misuse or defalcation may be addressed in terms of the appointment criteria, including provision of a security bond, an approach adopted by many insolvency laws (see also chapter III.B) and through other measures to address the liability of the insolvency representative.

223. Including a distinction in the insolvency law between disposals made in or outside the ordinary course of business may facilitate the continuing day-to-day operation of the business, both in reorganization and in liquidation where it is to be sold as a going concern, without imposing the complexity of obtaining court approval to conduct routine activities. The requirement for approval in the case of non-routine disposal can act as a check against abuse, such as disposals to related parties. Nevertheless, the insolvency law needs to provide clear guidance on what constitutes dealing in the ordinary course of business to avoid disputes and ensure the proceedings are conducted quickly and efficiently (for a discussion of what may constitute actions in the ordinary course of business see chapter II.F.2).

224. Some insolvency laws also distinguish between different types of assets in terms of how they may be used and the conditions that will apply. Special provision may apply, for example, to perishable or other assets that will diminish in value if not sold quickly, or for cash, or property held jointly by the debtor and another person or held by the debtor subject to a security interest.

**(b) Methods of sale**

225. Where assets of the insolvency estate are to be sold it is important that irrespective of which party may be required to supervise sales, the manner of sale chosen maximizes the value for the estate, and that creditors receive adequate notice of the sale, enabling them to challenge the sale in court if they disapprove. Different approaches are taken to achieving these goals. Many insolvency laws require assets to be sold by auction, with some providing that the creditor committee, or some other creditor representative or the insolvency representative can approve some other means of sale, such as by private contract, if it will be more profitable.

226. As noted above, some insolvency laws give the power of sale in the ordinary course of business to the insolvency representative and impose a duty to obtain the best price reasonably obtainable at the time of sale. Some of those laws also impose limits on the insolvency representative's discretion to choose the method of sale. In cases where the insolvency representative chooses to conduct the sale privately rather than through a public auction, the law may require that the court adequately supervise the sale or that the creditors specifically approve it. Other insolvency laws provide for the court to play a significant role in the sale of assets, with the court fixing the time, the form and the conditions of sale; the insolvency representative plays a subsidiary role in collecting offers and obtaining the views of the creditors.

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insolvency proceedings, particularly in reorganization.

Some insolvency laws also address issues such as sales to a creditor to offset that creditor's claim and sale of any of the debtor's assets in the possession of a third party to that third party for a reasonable market price. Where assets might be subject to rapid deterioration of value, such as where they are perishable, susceptible to devaluation or otherwise in jeopardy, notification and/or approval of creditors or the court might prove difficult to achieve quickly. In such cases it may be desirable for the law to provide that prior approval is not necessary. While the sale could be confirmed after it has been completed, it would not be feasible to create a possibility of reversing or modifying the sale (except in cases of fraud or collusion) due to the consequential contractual uncertainty, and the very nature of the assets may discount the likelihood of any resale.

227. Although it may be suggested that an insolvency law should specifically preclude a sale to related parties to avoid collusion, absolute prohibition of such a sale may not be necessary provided the sale is adequately supervised and carefully scrutinised before being allowed to proceed, to avoid fraud and collusion. Such supervision or scrutiny may require higher standards in terms of the valuation of assets and disclosure of business relationships.

228. While it may be expected that assets sold in the context of insolvency proceedings will achieve a lower sale price than similar assets sold under normal market conditions, an insolvency law can adopt a number of procedural protections to ensure that the process is fair, that the maximum price is achieved and that, overall, the process for disposal of assets is transparent and well-publicised. Such protections include providing notice to creditors and to prospective purchasers in a manner that will ensure the information is likely to come to the attention of interested parties; allowing creditors to raise their objections or concerns (either with the insolvency representative or the court, as appropriate); requiring assets to be valued by neutral, independent professionals (especially in the case of real estate and specialized property); and in the case of auctions, requiring pre-bidder qualification and minimum prices where appropriate, and preventing and punishing collusion among bidders.

**(c) Use or disposal of encumbered assets**

229. An insolvency law will need to address the question of use or disposal (other than by further encumbrance) of encumbered assets and, in particular, whether the insolvency representative or the secured creditor will have the power to sell those assets. To a large extent, the approach adopted will depend upon whether the insolvency law includes encumbered assets in the insolvency estate; if not the secured creditor will generally be free to enforce its security interest. Where encumbered assets are part of the estate, insolvency laws take different approaches to this issue. In some cases the approach depends upon the application of other provisions of the insolvency law, as well as other law, such as application of the stay (while the stay applies only the insolvency representative can dispose of the assets) and whether encumbered assets can be sold free and clear of interests. It may also depend on the nature of the sale proposed, whether as an individual asset or as an integral part of a sale of the business as a going concern. Some insolvency laws, for example, provide that only the insolvency representative will be able to dispose of encumbered assets in both liquidation and reorganization. Other laws distinguish between liquidation and reorganization; the insolvency representative will be able to

dispose of the assets during reorganization, but in liquidation this ability is time limited and once the insolvency representative's exclusive period has expired, the secured creditor may exercise its rights. Whichever approach is adopted an insolvency law should include requirements for provision of notice to secured creditors and an opportunity for them to object. However, where the claim exceeds the value of the asset or the asset is not required for the proceedings, the insolvency representative may be permitted to relinquish the encumbered asset to the secured creditor without notice.

230. An insolvency law should also outline the conditions for further encumbrance of assets subject to existing security interests, the most common being that the existing secured creditor will have priority for the secured portion of its claim over any new secured creditor (see chapter II.D.3).

**(d) Ability of the insolvency representative to sell free and clear of interests**

231. Some insolvency laws provide that the insolvency representative can sell assets of the estate free and clear of interests, including security interests, subject to certain conditions. These may include that the sale is permitted under general law other than the insolvency law; that the holder of the interest is notified of the proposed sale and consents; that the sale price is in excess of the value of the security interest; that the holder of the security interest could be compelled (in other legal proceedings) to accept cash or substitute equivalent security in settlement of its interest; and that the priority of interests in the proceeds of any sale will be preserved. Some laws also provide that where the holder of the security interest does not consent to the sale, the insolvency representative may apply to the court for authorization of the sale. This may be granted provided the court is satisfied, for example, that the insolvency representative has made reasonable efforts to obtain the consent, that the sale is in the interests of the debtor and its creditors and that the sale will not substantially prejudice the holder of the interest. Even where the court approves the sale, if the offer for the asset was inadequate, the law might permit the holder of the security interest to retain the right to offset the bid to protect its interest.

232. Some advantages of allowing the insolvency representative to sell free and clear are that assets sold subject to these interests are likely to obtain much lower prices and considerable uncertainty will exist for the buyer. Where encumbered assets are subject to conflicting claims (e.g. ownership, lease or lien) the ability to sell free and clear of interests will allow the assets (where they are not unique) to be sold without waiting for the claims to be resolved and the claimants can then dispute the distribution of the proceeds of sale.

**(e) Joint assets**

233. Where assets are owned by the debtor and another person in some form of joint or co-ownership, different approaches may be taken to the disposal of the debtor's interest. Where the assets can be divided under the general law between the debtor and the co-owners for the purposes of execution, the insolvency estate's interest can be sold without affecting the co-owners. Some insolvency laws, however, provide that both the estate's interest and the interest of co-owners may be sold by the insolvency representative where certain conditions are met. These conditions may include that division of the property between the estate and the co-

owners is impractical, that the sale of a divided part would realize significantly less for the estate than a sale of the undivided whole free of the interests of the co-owners, and that the benefit to the estate of such a sale outweighs any detriment to the co-owner. The insolvency law may also provide that the co-owner has an option or right to purchase the debtor's interest before completion of the sale to another party. As noted above (chapter II.A.2) the disposal of such assets in insolvency may be affected by the application of other law.

**(f) Burdensome, no value and hard to realize assets**

234. It may be consistent with the objective of maximizing value and reducing the costs of the proceedings to allow the insolvency representative to relinquish the estate's interest in certain assets, including land, shares, assets subject to a valid security interest, contracts and other property, where the insolvency representative determines relinquishment to be in the interests of the estate, and additionally where a secured creditor obtains relief from the stay. The exercise of that power may be subject to approval by the court and to certain conditions, such as that the relinquishment does not violate any compelling public interest, for example where the asset is environmentally dangerous or hazardous to public health and safety. Situations in which this approach may be appropriate include where assets have a no or insignificant value to the estate, where the asset is burdened in such a way that retention would require excessive expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money; or where the asset is unsaleable or not readily saleable by the insolvency representative, such as where the asset is unique or does not have a readily apparent market or market value. Creditors should be provided with notice of, and given an opportunity to object to, any proposal by the insolvency representative to relinquish assets.

**(g) Receivables**

235. Where the assets of the estate include receivables (the debtor's contractual right to payment of a monetary sum), it may be advantageous for the insolvency representative to be able to assign the rights to payment to obtain, for example, value for the estate or credit. Different approaches are taken to the question of assignment in the context of insolvency (see chapter II.D). Some insolvency laws specify that non-assignment clauses are made null and void by the commencement of insolvency proceedings. Other insolvency laws leave the matter to general contract law. If the contract contains a non-assignment clause then the contract cannot be assigned unless the agreement of the parties to the original contract is obtained. Some laws also provide that if the counterparty to the original contract does not consent to assignment, the insolvency representative may assign with permission from the court if it can be shown that the counterparty is withholding consent unreasonably. The insolvency representative is then free to assign the contract for the benefit of the estate. This approach is consistent with the approach taken in the UNCITRAL Convention on the Assignment of Receivables in International Trade (2001), article 9.<sup>54</sup>

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<sup>54</sup> Article 9 Contractual limitations on assignments:

1. An assignment of a receivable is effective notwithstanding any agreement between the initial or any subsequent assignor and the debtor or any subsequent assignee limiting in any way the assignor's right to assign its receivables.

### 3. Third party owned assets

236. There will be insolvency cases where third party owned assets, similarly to encumbered assets, may be crucial to the continued operation of the business, particularly in reorganization proceedings but also to a lesser extent in some liquidation proceedings where the business is to be sold as a going concern. In those cases, it will be advantageous for an insolvency law to provide some mechanism that will enable these assets to continue to be used in the insolvency proceedings. Some insolvency laws address this issue in terms of the types of assets to be included as part of the insolvency estate (see chapter II.A.2(c) and 3(a)). Other insolvency laws, where the possession of the asset by the debtor is subject to a contractual arrangement, address it in the context of the treatment of contracts (see chapter II.E). This may include, for example, imposing restrictions on the termination of the contract pursuant to which the debtor holds the assets (see chapter II.E.2(a)), or preventing the owner from reclaiming its assets in the insolvency (at least without the approval of the court or the insolvency representative) for a limited period of time after commencement by imposing of a stay.

237. Where third party owned assets are used in the insolvency proceedings, an insolvency law will need to consider protection of the interests of the owner of the assets against diminution in their value, in much the same way as protection is provided for secured creditors against diminution in the value of encumbered assets (see chapter II.B.3(b)). It is desirable that any benefits conferred on the estate by the continued use of the asset be paid for by the estate as an expense of administering the estate (see chapter II.E).

### 4. Treatment of cash proceeds

238. Where “liquid” encumbered assets, i.e. encumbered assets, such as inventory, that are easily converted to cash, are sold in the course of insolvency proceedings, most laws provide that a secured creditor with an interest in an encumbered asset continues to hold an equivalent interest in any cash derived from the disposal of that asset.

239. Those cash proceeds can represent an important source of capital for the insolvency estate during the course of insolvency proceedings, especially in reorganization, and may be used for a number of purposes associated with the running of the business, such as payment of electricity and other service charges. In order to use cash proceeds, an insolvency representative must generally pursue one of two courses of action. Cash proceeds may be used with the consent of the relevant secured creditor on the terms agreed between the parties or, alternatively,

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2. Nothing in this article affects any obligation or liability of the assignor for breach of such an agreement, but the other party to such agreement may not avoid the original contract or the assignment contract on the sole ground of that breach. A person who is not party to such an agreement is not liable on the sole ground that it had knowledge of the agreement.

3. This article applies only to assignments of receivables:

(a) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of real property;

(b) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;

(c) Representing the payment obligation for a credit card transaction; or

(d) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties.

following provision of notice to effected creditors, the debtor may seek a court order to use the cash proceeds. In general, a court will make three inquiries before authorizing such use: both the relevant security interest and the value of the underlying property will need to be determined; the risk to the secured creditor will need to be identified; and the court will need to determine whether sufficient measures are in place to protect the economic value of the secured claim (see chapter II.B. 8(b))

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on use and disposal of assets is to:

- (a) permit the use of assets, including encumbered assets and assets owned by a third party in the insolvency proceedings and specify the conditions for their disposal;
- (b) establish the limits to powers of use and disposal;
- (c) provide notice to creditors of proposed disposal, where appropriate;
- (d) provide for the treatment of burdensome assets.

### **Contents of legislative provisions**

#### *Power to use and dispose of assets of the estate*

(40) The law should permit:

- (a) the use and disposal of assets of the estate (including assets subject to security interests) in the ordinary course of business;
- (b) the use or disposal of assets of the estate (including assets subject to security interests) other than in the ordinary course of business, subject to the requirements of recommendations (41) and (44).

#### *Notification and publication of disposal*

(41) The law should specify that adequate notice of any disposal conducted outside the ordinary course of business is given to creditors<sup>55</sup> and that they have the opportunity to object.

(42) The law should specify that public auctions are publicised in a manner that will ensure the information is likely to come to the attention of interested parties.

#### *Ability to sell assets of the estate free and clear of encumbrances and other interests*

##### *- Sale in the ordinary course of business*

(43) The law may permit the insolvency representative to sell assets of the estate free and clear of encumbrances and other interests, in the ordinary course of business, provided that:

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<sup>55</sup> When the assets used in the insolvency proceedings are encumbered assets, that use will also be subject to recommendation (43).



- (a) the insolvency representative gives notice of the proposed sale to the holders of encumbrances or other interests;
- (b) the holders are given the opportunity to object to the proposed sale;
- (c) relief from the stay has not been granted;
- (d) the priority of interests in the proceeds of sale of the asset is preserved.

*- Sale outside the ordinary course of business*

[(44) The law may permit the insolvency representative to sell assets of the estate free and clear of encumbrances and other interests outside the ordinary course of business provided that the requirements of recommendations (41) and (43) are met.]

*General methods of sale*

(45) The law should specify methods of sale for sales conducted outside the ordinary course of business that will maximize the price obtained for assets being sold in insolvency proceedings, and permit both public auctions and private sales.

*Urgent sales*

(46) The law should permit urgent sales of assets to be conducted outside the ordinary course of business, where the assets by their nature or because of other circumstances, are perishable, susceptible to devaluation or otherwise in jeopardy. The law may provide that prior approval of the court or of creditors is not required in such circumstances.

*Disposal of assets to related persons*

(47) The law should require any proposed disposal of assets to related persons to be carefully scrutinised before being allowed to proceed.

*Burdensome assets*

(48) The law should permit the insolvency representative to determine the treatment of any assets that are burdensome to the estate. In particular, the law may permit the insolvency representative to relinquish burdensome assets following the provision of notice to creditors and the opportunity for creditors to object to the proposed action, except that where a secured claim exceeds the value of the encumbered asset, and the asset is not required for a reorganization or sale of the business as going concern, the law may permit the insolvency representative to relinquish the asset to the secured creditor without notice to other creditors.

## **D. Post-commencement finance**

### **1. Need for post-commencement finance**

240. The continued operation of the debtor's business after the commencement of insolvency proceedings is critical to reorganization and, to a lesser extent, liquidation where the business is to be sold as a going concern. To maintain its business activities, the debtor must have access to funds to enable it to continue to

pay for crucial supplies of goods and services, including labour costs, insurance, rent, maintenance of contracts and other operating expenses, as well as costs associated with maintaining the value of assets. In some insolvency cases, the debtor may already have sufficient liquid assets to fund the ongoing business expenses in the form of cash or other assets that can be converted to cash (such as anticipated proceeds of receivables). Alternatively, those expenses can be funded out of the debtor's existing cash flow through operation of the stay and cessation of payments on pre-commencement liabilities. Where the debtor has no available funds to meet its immediate cash flow needs, it will have to seek financing from third parties. This financing may take the form of trade credit extended to the debtor by vendors of goods and services, or loans or other forms of finance extended by lenders.

241. To ensure the continuity of the business where this is the object of the proceedings, it is highly desirable that a determination on the need for new finance is made at an early stage, in some cases even in the period between the making of the application and commencement of proceedings. Beyond that initial period, particularly in reorganization proceedings, the availability of new finance will also be important after commencement of the proceedings and before consideration of the plan; obtaining finance in the period after approval of the plan generally should be addressed in the plan, especially in those jurisdictions which prohibit new borrowing unless the need for it is identified in the plan.

242. Notwithstanding that it might be desirable for the proceedings for the debtor to be able to obtain new money, a number of jurisdictions restrict the provision of new money in insolvency or do not specifically address the issue of new finance or the priority for its repayment in insolvency, creating uncertainty. Under some laws, for example, new money can only be provided on the basis of security as provision of a preference for new lending is prohibited. In those cases where there are no unencumbered assets that the debtor can offer as security or no excess value in already encumbered assets, no new money will be available unless the lender is prepared to take the risk of lending without security or unless it can be obtained from sources such as the debtor's family or group companies. The provision of finance in the period before commencement may also raise difficult questions relating to the application of avoidance powers and the liability of both the lender and the debtor. Some insolvency laws provide, for example, that where a lender advances funds to an insolvent debtor, it may be responsible for any increase in the liabilities of other creditors or the advance will be subject to avoidance in any ensuing insolvency proceedings. In other examples, the insolvency representative is required to borrow the money, potentially involving questions of personal liability for repayment.

243. Where an insolvency law promotes the use of insolvency proceedings that require the insolvent business to continue trading, whether it be reorganization or sale of the business in liquidation as a going concern, it is essential that the issue of new funding is addressed and limitations such as those discussed above are considered. An insolvency law can recognize the need for such post-commencement finance, provide authorization for it and create priority for repayment of the lender. The central issue is the scope of the power, and in particular, the inducements that can be offered to a potential creditor to encourage it to lend. To the extent that the solution adopted impacts the rights of existing secured creditors or those holding an

interest in assets that was established prior in time, it is desirable that provisions addressing post-commencement finance are balanced against the general need to uphold commercial bargains, protect the pre-existing rights and priorities of creditors and minimize any negative impact on the availability of credit, in particular secured finance, that may result from interfering with those pre-existing security rights and priorities. It is also important to consider the impact on unsecured creditors who may see the remaining unsecured assets disappear to secure new lending, leaving nothing available for distribution, especially if the reorganisation were to fail.

244. In addition to issues of availability and security or priority for new lending, an insolvency law will need to consider the authorization required to obtain that new money (discussed further below) and, where a reorganization fails and the proceedings are converted to liquidation, the treatment of funds that may have been advanced before the conversion (discussed further below).

## **2. Sources of post-commencement finance**

245. Post-commencement lending is likely to come from a limited number of sources. The first is pre-insolvency lenders or vendors of goods who have an ongoing relationship with the debtor and its business and may advance new funds or provide trade credit in order to enhance the likelihood of recovering their existing claims and perhaps gaining additional value through the higher rates charged for the new lending. A second type of lender has no pre-insolvency connection with the business of the debtor and is likely to be motivated only by the possibility of high returns. The inducement for both types of lender is the certainty that special treatment will be accorded to the post-commencement finance. For existing lenders there are the additional inducements of the ongoing relationship with the debtor and its business, the assurance that the terms of their pre-commencement lending will not be altered and under some laws, the possibility that, if they do not provide post-commencement finance, their priority may be displaced by the lender who does provide that finance.

## **3. Attracting post-commencement finance—providing security or priority**

246. A number of different approaches can be taken to attracting post-commencement finance and providing for repayment, including the provision of security on unencumbered or partially encumbered assets or, where that option is not available, establishing a priority.

### **(a) Granting security**

247. Where the lender requires security, it can be provided on unencumbered property or as a junior or lower security interest on already encumbered property where the value of the encumbered asset is significantly in excess of the amount of the pre-existing secured obligation. In that case, no special protections will generally be required for the pre-existing secured creditor, as their rights will not be adversely affected unless circumstances change at a later time (such as that the value of the encumbered assets begin to erode) and they will retain their pre-commencement priority in the encumbered asset, unless they agree otherwise. Frequently, the only unencumbered assets that may be available for securing post-commencement finance will be assets recovered through avoidance proceedings.

**(b) Establishing priority**

248. Where the approaches discussed above are either insufficient or not available, for example because there are no unencumbered assets or there is no excess value in those assets already encumbered, insolvency laws adopt a variety of approaches to encouraging the provision of new finance.

249. Some insolvency laws provide that new lending will be afforded some level of priority over other creditors, in some cases including existing secured creditors. One level of priority is classed as an administrative priority (see chapter V.B), which will rank ahead of ordinary unsecured creditors, but not ahead of a secured creditor with respect to its security. In some cases, this priority is afforded on the basis that the new lending is extended to the insolvency representative, rather than to the debtor, and becomes an expense of the insolvency estate. Some insolvency laws require such borrowing to be approved by the court or by creditors, while other laws provide that the insolvency representative may obtain the necessary finance without approval, although this may involve an element of personal liability and, where it does, is likely to result in reluctance to seek new finance.

250. Other insolvency laws provide for a “super” administrative priority, which ranks ahead of administrative creditors or a priority that ranks ahead of all creditors, including secured creditors (sometimes referred to as a “priming lien”). In countries where this latter type of priority is permitted, insolvency courts recognize the risk to the existing secured creditors and authorize these types of priority reluctantly and as a last resort. The granting of such a priority may be subject to certain conditions such as the provision of notice to affected secured creditors and the opportunity for them to be heard by the court; proof by the debtor that it is unable to obtain the necessary finance without the priority; and the provision of protection for any diminution of the economic value of encumbered assets, including by a sufficient excess in the value of the encumbered asset so that the existing secured creditor will not be exposed to an unreasonable risk that its position will be affected beyond that of the super priority. In some legal systems, all of these options for attracting post-commencement finance are available. As a general rule, the economic value of the rights of pre-existing secured creditors should be protected so that they will not be unreasonably harmed. If necessary (and as already discussed in relation to protection of the insolvency estate: see chapter II.B.8) this can be achieved by making periodic payments or providing security rights in additional assets in substitution for any assets that may be used by the debtor or encumbered in favour of new lending.

**4. Authorization for post-commencement finance**

251. It may be desirable to link the issue of authorization for new lending to the damage that may occur or the benefit that is likely to be provided as a result of the provision of new finance. A number of insolvency laws permit the insolvency representative to determine that new money is required for the continued operation or survival of the business or the preservation or enhancement of the value of the estate and provide that the insolvency representative (or a debtor-in-possession where that approach is followed) can obtain unsecured credit without approval by the court or by creditors, while other laws require approval by the court or creditors in certain circumstances. Given that new finance may be required on a fairly urgent basis to ensure the continuity of the business, it is desirable that the number of authorizations required be kept to a minimum, although clearly an insolvency law may take a

hierarchical approach, depending upon the security or priority to be provided. Although generally requiring court involvement may assist in promoting transparency and provide additional assurance to lenders, in many instances the insolvency representative may be in a better position to assess the need for new finance. In any event, the court generally will not have expertise or information additional to that provided by the insolvency representative on which to base its decision.

252. The question of providing security over unencumbered assets or assets that are not fully encumbered is not one that should generally require approval of the court. Where the insolvency law establishes the level of priority that generally can be given, for example, an administrative priority, court approval may not be required. Should court approval be considered desirable, an intermediate approach may be to establish a threshold above which approval of the court is required. However, where the security or priority to be given affects the interests, for example, of existing secured creditors and those secured creditors do not support what is proposed, approval of the court should be required. Where secured creditors consent to revised treatment of their security interests, approval of the court may not be required.

#### **5. Effects of conversion**

253. Some insolvency laws provide that any security provided in respect of new lending can be set aside in a subsequent liquidation, and may give rise to liability for delaying the commencement of liquidation and potentially damaging the interests of creditors. Such an approach has the potential to act as a disincentive to commence reorganization. A more desirable approach may be to provide that creditors obtaining priority for new funding will retain that priority in any subsequent liquidation. A further approach provides that the priority will be recognized in a subsequent liquidation, but will not necessarily be accorded the same level of priority and may rank, for example, after administrative claims relating to the costs of the liquidation or *pari passu* with administrative expenses.

### **Recommendations**

#### **Purpose of legislative provisions**

The purpose of provisions on post-commencement finance is to:

- (a) facilitate finance to be obtained for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the assets of the estate;
- (b) ensure appropriate protection for the providers of post-commencement finance;
- (c) ensure appropriate protection for those parties whose rights may be affected by the provision of post-commencement finance.

#### **Contents of legislative provisions**

(49) The law should facilitate the insolvency representative obtaining post-commencement finance where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the

preservation or enhancement of the value of the assets of the estate. The law may require authorization by the court or creditors (or the creditor committee).

*Security for post-commencement finance*

(50) The law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on unencumbered assets, including after-acquired assets, or a junior or lower priority security interest on already encumbered assets of the estate.

(51) The law<sup>56</sup> should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation (52).

(52) The law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interest provided specified conditions are satisfied, including:

- (a) the existing secured creditor was given the opportunity to be heard by the court;
- (b) the debtor can prove that it cannot obtain the finance in any other way;
- (c) the interests of the existing secured creditor will be protected,<sup>57</sup> including by a sufficient excess in the value of the encumbered asset so that the existing secured creditor will not be exposed to an unreasonable risk of harm.

*Priority for post-commencement finance*

(53) The law should establish the priority that may be accorded to post-commencement finance, ensuring at least the payment of the post-commencement finance provider ahead of ordinary unsecured creditors including those unsecured creditors with administrative priority.

*Effect of conversion on post-commencement finance*

(54) Where reorganization proceedings are converted to liquidation, the insolvency law should specify that any priority provided to post-commencement finance in the reorganization should continue to be recognized in the liquidation.<sup>58</sup>

## **E. Treatment of contracts**

### **1. Introduction**

254. As an economy develops, more and more of its wealth is likely to be contained in or controlled by contracts. As a result, the treatment of contracts is of overriding

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<sup>56</sup> This rule may be in a law other than the insolvency law, in which case the insolvency law should note the existence of the provision.

<sup>57</sup> See chapter II.B.8.

<sup>58</sup> The same order of priority may not necessarily be recognized. For example, post-commencement finance may rank in priority after administrative claims relating to the costs of the liquidation.

importance in insolvency. There are two overall difficulties in developing legal policies in that regard. The first difficulty is that, unlike all other assets of the insolvency estate, contracts usually are tied to liabilities or claims. That is, it is often the case that the estate must perform or pay in order to enjoy the rights that are potentially valuable assets. The result is that difficult decisions must be made about the treatment of a contract so as to produce the most value for the estate. A second difficulty is that contracts are of many different types. They include simple contracts for the sale of goods; short-term or long-term leases of land or of personal property; and immensely complicated contracts for franchises or for the construction and operation of major facilities, among many others. Additionally, the debtor could be involved in the contract as buyer or seller, lessor or lessee, licensor or licensee, provider or receiver and the problems presented in insolvency may be very different when viewed from different sides.

255. Achieving the objectives of maximizing the value of the estate and reducing liabilities and, in reorganization, enabling the debtor to survive and continue its affairs to the maximum extent possible in an uninterrupted manner may involve taking advantage of those contracts that are beneficial and contribute value to the estate (including contracts that will enable the continued use of crucial property that may be owned by a third party), and rejecting those that are burdensome, or those where the ongoing costs of performance exceed the benefit to be derived from the contract. As an example, in a contract where the debtor has agreed to purchase particular goods at a price which is half the market price at the time of the insolvency, obviously it would be advantageous to the insolvency representative to be able to continue to purchase at the lower price and sell at the market price. The counterparty would naturally like to get out of what is now an unprofitable agreement, but to require performance of the contract demands no more of the counterparty than that it observe the bargain it made prior to insolvency. In many systems it will not be permitted to escape performance of the contract, although it may be entitled to an assurance that it will be paid the contract price in full. In many examples, continuation of the contract will be beneficial to both contracting parties, not just to the debtor.

256. Deciding how contracts are to be treated in insolvency raises an initial question of the relative weight to be attached to upholding general contract law in insolvency on the one hand and the factors justifying interference with those established contractual principles on the other. A number of competing interests may need to be weighed to ensure an appropriate balance is achieved between general public policy goals, the goals of insolvency and the need for predictability in commercial relations. These interests include the relative importance of reorganization and the involvement of secured creditors in insolvency; particular social concerns raised by some types of contracts such as labour contracts (see below); the effect of permitting interference with the continuation of performance of contracts on commencement of insolvency proceedings, on the predictability of commercial and financial relations, and on the cost and availability of credit (the wider the powers to continue or reject contracts in insolvency, the higher the cost and the lower the availability of credit is likely to be); as well as the extent to which the powers to affect the performance of contracts will enhance the reuse of assets.

257. Where the insolvency law adopts the approach of permitting the performance of contracts to be affected in circumstances that may be contrary to general

contractual principles, further considerations are the extent of those powers and the types of contracts that can be affected. It is almost inevitable that at the commencement of insolvency proceedings, the debtor will be a party to at least one contract where both the debtor and the counterparty have remaining obligations to be performed other than the payment of money for goods delivered. No special rules are required for the situation where only one party has not fully performed its obligations. If it is the debtor that has not fully performed, the other party will have a claim for performance or damages which it can submit in the insolvency (see chapter V.A). If it is the counterparty that has not fully performed its obligations, the insolvency representative can demand performance or damages from that party. However, where both parties have not fully performed their obligations, it is a common feature of many insolvency laws that in defined circumstances, those contracts may be subject to the stay in a manner that prevents the counterparty from exercising a right of termination and they can be continued or rejected (or possibly assigned, although this is not widely permitted). Typically, the insolvency representative is charged with making this evaluation of how the contract should be treated. Jurisdictions differ, however, on the question of whether court approval is also required.

258. In reorganization, where the objective of the proceedings is to enable the debtor to survive and continue its affairs to the extent possible, the continuation of contracts that are beneficial or essential to the debtor's business and contribute value to the estate may be crucial to the success of the proceedings. These may include contracts for the supply of essential goods and services or contracts concerning the use of property crucial to the continued operation of the business, including property owned by third parties. Similarly, the prospects of success may be enhanced by allowing the insolvency representative to reject burdensome contracts, such as those contracts where the cost of performance is higher than the benefits to be received or, in the case, for example, of an unexpired lease, the contract rate exceeds the market rate. In liquidation, the desirability of contracts continuing after commencement of proceedings is likely to be less important than in reorganization, except where the contract may add value to the debtor's business or to a particular asset or promote the sale of the business as a going concern. A lease agreement, for example, where the rental is below market price and the remaining term is substantial, may prove central to any proposed sale of the business or may be sold to produce value for creditors.

259. As to the types of contracts to be affected, a common solution is for insolvency laws to provide general rules for all kinds of contracts and exceptions for certain special contracts. The ability to reject labour contracts, for example, may need to be limited in view of concerns that insolvency can be used as a means of expressly eliminating the protections that these contracts afford to employees. Other types of contracts requiring special treatment may include financial contracts (see chapter II.H), contracts for personal services, where the identity of the party to perform the agreement, whether the debtor itself or an employee of the debtor, is of particular importance, as well as contracts for loans and contracts for insurance.

## **2. Automatic termination clauses**

260. Many contracts include a clause that defines events of default giving the counterparty an unconditional right, for example, of termination or acceleration of



the contract (sometimes referred to as “ipso facto” clauses). These events of default commonly include the making of an application for commencement, or commencement, of insolvency proceedings; the appointment of an insolvency representative; the fact that the debtor satisfies the criteria for commencement of insolvency proceedings; and even indications that the debtor is in a weakened financial position. Some laws uphold the validity of these termination or acceleration clauses. In those cases where it is desirable that a contract continue to be performed after commencement of insolvency proceedings, this will only be possible if the counterparty does not elect, or can be persuaded not to elect, to exercise its rights under the contract or if the insolvency law includes a mechanism that can be used to persuade the counterparty to allow the contract to continue. Such a mechanism may include establishing a priority for payment for services provided after the commencement of proceedings (in some insolvency laws this may exist as a general provision which typically treats costs incurred after the commencement of proceedings as a first priority).

261. The approach of upholding these types of termination clauses may be supported by a number of factors including the desirability of respecting commercial bargains; the need to prevent the debtor from selectively performing contracts which are profitable and cancelling others (an advantage which is not available to the counterparty); the effect on financial contract netting of not upholding an automatic termination provision; the belief that since an insolvent business will generally be unable to pay, delaying the termination of contracts potentially only increases existing levels of debt; the need for creators of intellectual property to be able to control the use of that property; and the effect on the counterparty’s business of termination of a contract, especially one with respect to an intangible.

262. A different approach recognizes that a clause permitting termination or acceleration of a contract on the occurrence of a defined event of default, such as those noted above, is overridden by operation of the insolvency law, and the contract can be continued over the objection of the counterparty. In the first instance the counterparty’s right of termination will be subject to the stay, providing the insolvency representative with time to consider the contract and decide what action should be taken. Although the approach of overriding termination clauses can be regarded as interfering with general principles of contract law, nevertheless such interference may be crucial to the success of the proceedings. In reorganization, where, for example, the contract is a critical lease or involve the use of intellectual property embedded in a key product, continuing the contract may enhance the earnings potential of the business; reduce the bargaining power of an essential supplier; capture the value of the debtor’s contracts for the benefit of all creditors and assist in locking all creditors into a reorganization.

263. In liquidation, the arguments in favour of overriding termination clauses include the need to keep the business together to maximize its sale value or to enhance its earnings potential; to capture the value of the contract for the benefit of all creditors rather than forfeiting it to the counterparty; and the desirability of locking all parties into the final disposal of the business.

264. Although some insolvency laws do permit termination clauses to be overridden if insolvency proceedings are commenced, these clauses have not yet become a general feature of insolvency laws. There is an inherent tension between

promoting the debtor's survival, which may require the preservation of contracts, and injecting unpredictability and extra cost into commercial dealings by creating a variety of exceptions to general contract rules. While this issue clearly is one that may require a careful weighing of the advantages and disadvantages there are, nevertheless, circumstances where the ability of the insolvency representative to ensure that a contract continues will be crucial to the success of reorganization and also, but perhaps to a lesser extent, liquidation where the business is to be sold as a going concern. For these reasons, it is desirable that an insolvency law permit such clauses to be overridden. Any negative impact of a policy of overriding termination clauses can be balanced by providing compensation to creditors who can demonstrate that they have suffered damage or loss as a result of the contract continuing after commencement of insolvency proceedings, or including exceptions to a general override of automatic termination clauses for certain types of contracts, such as contracts to lend money and, in particular, financial contracts (see chapter II.H).

265. Where an insolvency law provides that termination clauses can be overridden, creditors may be tempted to take pre-emptive action to avoid that outcome by terminating the contract on some other ground before the application for insolvency proceedings is made (assuming a default by the debtor other than one triggered by commencement of the proceedings). Such a result may be mitigated by providing that the insolvency representative has the power to reinstate those contracts, provided both pre- and post-commencement obligations are fulfilled.

### **3. Continuation or rejection of contracts**

#### **(a) Procedure for continuation or rejection of contracts**

266. Insolvency laws adopt different approaches to continuation and rejection of contracts. Under some laws, contracts are unaffected by the commencement of insolvency proceedings so that contractual obligations remain binding and the general rules of contract law will continue to apply unless the insolvency law expressly provides for different rules, such as an express power to override automatic termination clauses (see above) or to reject a contract.

267. Other laws link continuation and rejection in a common procedure which requires the insolvency representative to take some positive action with respect to a contract, such as providing notice to the counterparty that the contract is to continue (and in some cases be adopted by the insolvency estate) or be rejected. Under laws that adopt this approach, the stay should apply to the counterparty's right to terminate, allowing the insolvency representative time to consider what action should be taken with respect to the contract (see chapter II.B). One disadvantage of the approach of requiring the insolvency representative to take positive action on all contracts is that in practice there may be many cases where no decision as to the contract can be taken because the contract cannot be performed. To require an explicit choice to be made on every contract also could be excessively costly and cumbersome. A further difficulty associated with this approach relates to whether or not the insolvency representative is well informed of all contracts to which the debtor is a party, and is therefore in a position to take action with respect to each one. The manner in which the law deals with contracts of which the insolvency representative is not aware, particularly in terms of default rules, is therefore important.

(i) *Specifying time periods*

268. Some laws requiring a positive action also require that action to be taken within a specified period of time (with perhaps provision for extension in certain circumstances), which would generally be longer in reorganization than in liquidation. Examples of specific time periods vary from 28 to 60 days. Other laws provide for the time period to be determined by the court. This approach is aimed at ensuring certainty for both parties. It requires the insolvency representative to take timely action with respect to contracts outstanding at the time of commencement and offers the counterparty some certainty as to the continued performance of the contract within a reasonable period after commencement of proceedings.

(ii) *Default rules*

269. A number of laws adopt a default rule to the effect that failure of the insolvency representative to act within the specified time results in the contract being treated, for example, as rejected or unenforceable. Where a default rule is adopted, a distinction between liquidation and reorganization might be made, as well as a distinction between those contracts of which the insolvency representative is aware and those of which it is not aware. In liquidation, since it may be reasonable to assume that the failure of the insolvency representative to take a decision with respect to a contract would most likely imply a decision to reject, contracts could be automatically rejected unless action is taken to preserve a contract. That result would be consistent with the goal of liquidation where it requires piecemeal sale of the assets.

270. The same assumption may not always be appropriate in reorganization or sale of the business as a going concern and more flexibility might be required to avoid a situation where the failure to take a timely decision deprives the estate of a contract that might be crucial for the proceedings. Accordingly, it may be appropriate to allow the insolvency representative to make a decision as to rejection up to the time of approval of the reorganization plan, provided that any benefit received under the contract is paid for up to the time of rejection as an administrative expense and that the counterparty has the ability to compel an earlier decision where it is required or desired. It is desirable that treatment of specific contracts is addressed clearly in the plan, with perhaps a provision that contracts not so addressed should be treated as automatically rejected on approval of the plan.

(iii) *Right of counterparty to demand a decision*

271. Some laws provide that the counterparty has an unconditional right to request the insolvency representative to make a decision on a particular contract within a specified period of time. Such a rule may apply even where the insolvency law specifies a time limit for the insolvency representative to make a decision as it will enable the counterparty to seek a decision without having to wait for the time limit to expire. This may be of particular importance where the contract in question involves provision of an ongoing service, and failure by the insolvency representative to act may lead to the accrual of unnecessary expense (e.g. rent for property which is leased by the debtor can be a significant administrative cost if a lease is not promptly terminated), or to the provision of an essential service being terminated (where the insolvency representative is required to promptly decide that a contract should continue). Where no decision is made by the insolvency

representative within the specified time period, the insolvency law may either permit the counterparty to apply to the court to require a decision to be made or apply a default rule that the contract be treated either as continued or rejected.

(iv) *Continuation of contract as a whole*

272. Whatever rules are adopted with respect to the continuation and rejection of contracts, it is desirable that any rights of the insolvency representative should be limited to the contract as a whole, thus avoiding a situation where the insolvency representative could choose to continue or adopt certain parts of a contract and reject others.

(v) *Contracts known to the insolvency representative*

273. It is also desirable that the insolvency representative's power with respect to contracts is limited to those contracts that are known to it or the court (where the insolvency law requires the court to make determinations with respect to contracts). If this limitation is not adopted, the consequences of failure to take a decision with respect to a contract, the existence of which is not known to the insolvency representative, might lead to claims for damages and possible professional liability. Where the insolvency representative is not aware of a particular contract, it also may be undesirable for the law to apply a default rule that will lead to continuation or rejection before the insolvency representative has had the opportunity to assess the contract. One solution to this issue (to the extent that the debtor complies) would be to include in the law a requirement for the debtor to provide to the insolvency representative a list of contracts that have not been fully performed (see chapter III.A.4(b)).

**(b) Timing and notice of continuation and rejection**

274. Where the law permits the insolvency representative to reject a contract, it will be desirable to establish the time from which the rejection will be effective, whether from the time of making the decision or retroactively. One approach is to make rejection retroactive to the time of application, with the result that no post-application liability will arise under a contract, except in respect of post-application goods or services supplied to the benefit of the estate.

275. Where the law provides for the insolvency representative to take a decision as to continuation or rejection of a contract, it is desirable that it also include a requirement for the giving of notice of that decision to the counterparty or counterparties. The notice should inform the counterparty of its rights, including to challenge the insolvency representative's decision with respect to the contract and to submit a claim in the insolvency (either with respect to a pre-commencement default or arising from the decision on the contract), including the relevant formalities.

**(c) Continuation of contracts where the debtor is in default**

276. Where the debtor is in default under a contract at the time of the application for insolvency, there is a policy issue of whether it is fair to require the counterparty to continue to deal with an insolvent debtor in these circumstances. Some insolvency laws require, as a condition of continuing the performance of such a contract for the remainder of the contract term, that the insolvency representative

cure any defaults by the debtor under the contract (returning the counterparty to the economic position it was in before the default occurred) and guarantee future performance by providing, for example, a bond or guarantee. Other insolvency laws do not require past defaults to be cured, but may impose restrictions as to the circumstances in which performance can be continued, for example, contracts which can be divided into severable units, such as contracts for the supply of utilities, which are billed on a monthly basis. Insolvency laws often specifically allow the continuation of these contracts for the provision of essential services, which may include telephone, electricity, gas, water and waste collection. There is some justification for assuring the debtor access to those services without requiring cure of the default, especially in the case of a creditor application for commencement and, on the basis that the debtor could perform its post-commencement obligations, providing for the continuation of the service. The insolvency representative may be required to guarantee future performance and in some cases accept personal liability in the event of future default.

**(d) Effect of continuation or rejection on the counterparty**

*(i) Continuation*

277. Where a contract continues to be performed after commencement of insolvency proceedings, pending a decision as to how that contract is to be treated, it is desirable that the insolvency estate be required to pay for the post-commencement performance of the contract, particularly where the contract is ultimately rejected. The rationale for such an approach is that it is fair to assume that post-commencement performance of a contract or continued use of a third party asset is of benefit to the estate, or otherwise the insolvency representative would have rejected the contract.

278. Although it is not common for insolvency laws to do so, it may also be desirable to address the question of the obligations of the counterparty in the period between commencement of proceedings and a decision as to treatment of a particular contract (in those cases where such a decision is required), and in particular whether the counterparty is required to commence or continue its performance. Such an approach would satisfy objectives of certainty and predictability for all parties concerned.

279. Under those laws that require a positive action by the insolvency representative, contracts that the insolvency representative elects to continue to perform after commencement are treated as ongoing post-commencement obligations of the debtor that must be performed both by the estate and the counterparty. Claims arising from performance of these contract are treated in a number of insolvency laws as an administrative expense (see chapter V.A) (not as an unsecured claim) and given priority in distribution. Since the granting of such a priority constitutes a potential risk for other creditors (who will be paid after the priority creditors), it is desirable if this approach is followed, that only contracts that will be profitable or essential to the continued operation of the debtor continue after commencement of insolvency proceedings. In those jurisdictions where the general rules of contract law will apply and no decision as to continuation is required from the insolvency representative, the insolvency law may provide that such claims will have no priority and be ranked with other unsecured claims.

280. Since continuation of a contract with a party subject to insolvency proceedings may involve an element of risk for the counterparty that would not otherwise have arisen, such as non-payment, it may be appropriate for the insolvency law to consider whether certain measures of protection should be afforded the counterparty. A number of factors will need to be weighed, including the importance of the contract to the proceedings; the cost to the proceedings of providing the necessary protections; whether the debtor or the estate will be able to actually perform the obligations under the continued contract; and the impact on commercial contracting of forcing the counterparty to assume the risk of non-payment. If the contract provides, for example, for the seller to extend credit to the debtor for a certain period of time before requiring payment, or provides for payment on delivery, the seller may incur substantial costs and suffer harm if by the time of the payment or the delivery the insolvency representative is no longer able to pay. Some laws address these issues by requiring the insolvency representative to guarantee payment or performance to the counterparty, such as through a bank guarantee or letter of credit. Under other laws, the insolvency representative may be personally liable for performance, an approach that may have the potential to discourage continuation of contracts where there is some risk of failure and thus affect the reorganization. Personal liability may be particularly onerous in the case of contracts such as labour contracts. Under a further approach, the counterparty is required to assume the risk of non-payment on the basis that that risk is a usual risk of commercial dealings. Providing an administrative priority for claims and payments relating to post-commencement performance under a continued contract may afford a measure of protection to the counterparty (although it may be limited if assets available for the payment of such expenses are limited).

(ii) *Rejection*

281. Where a contract is rejected, the counterparty is generally excused from performing the remainder of the contract and the principal issue to be determined is the remedies that will be available to the counterparty. Many laws provide that the counterparty is only entitled to a remedy in damages, even if other remedies would have been available outside of insolvency. One of the reasons for this approach is that allowing other remedies, such as delivery of goods manufactured but not delivered prior to commencement of insolvency proceedings, would amount to paying the full claim of the counterparty, a result not available to other unsecured creditors and one which represents a departure from the principle of equal treatment. Some laws however do permit such a remedy in respect of the delivery of goods, while other laws permit performance in the case of contracts for the sale of land.

282. Where the remedy is one of damages, calculation of the unsecured damages that result from the rejection might be determined in accordance with applicable general law and the counterparty becomes an unsecured creditor with a claim equal to the determined amount. In addition to damages resulting from the rejection, the counterparty may have a claim with respect to performance of the contract in the period before rejection (which may rank as an administrative claim).<sup>59</sup>

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<sup>59</sup> See chapter V.C on ranking of claims.

**(e) Amendment of continuing contracts**

283. A further issue to be considered in respect of continued contracts is the circumstances in which an insolvency representative may alter the terms and conditions of those contracts. As noted above, the terms and conditions of the contract must be respected and, as a general principle, the insolvency representative will have no greater rights in respect of amendment of the contract than the debtor itself would normally have under the contract. The insolvency representative generally would be required to negotiate any amendment with the counterparty, and any modification without the consent of that other party will constitute a breach of contract for which the counterparty may claim damages.

**4. Leases of land and premises**

284. Some insolvency laws include specific provisions on unexpired leases of land and premises, distinguishing between residential and commercial leases. Commercial leases in particular are often of significance in reorganization cases. For example, leases at below market price represent an asset that might be sold and return a benefit to the estate. The ability to escape a lease of a money-losing location may be an advantage where the debtor needs to reduce the size of its business to ensure the success of reorganization.

285. Under some laws, a lease of which the debtor is the lessee can be rejected without reference to the expiry date, provided the notice periods in the law or the lease are observed. Rejection would give rise to a claim by the lessor for compensation for premature termination. Where the debtor is a lessee and its lease is to continue, it may be appropriate for certain conditions to be imposed on the insolvency estate, such as that the insolvency representative must cure any default, provide compensation for any harm arising from such a default and provide assurance as to future performance under the lease. It may also be desirable to set a ceiling on damages claimed by the lessor (which may be a monetary amount or a specified period of time in respect of which damages may be payable) so that the claim under a long-term lease does not overwhelm the claims of other creditors. Lessors ordinarily will have the opportunity to mitigate losses by re-letting the property.

**5. Assignment**

286. The ability of the insolvency representative to elect to assign a contract notwithstanding insolvency-triggered termination provisions or restrictions on transfer contained in the contract can have significant benefits to the estate, and therefore to the beneficiaries of the proceeds of distribution following liquidation or as part of a reorganization. There may be circumstances, such as where the contract price is lower than the market value, where rejection of the contract may result in a windfall for the counterparty. If the contract can be assigned, the insolvency estate rather than the counterparty will benefit from the difference between the contract and market prices.

287. However, providing for assignment of a contract against the terms of the contract may undermine the contractual rights of the counterparty and raise issues of prejudice, especially where the counterparty has little or no say in the selection of the assignee. It may also be undesirable to compel the transfer of a contract to a transferee who may not be known to the counterparty or with whom the counterparty may not wish to do

business. Different approaches are taken to the issue of assignment. Some insolvency laws specify that non-assignment clauses are made null and void by the commencement of insolvency proceedings. Other insolvency laws leave the matter to general contract law; if the contract contains a non-assignment clause then the contract cannot be assigned unless the counterparty or of all parties to the original contract agree. Some of these laws also provide that if the counterparty does not consent to assignment, the court may approve the assignment if certain conditions are met, for example, it can be shown that the counterparty is withholding consent unreasonably, if the counterparty will not be substantially disadvantaged by the assignment, or if the insolvency representative can demonstrate to the counterparty that the assignee can adequately perform the contract. The insolvency representative is then free to assign the contract for the benefit of the estate.<sup>60</sup>

288. Where an insolvency law allows assignment of contracts, it would be highly desirable to also require the debtor to cure any defaults prior to the assignment of a contract. This would help ensure a successful problem-free substitution of the assignee for the debtor as the contracting party.

289. Irrespective of the powers of the insolvency representative to assign contracts, some contracts cannot be assigned because they require the performance of irreplaceable personal services or because assignment is prevented by the operation of law. Some countries, for example, prevent the assignment of government procurement contracts.

#### **6. General exceptions to the power to continue, reject and assign contracts**

290. Exceptions to the powers of the insolvency representative with respect to treatment of contracts generally fall into two categories. In respect of the first, where the insolvency representative has the power to override automatic termination provisions, specific exceptions may be desirable for contracts such as short-term financial contracts (e.g. swap and futures contracts—see chapter II.H). Other contracts in this category might include insurance contracts and contracts for the making of a loan. Limitations to the power to reject may also be appropriate in the case of labour agreements and agreements where the debtor is a lessor or franchisor, or a licensor of intellectual property and termination of the agreement would end or seriously affect the business of the counterparty, particularly where the advantage to the debtor may be relatively minor. Limitations may also apply in the case of contracts with government, such as licensing agreements and procurement contracts.

##### **(a) Labour contracts**

291. As noted above, one important exception to the powers discussed in this section is that of labour contracts. Although particularly relevant to reorganization, such contracts are also relevant in liquidation where the insolvency representative is attempting to sell the debtor's business as a going concern. A higher price may be obtained if the insolvency representative is able to terminate onerous labour contracts or to achieve necessary downsizing of the labour force of the debtor. However, the relationship between employee and employer raises some of the most difficult questions in insolvency law. It is not simply the contract itself, which in essence is a

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<sup>60</sup> This approach is consistent, for example, with the approach taken in the UNCITRAL Convention on the Assignment of Receivables in International Trade (2001), article 9.



pending contract like any other contract, but also the usually mandatory provisions of other laws that protect the position of employees. These may relate, for example, to unfair dismissal; minimum rates of pay; paid leave; maximum work periods; maternity leave; equal treatment and non-discrimination. The difficult question is generally the extent to which these provisions will impact upon the insolvency, raising issues that are much broader than termination of the contract and priority of monetary claims in respect of unpaid wages and benefits (see chapter V.A and C). For these reasons, a number of countries have adopted special regimes to deal with the protection of employees' claims in insolvency and, in order to avoid insolvency proceedings being used as a means of eliminating employee protection, these laws specifically limit the insolvency representative's ability to reject labour contracts. This approach may include limiting the use of the powers to certain specified circumstances, for example, where the employee's remuneration is excessive in comparison to what the average employee would receive for the same work. In some countries the law provides for employees to follow the business in case of sale as a going concern in both liquidation and reorganization, in others only in reorganization.

**(b) Contracts for irreplaceable and personal services**

292. Another category relates to those contracts where, irrespective of how the insolvency law treats automatic termination provisions, the contract cannot continue because it provides for performance by the debtor or an employee of the debtor of irreplaceable personal services (the contract may involve, for example, particular intellectual property, services involving a partnership agreement, provision of services by a person with highly specialised skills, or by a named person with a particular skill).

293. To enhance the transparency of the insolvency regime, it is desirable that the limitations on the powers of the insolvency representative to deal with the types of contracts discussed in this section are stated clearly in the insolvency law.

**7. Post-commencement contracts**

294. A further category of contracts in insolvency, in addition to contracts that are not fully performed, is contracts entered into after the proceedings have commenced. In reorganization and where the business is to be sold as a going concern in liquidation, there will often be a need for contracts to be entered into (both in the ordinary course of business and otherwise) to maintain the business as a going concern and enable it to continue earning for the ultimate benefit of creditors. These contracts are generally regarded as post-commencement obligations of the estate and costs and expenses incurred in their performance are paid in full as an expense of the insolvency administration (see chapter V.C).

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on treatment of contracts is to:

- (a) establish the manner in which contracts, under which both the debtor and its counterparty have not yet fully performed their respective obligations, should be addressed in the law, including the relationship between the law and applicable

general law, with the objective of maximizing the value and reducing the liabilities of the estate;

(b) define the scope of the powers to deal with these contracts and the situations in which and by whom these powers may be exercised;

(c) identify the types of contracts that should be excluded from the exercise of these powers;

(d) identify the kinds of protection that will be available to counterparties to continued contracts.

#### **Contents of legislative provisions**

(55) The law should specify the treatment of contracts under which both the debtor and its counterparty have not yet fully performed their respective obligations.

#### *Automatic termination clauses*

(56) The law should specify that, on the commencement of insolvency proceedings, any contract clause that automatically terminates a contract upon the occurrence of any of the following events is unenforceable as against the insolvency representative and the debtor:

(a) an application for commencement, or commencement, of insolvency proceedings;

(b) the appointment of an insolvency representative.<sup>61</sup>

(57) The law should specify the contracts that are exempt from the operation of recommendation (56), such as financial contracts, or subject to special rules, such as labour contracts.

#### *Continuation or rejection*

(58) The law should specify that the insolvency representative may decide to continue the performance of a contract of which it is aware where continuation would be beneficial to the insolvency estate.<sup>62</sup> The law should specify that the right to continue applies to the contract as a whole and that the effect of continuation is that all terms of the contract are enforceable.

(59) The law may permit the insolvency representative to decide to reject a contract.<sup>63</sup> The law should specify that the right to reject applies to the contract as a whole.

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<sup>61</sup> This recommendation would apply only to those contracts where such clauses could be overridden (see commentary at chapter II.E.6 on exceptions) and is not intended to be exclusive, but to establish a minimum: the court should be able to examine other contractual clauses that would have the effect of terminating a contract on the occurrence of similar events.

<sup>62</sup> Provided the automatic stay on commencement of proceedings applies to prevent termination (pursuant to an automatic termination clause) of contracts with the debtor, all contracts should remain in place to enable the insolvency representative to consider the possibility of continuation, unless the contract has a termination date which happens to fall after the commencement of insolvency proceedings.

<sup>63</sup> An alternative to providing a power to reject contracts is the approach of those jurisdictions that provide that performance of a contract simply ceases unless the insolvency representative decides to continue its performance.

*Timing and notice of decision to continue or reject*

(60) The law should specify a time period within which the insolvency representative is required to make a decision to continue or reject a contract, which time period may be extended by the court.

(61) The law should specify the time at which the rejection will be effective.

(62) Where a contract is continued or rejected, the law should specify that the counterparty be given notice of the continuation or rejection, including its rights in respect to submitting a claim (in particular the time in which the claim should be submitted), and permit the counterparty to object to that decision [in the court].

*Counterparty's right to request a decision*

(63) Notwithstanding recommendation (60), the law should permit a counterparty to request the insolvency representative (within any specified time limit) to make a prompt decision and, in the event that the insolvency representative fails to act, to request the court to direct the insolvency representative to make a decision to continue or reject a contract.

*Consequences of failure to make a decision*

(64) The law should specify the consequences of the failure of the insolvency representative to make a decision within the specified time period with respect to contracts of which it is aware. Failure by the insolvency representative to act within the specified time period should not operate to continue a contract of which the insolvency representative was not aware.<sup>64</sup>

*Continuation of contracts where the debtor is in breach*

(65)(a) The law should specify that where the debtor is in breach under a contract the insolvency representative can continue the performance of that contract, provided the breach is cured, the non-breaching counterparty is substantially returned to the economic position it was in before the breach, and the estate is able to perform under the continued contract.

(b) The law should specify that where the debtor is in breach under a contract for the provision of essential services,<sup>65</sup> the continued provision of those services to the debtor should be assured, without requiring cure of the default, provided the estate is able to perform under the continued contract.

*Claims associated with continued or rejected contracts*

(66) The law should specify that where a decision is made to continue performance of a contract, damages for the subsequent breach of that contract should be payable as an administrative expense.

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<sup>64</sup> See chapter III.A.4(b) which refers to the debtor's obligation to provide information, including a list of contracts not fully performed.

<sup>65</sup> Essential services might include telephone, gas, water, electricity, waste collection: see chapter II.E.3(c).

(67) In the period after the commencement of insolvency proceedings, and before a contract is rejected, the law should specify:

(a) that if the counterparty has performed the contract to the benefit of the estate, the benefits conferred upon the estate, pursuant to the terms of the contract, are payable as an administrative expense.<sup>66</sup>

(b) that if the insolvency representative uses assets owned by a third party that are in the possession of the debtor subject to contract, that party should be protected against erosion of the value of those assets and the benefit conferred on the estate by the use of those assets should be treated in accordance with paragraph (a).

(68) The law should specify that any damage arising from the rejection of a pre-commencement contract would be determined in accordance with applicable general law and should be treated as an ordinary unsecured claim. Claims relating to the rejection of a long-term contract may be limited by the law.

#### *Assignment of contracts*

(69) The law may specify that the insolvency representative can decide to assign a contract, notwithstanding restrictions in the contract, provided the assignment would be beneficial to the estate.

(70) Where the counterparty objects to assignment of a contract, the law may permit the court to nonetheless approve the assignment provided:

- (a) the insolvency representative continues the contract;
- (b) the assignee can perform the assigned contractual obligations;
- (c) the counterparty is not substantially disadvantaged by the assignment.

(71) The law may specify that where the contract is assigned, the assignee will be substituted for the debtor as the contracting party with effect from the date of the assignment.

#### *Post-commencement contracts*

(72) The law should specify that contracts entered into after the commencement of insolvency proceedings are post-commencement obligations of the estate. Claims arising from those contracts should be payable as an administrative expense.

## **F. Avoidance proceedings**

### **1. Introduction**

295. Insolvency proceedings (both liquidation and reorganization) may commence at lengthy periods after a debtor first becomes aware that such an outcome cannot be avoided. In that intervening period, there may be significant opportunities for the debtor to attempt to hide assets from creditors, incur artificial liabilities, make donations or gifts to relatives and friends, or pay certain creditors to the exclusion of others. There may also be opportunities for creditors to initiate strategic action to

place themselves in an advantageous position. The result of such activities, in terms of the eventual insolvency proceedings, is to generally disadvantage ordinary unsecured creditors who were not party to such actions and do not have the protection of security.

296. The use of the word “transaction” in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, a security interest, a guarantee, a loan or a release, and may include a composite series of these transactions.

297. Many insolvency laws include provisions which apply retroactively from a particular date (such as the application for, or commencement of, insolvency proceedings) for a specified period of time (often referred to as the suspect period) and are designed to overturn those past transactions to which the insolvent debtor was a party or which involved the debtor’s property where they have certain effects. These effects include reducing the net worth of the debtor (for example, by gifting of its assets, or transferring or selling assets for less than their fair commercial value); or upsetting the principle of equal sharing between creditors of the same rank (for example, by payment of a debt to a particular unsecured creditor or granting a security to a creditor who is otherwise unsecured when other unsecured creditors remain unpaid and unsecured). Many non-insolvency laws also address these types of transactions as being detrimental to creditors outside of insolvency. In some cases, the insolvency representative will be able to use those non-insolvency laws in addition to the provisions of the insolvency law.

298. It is a generally accepted principle of insolvency law that collective action is more efficient in maximising the assets available to creditors than a system that leaves creditors free to pursue their individual remedies and that collective action requires all like creditors be treated alike. Provisions dealing with avoidance powers are designed to support those collective goals, ensuring that creditors receive a fair allocation of an insolvent debtor's assets consistent with established priorities for payment and preserving the integrity of the insolvency estate. Avoidance provisions may also have a deterrent effect, discouraging creditors from pursuing individual remedies in the period leading up to insolvency if they know that these may be reversed or their effects nullified on commencement. For these reasons, transactions typically are made avoidable in insolvency to prevent fraud (for example, transactions designed to hide assets for the later benefit of the debtor or to benefit the officers, owners or directors of the debtor); to uphold the general enforcement of creditors’ rights; to ensure equitable treatment of all creditors by preventing favouritism where the debtor wishes to advantage certain creditors at the expense of the rest; to prevent a sudden loss of value from the business entity just before the supervision of the insolvency proceedings is imposed; and, in some countries, to create a framework for encouraging out-of-court settlement—creditors will know that last-minute transactions or seizures of assets can be set aside and therefore will be more likely to work with debtors to arrive at workable settlements without court intervention.

299. Notwithstanding the rationale of avoidance provisions, it is important to bear in mind that many of the transactions that may be subject to avoidance are perfectly normal and acceptable when they occur outside an insolvency context, but become

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<sup>66</sup> See chapter V.C.

suspect only when they occur in proximity to the commencement of insolvency proceedings. Avoidance powers are not intended to replace or otherwise affect other devices for the protection of the interests of creditors that would be available under general civil or commercial law.

300. Avoidance rules are much discussed, principally as to their effectiveness in practice and the somewhat arbitrary rules that are necessary to define, for example, relevant time periods and the nature of the transactions that may be avoided. Nevertheless, avoidance provisions can be important to an insolvency law not only because the policy upon which they are based is sound, but also because they may result in recovery of assets or their value for the benefit of creditors generally, and because provisions of this nature help to create a code of fair commercial conduct that is part of appropriate standards for the governance of commercial entities. It should be noted that in the cross-border context, jurisdictions with insolvency laws which do not provide that certain types of transactions are subject to avoidance, may encounter difficulties with recognition of proceedings and cooperation with courts and insolvency officials of jurisdictions where those transactions are subject to avoidance.

301. As is the case with a number of the core provisions of an insolvency law, the design of avoidance provisions requires a balance to be reached between competing social benefits such as, on the one hand, the need for strong powers to maximize the value of the estate for the benefit of all creditors and on the other hand, the possible undermining of contractual predictability and certainty. It may also require a balance to be reached between avoidance criteria that are easily proven and will result in a number of transactions being avoided and narrower avoidance criteria that are difficult to prove but more restricted in the number of transactions that will successfully be avoided. To minimize the potentially negative effects of avoidance powers on contractual predictability and certainty, it is desirable that as far as possible the categories of transactions to be avoidable (irrespective of whether they are broadly or narrowly defined), and the exercise of avoidance powers be subject to clear criteria that will enable business and commercial risks to be ascertained.

302. The decision whether or not to commence avoidance proceedings requires a number of different considerations to be weighed. These will generally relate to cost and likely benefit; in the case of actions to restore assets to the insolvency estate, they will include whether avoidance of the transaction will be beneficial to the estate or detrimental (such as where the taking of an avoidance action may disrupt reorganization proposals, especially where the action can be taken by creditors without the consent of the insolvency representative); the likely cost to the estate; the likelihood of recovering value for the estate; possible delays in recovery; and the difficulties associated with proving the elements necessary to avoid a particular transaction.

## **2. Avoidance criteria**

303. Approaches to establishing the criteria for avoidance actions vary considerably among insolvency laws in terms of specific criteria and how they are combined in each law. In terms of the applicable criteria, they can be grouped broadly as objective and subjective criteria.

**(a) Objective criteria**

304. One approach emphasizes the reliance on generalized, objective criteria for determining whether transactions are avoidable. The question would be, for example, whether the transaction took place within the suspect period or whether the transaction evidenced any of a number of general characteristics set forth in the law (e.g. whether appropriate value was given for the assets transferred or the obligation incurred, whether the debt was mature or the obligation due, or whether there was a special relationship between the parties to the transaction). While such generalized criteria may be easier to apply than criteria that rely upon proof, for example, of intent, they can also have arbitrary results if relied upon exclusively. So, for example, legitimate and useful transactions that fall within the specified period might be avoided, while fraudulent or preferential transactions that fall outside the period are protected.

**(b) Subjective criteria**

305. Another approach emphasizes case-specific, subjective criteria such as whether there is evidence of intention to hide assets from creditors, whether the debtor was insolvent when the transaction took place or became insolvent as a result of the transaction, whether the transaction was unfair in relation to certain creditors and whether the counterparty knew that the debtor was insolvent at the time the transaction took place or would become insolvent as a result of the transaction. This individualized approach may require detailed consideration of the intent of the parties to the transaction and of other factors such as the debtor's financial circumstances at the time the transaction occurred, the financial effect of the transaction on the debtor's assets and what might constitute the normal course of business between the debtor and particular creditors.

**(c) Combining the elements**

306. Very few insolvency laws rely solely on subjective criteria as the basis of avoidance provisions; they are generally combined with time periods within which the transactions must have occurred. In some countries a heavy reliance upon subjective criteria has led to considerable litigation and imposition of extensive costs on insolvency estates. In order to avoid these costs, some laws recently have adopted a strictly objective approach of a short suspect period, such as three to four months, which in some cases is combined with an arbitrary rule that all transactions occurring within that period would be suspect unless there was a roughly contemporaneous exchange of value between the parties to the transaction. Additionally the short suspect period may be used to create a presumption of necessary intent or knowledge, especially of insolvency, on the part of the debtor or the person receiving the transfer or both. Some laws adopt a two-tiered approach combining the short period within which all transactions are avoided, with a longer period in which certain additional elements have to be proven. So for example, the law may specify that a certain type of transaction occurring within, for example, a six month period of commencement, is avoided without requiring the insolvency representative to show anything other than that it is a transaction as defined for the purposes of the legislation and that it occurred within the time limit, and no defences are available to the counterparty. For transactions occurring within, for example, a one year period, the insolvency representative is required to show that

the transaction was not in the ordinary course of business and that it had, for example, a preferential effect. To defeat the claim the counterparty must show that it has a relevant defence.

307. A number of insolvency laws also combine these different approaches to address different types of transactions. For example, preferential transactions and undervalued transactions may be defined by reference to objective criteria, while transactions aimed at defeating or hindering creditors will be defined by reference to the more subjective elements involving questions of intent of both the debtor and the counterparty. One insolvency law that adopts a combination of those elements provides, for example, that transactions such as gifts, security for existing debts and extraordinary payments (those that have not been made with the usual means of payment or before the due time) can be avoided where they are made within three months prior to commencement. Other transactions can be set aside if the debtor was insolvent at the time of the transaction, the transaction was unfair or improper in relation to a group of creditors and the counterparty knew that the debtor was insolvent at the time the transaction occurred.

**(d) Ordinary course of business**

308. Of special note, many insolvency laws use the concept of the “ordinary course of business” in defining their avoidance criteria, so that an extraordinary payment, as noted above, may be subject to avoidance. The concept has wider relevance to an insolvency regime as it may also be used, for example, to draw a distinction between the exercise of powers regarding the use and disposition of assets during the insolvency proceedings in the “ordinary course of business” and in other circumstances, both in terms of who may exercise such powers, and the protections that are required.

309. States define the “ordinary course of business” with a varying emphasis on different elements. A common purpose of the definition in most jurisdictions, however, is to allow a business to have made or continue making routine payments as it trades, without subjecting such transactions to possible avoidance. Such permitted payments might include the payment of rent, utilities such as electricity and telephone, and possibly also payment for trade supplies.

310. Some laws focus on the prior conduct of the parties, especially regarding the method, quantity and regularity of supply or payment. In such a case, any variation from contract, custom or what may be deemed to be regular practice between the parties, e.g. a payment by abnormal means will be regarded as being outside the “ordinary course of business”. Another approach is to focus on the intention of one or both of the parties, by asking whether the creditor had knowledge, or ought to have had knowledge, of the debtors financial state, or that the debtor intended to prefer one creditor over others.

311. A further approach is to apply standards based upon usual industry, or even general commercial practice to the terms of the transaction and the circumstances in which it was entered into. Other laws regard any payment exceeding a certain percentage of the value of the debtor’s assets as extraordinary.

312. It is important that a test for the “ordinary course of business” balance flexibility, so as to not unduly restrict new developments in commercial practice, with an overriding requirement for certainty.



**(e) Defences**

313. Where an insolvency law provides defences to avoidance provisions for individual counterparties, those defences may have the potential to dilute the efficacy of the principal purpose of the provisions. Defences that involve elements that may be subject to dispute, such as that the transaction occurred in the ordinary course of business or that the counterparty acted in good faith can create uncertainty for all parties and may require determination by the court. The likelihood of such uncertainty occurring will be bolstered by the courts adopting a wide interpretation of these defences in favour of counterparties, and by the consequent inability or reluctance of the insolvency representative to use avoidance provisions as an effective tool in an insolvency, whether because of associated costs or because the procedures are inefficient and unpredictable. These potential difficulties underscore the desirability of an insolvency law adopting clear and predictable avoidance criteria and defences that will enable all parties to assess potential risks and avoid disputes, for example objective criteria focussing on the effect or result of transactions rather than on the intent of the parties. Where elements such as “ordinary course of business” are included they should be clearly defined and circumscribed by the insolvency law.

**3. Types of transactions subject to avoidance**

314. Although variously defined, there are three broadly common types of avoidable transactions that are found in most legal systems and are used in this Guide as the basis for discussion. They are: transactions intended to defeat, hinder or delay creditors from collecting their claims, transactions at an undervalue, and transactions with certain creditors which could be regarded as preferential. Some transactions may have the characteristics of more than one of these different classes, depending upon the individual circumstances of each transaction. For example, transactions which appear to be preferential may be more in the character of transactions intended to defeat, hinder or delay creditors when the purpose of the transaction is to put assets beyond the reach of a creditor or potential creditor or to otherwise prejudice the interests of that creditor and the transaction occurs when the debtor will be unable to pay its debts as they become due or where they leave the debtor with insufficient assets to conduct its business. Similarly, transactions at an undervalue may also be preferential when they involve creditors, but not when they involve third parties, and where there is a clear intent to hinder, defeat or delay creditors, they will fall into the first category of transactions. In cases such as these, the insolvency representative may be able to choose the category under which a particular transaction is to be avoided and thus take advantage of the variations in requirements of proof and suspect periods that typically apply.

315. To achieve as much clarity and certainty as possible and avoid unnecessary overlap, it is desirable that in determining the categories of transaction to be subject to avoidance provisions, an insolvency law specifies the particular characteristics of a transaction (including the effect of the transaction) that are essential for it to be avoided, rather than relying on broader labels, such as “fraudulent” or “preferential”.

**(a) Transactions intended to defeat, hinder or delay creditors**

316. These types of transactions involve the debtor transferring assets to any third party with the intention of putting them beyond the reach of creditors, and generally

require that the third party knew or should have known, of the debtor's intent in effecting such a transfer. Such transfers will generally disadvantage all unsecured creditors. These transactions generally cannot be avoided automatically by reference to an objective test of a fixed period of time in which the transactions occurred because of the need to prove the intent of the debtor. That intent is rarely proven by direct evidence, but rather by identifying circumstances that are common to these types of transactions. Although these circumstances differ between jurisdictions, there are a number of common indicators, including:

- (i) the relationship between the parties to the transaction, where a transaction took place directly with a related person or via a third party to a related person;
- (ii) the lack or inadequacy of the value received for the transaction;
- (iii) the financial condition of the debtor both before and after the transaction was entered into, particularly where the debtor was already insolvent or became insolvent after the transaction occurred;
- (iv) the existence of a pattern or series of transactions transferring some or substantially all the debtor's assets occurring after the onset of financial difficulties or the threat of action by creditors;
- (v) the general chronology of the events and transactions under inquiry, where for example, the transaction occurred shortly after a substantial debt was incurred;
- (vi) the transaction is concealed by the debtor, especially when it was not made in the ordinary course of business, or fictitious parties were involved; or
- (vii) the debtor absconds.

317. Some laws also specify circumstances in which there may be a presumption of intent or specify those transactions where intent or bad faith is deemed to exist, for example, in the case of transactions involving related persons occurring within a specified period of time prior to the commencement of proceedings (discussed further below). Under other laws it may be sufficient for a transaction to be avoided if the debtor could, and therefore should, have realised that the effect, if not the intent, of a transaction would have been to disadvantage creditors and that the beneficiary could and therefore should have realised that the debtor's action could produce that effect. Some laws also provide that certain transfers, such as conveyances of land, will be exempt from avoidance under this category of transactions if the transfer was bona fide for good value to a person who had no notice or was unaware of any intent to defraud the creditors.

**(b) Undervalued transactions**

*(i) Criteria*

318. A debtor who is in need of cash may sell assets quickly at a price significantly below the real value in order to achieve a quick sale, without ever having any intention to defeat or delay creditors. The result, however, may be a clear reduction of the assets available to creditors in insolvency. For this reason, many insolvency laws focus on the exchange of value in a transaction by making transactions generally avoidable where the value received by the debtor as the result of the

transaction with a third party was either nominal or non-existent, such as a gift, or much lower than the true value or market price of the asset disposed of or the obligation incurred, provided the transaction occurred within the suspect period. Other laws also require a finding that the transaction had a catastrophic effect on the debtor, such as the debtor was left with an unreasonably small amount of capital as a result of the transaction, was insolvent at the time the transaction occurred, or became insolvent as a result of the transaction. These undervalued transactions include those with both creditors and third parties.

319. An important question in respect of these types of transactions is what constitutes a sufficient "undervalue" for the purposes of avoidance and how it can be determined. In many countries, it is left to the courts to determine by reference to standards such as reasonable or market value prevailing at the time the transaction occurred on the basis of appropriate expert evidence. Where the relevant amounts in a transaction may not be certain, one approach to assist the court may be for the insolvency representative to provide the court with an estimated valuation of such amounts, which could be disputed upon the presentation of further evidence by the counterparty to the transaction. The court might also be given a power to specify a mode of determining the valuation rather than necessarily being required to determine the value itself. Given the difficulties in proving undervalue, in some jurisdictions it may be easier to avoid a transaction on the grounds of preferential effect if it was entered into at a time when the company was unable to pay its due debts. Further, some laws presume less than fair, or no, consideration to be evidence of a transaction intended to defeat, hinder or delay creditors.

(ii) *Defences*

320. Some insolvency laws provide that these types of transactions will not be avoided if certain conditions are satisfied, such as that the beneficiary acted in good faith, that the transaction was for the purpose of carrying on the debtor's business, that there were reasonable grounds for believing that the transaction would benefit the debtor's ordinary business and, where cessation of payments is a relevant requirement, that the debtor's assets exceeded its liabilities at the time of the transaction (i.e. it was solvent).

(c) **Preferential transactions**

(i) *Criteria*

321. Preferential transactions may be subject to avoidance where (i) the transaction took place within the suspect period; (ii) the transaction involves a transfer to a creditor on account of a pre-existing debt; and (iii) as a result of the transaction, the creditor receives a larger percentage of its claim from the debtor's assets than other creditors of the same rank or class (in other words, a preference). Many insolvency laws also require that the debtor was insolvent or close to insolvent when the transaction took place, and some also require that the debtor have an intention to create a preference. The rationale for including these types of transactions within the scope of avoidance provisions is that when they occur very close to the commencement of proceedings, a state of insolvency is likely to exist and they breach the key objective of equitable treatment of similarly situated creditors, by giving one member of a class more than they would otherwise legally be entitled to receive.

322. Examples of preferential transactions may include payment or set-off of debts not yet due; performance of acts which the debtor was under no obligation to perform; provision of security to secure existing unsecured debts; unusual methods of payment, other than in money, of debts that are due; payment of a debt of considerable size in comparison to the assets of the debtor; and, in some circumstances, payment of debts in response to extreme pressure from a creditor, such as litigation or attachment, where that pressure has a doubtful basis. A setoff, while not avoidable as such, may be considered prejudicial when it occurs within a short period of time before the application for commencement of the insolvency proceedings and has the effect of altering the balance of the debt between the parties in such a way as to create a preference or where it involves transfer or assignment of claims between creditors to build up setoffs. It may also be subject to avoidance where the setoff occurs in irregular circumstances such as where there is no contract between the parties to the setoff.

(ii) *Defences*

323. One defence to an allegation of a preferential transaction may be to show that although containing the elements of a preference the transaction was in fact consistent with normal commercial practice and, in particular, with the normal course of business between the parties to the transaction. For example, a payment made on receipt of goods that are regularly delivered and paid for may not be preferential even if made within proximity of the commencement of insolvency proceedings. This approach encourages suppliers of goods and services to continue to do business with a debtor which may be having financial problems, but which is still potentially viable. Other defences available under insolvency laws (depending upon applicable avoidance criteria) include that the beneficiary extended credit to the debtor after the transaction and this credit has not been paid (the defence is limited to the amount of the new credit); that the beneficiary gave new value for which it received no security; the beneficiary can show that it did not know a preference would be created; the beneficiary did not know or could not have known that the debtor was insolvent at the time of the transaction; or that the debtor's assets exceeded its liabilities at the time of the transaction.

(d) **Security interests**

324. While security interests effective and enforceable under the laws permitting the grant of a security interest to creditors should generally be regarded as valid under insolvency law, they may nevertheless be avoidable in insolvency proceedings on the same grounds that any other transaction might be challenged and avoided. The purpose of such an approach is to prevent a debtor that is not able to pay its debts from encumbering assets unless the security interest provided is in consideration of new funds being advanced. Otherwise the encumbered assets will not be available to creditors generally and will place restrictions on the debtor's use of those assets. A transaction granting a security interest might be avoided on the basis that it is a transaction intended to defeat, delay or hinder creditors, or a preferential or undervalued transaction. In many cases it will be a preferential transaction because it involves an existing creditor. For example, the grant of a security interest shortly before commencement of proceedings, although otherwise valid, may be found to have favoured unfairly a certain creditor at the expense of the rest. Where the security interest is granted to secure a prior debt or on the basis

of past consideration (permitted in some legal systems, but not in others) it may also be invalid as favouring that particular creditor unfairly. Payments received by a secured creditor might be regarded as preferential (at least in part) if a secured creditor who is undersecured is paid in full within the suspect period. Where the security interest is granted to a new creditor, the transaction may not be preferential within the meaning of that category of transaction, but may be covered by another category. There are examples of laws that include provisions dealing specifically with the avoidance of such transactions, especially in the context of security interests in favour of directors (which might also be covered by provisions on transactions with related persons) to which different criteria apply in terms of provision of value and the suspect period.

325. Avoidance provisions may also apply to a secured interest that was not perfected under the relevant secured transactions law and, under some laws, to a secured interest perfected within a short period before the commencement of proceedings, as well as to transfers to a secured creditor from the proceeds of an encumbered asset, where the transaction creating the security interest was tainted.

**(e) Transactions with related persons**

326. As noted above, one criterion relevant to avoidance of certain transactions is the relationship between the debtor and the counterparty. Where the types of transactions subject to avoidance involve related persons (sometimes referred to as connected persons or insiders), insolvency laws often provide stricter rules, particularly with regard to the length of suspect periods and treatment of any claim by the related person (see chapter V.A), as well as presumptions or shifted burdens of proof (see below) to facilitate avoidance proceedings and dispensing with requirements that the debtor was insolvent at the time of the transaction, or was rendered insolvent as a result of the transaction. A stricter regime may be justified on the basis that these parties are more likely to be favoured and tend to have the earliest knowledge of when the debtor is, in fact, in financial difficulty.

327. Related persons are generally defined by varying levels of connection to the debtor. Most jurisdictions regard those with some form of corporate or family relationship with the debtor as related persons. The legislative approach taken is generally, but not always, prescriptive. With regard to those with some form of business association with the debtor, a narrow approach would focus on the directors or management of the debtor, while a wider definition may extend not only to those who have effective control of the debtor, but may include all employees of the debtor and guarantors of the debts of any person with a business connection to the debtor. Similarly, a family relationship may be defined to include relatives by blood or marriage and even, in some laws, persons living in the same household as the debtor, as well as trustees of any trust of which the debtor or a person connected with the debtor is a beneficiary. Relatives of those who have a business association with the debtor are also commonly regarded as related persons. An important element in many jurisdictions is to include as related persons those who had a defined relationship with the debtor in the past or may have a defined relationship in the future.

328. Where the debtor is a natural person, other legislation (such as that dealing with marital property) may be relevant and may affect the operation of the insolvency law in terms of transactions that can be avoided, such as by

supplementing or limiting the avoidance provisions of the insolvency law. It is desirable that these laws are aligned and that any affect on the insolvency law is clearly stated in the insolvency law.

**4. Transactions exempt from avoidance actions**

329. It may be desirable for an insolvency law to include specific exemptions from the operation of avoidance powers for certain types of transactions. These might include transactions that occur in the course of implementing a reorganization plan, including those relating to post-commencement finance, payments made pursuant to a plan approved by the court under expedited reorganization proceedings or payments made pursuant to a voluntary restructuring agreement (approved between the debtor and at least a majority of unsecured creditors), where the implementation of the plan or arrangement fails and the proceedings are subsequently converted to liquidation or, in the case of the negotiated agreement, liquidation proceedings are commenced. Transactions essential to the functioning of financial markets, such as close-out netting of securities and derivative contracts (see chapter II.H) should be exempted from the operation of avoidance provisions.

**5. Effect of avoidance—void or voidable transactions**

330. Where a transaction falls into any of the categories of transactions subject to avoidance, insolvency laws either render it automatically void or make it voidable, depending upon the test that is adopted in respect of each category of transaction. For example, those laws which refer only to transactions occurring within a certain fixed period of time and include no subjective criteria, sometimes specify that relevant transactions will be void. However, even where that approach is adopted the insolvency representative may have to commence proceedings to recover the assets or their equivalent value from the counterparty where the counterparty fails to return the assets.

331. In those laws where the transaction is voidable, the insolvency representative will be required to decide whether the avoidance of the transaction will be beneficial to the estate, taking into account the elements of each category of avoidable transaction as well as possible delays in recovering either the assets involved or the value of the assets and the possible costs of litigation. That discretion would generally be subject to the insolvency representative's obligation to maximize the value of the estate, and it may be responsible for its failure to do so.

**6. Establishing the suspect period**

332. Most insolvency laws explicitly specify the duration of the suspect period with reference to the particular types of transactions to be avoided and indicate the date from which the period is calculated retroactively. For example, so many days or months before a particular event or date such as the making of the application for commencement of proceedings, the commencement of insolvency proceedings or the date decided by the court as being the date on which the debtor ceased paying its debts in the normal way ("cessation of payments"). The event or date specified by the law will depend upon other design features of the insolvency regime such as the requirements for commencement and whether there is a potential for delay between the application for and commencement of insolvency proceedings. For example, if commencement typically takes several months from the time of application and the

suspect period is a fixed period relating back from the time of commencement, then several months of that period will be used to cover the period of delay between application and commencement, limiting the potential effectiveness of the avoidance powers. However, if the application operates to automatically commence proceedings, the same delay will not occur. To address situations where there is the potential for delay between application and commencement, an insolvency law could stipulate that the suspect period apply retroactively from application and address transactions between application and commencement in other terms, such as whether they were fraudulent or whether they were in the ordinary course of business or, where an interim insolvency representative is appointed, in terms of unauthorized transactions (see chapter II.B). Where commencement occurs shortly after application, the suspect period could apply retroactively from commencement.

333. A related issue is whether suspect periods stipulated in the insolvency law can be extended by the court in appropriate situations, such as where transactions, which occurred outside the specified suspect periods in questionable circumstances, had the effect of diminishing the estate. While a discretionary approach may allow a certain degree of flexibility with respect to the transactions to be caught by the avoidance provisions, it may also lead to delay in the proceedings and does not give a predictable or transparent indication to creditors as to the transactions that are likely to be avoided. If transactions can be unwound where they took place at some unspecified time prior to the commencement of insolvency proceedings and subject to the discretion of the court, there is likely to be less safety in commercial and financial transactions. For these reasons, it is desirable that an extension of the suspect period be limited to transactions intended to defeat, hinder or delay, where issues of commercial certainty are of less concern.

334. Some insolvency laws provide one suspect period for all types of avoidable transactions, while others have different periods depending upon the type of transaction and whether the transferee was a related person. As noted above there are also examples of laws which adopt the approach of combining a short suspect period within which certain types of transactions are automatically avoided (and no defences are available) and a longer period where additional elements have to be proved. Because some transactions involve intentionally wrongful conduct, many insolvency laws do not limit the time period within which these types of transactions must have occurred in order for them to be avoided. Other insolvency laws establish a very long limit (examples range from one to ten years) where the suspect period is generally calculated from the date of commencement of proceedings.

335. Where preferential and undervalued transactions involve creditors who are not related persons, the suspect period may be relatively brief, perhaps no more than several months (examples range from three to six months). However, where related persons are involved, many countries apply stricter rules, and longer suspect periods (for example two years as opposed to three to six months where the transaction does not involve a related person are not uncommon).

## **7. Conduct of avoidance proceedings**

### **(a) Parties who may commence**

336. Avoidance of a particular transaction generally requires an application to the court to declare the transaction void, and insolvency laws adopt a variety of

approaches to the party that may commence such a proceeding. Recognising the central role played by the insolvency representative with respect to the administration of the estate, many insolvency laws provide that proceedings for the avoidance of specified transactions should be taken by the insolvency representative, although some do require the insolvency representative to gain the agreement of creditors, or a majority of creditors before any proceeding can be commenced. There are also laws that permit avoidance proceedings to be commenced by creditors (and, in some cases, the creditors committee), some of which limit the right to commence to those creditors whose debt precedes the challenged transaction in time. Some of the laws that permit creditors to commence such proceedings require the consent of the insolvency representative to be obtained. Should it be regarded as desirable to permit creditors to take such actions, requiring the insolvency representative's consent ensures the insolvency representative is informed as to what creditors propose and gives the insolvency representative the opportunity to refuse permission, thus avoiding any negative impact of such avoidance proceedings on administration of the estate.

337. Where the consent of the insolvency representative is required, but not obtained, some insolvency laws permit the creditor(s) to seek court approval for the commencement of avoidance proceedings. The insolvency representative has a right to be heard in any resulting court hearing to explain why it believes the proceedings should not go ahead. At such a hearing, the court might give leave for the avoidance proceeding to be commenced, or may decide to hear the case on its own merits. Such an approach may work to lower the likelihood of any deal-making between the various parties. Where creditor-initiated avoidance actions are available, some laws require creditors to pay the costs of any action or allow sanctions to be imposed on creditors to discourage potential creditor abuse of avoidance proceedings.

338. Where the insolvency representative has the sole power to commence avoidance proceedings and, based on the balance of the considerations discussed above, (that is for reasons other than negligence, bad faith, or omission<sup>67</sup>), decides not to commence proceedings in respect of certain transactions, insolvency laws adopt different approaches to the conduct and funding of those proceedings. The manner in which they may be funded may be of particular importance where there are insufficient assets in the insolvency estate to do so (funding is discussed further below). As to the conduct of those proceedings, some laws permit a creditor or the creditor committee to require the insolvency representative to initiate an avoidance proceeding where it appears to be beneficial to the estate to do so or also permit a creditor itself or the creditor committee to commence proceedings to avoid these transactions, where other creditors agree.

339. Where creditors are permitted to commence avoidance proceedings, either on an equal basis with the insolvency representative or because the insolvency representative decides not to commence such proceedings, insolvency laws adopt different approaches to the assets or value recovered. The most common approach is to treat the assets or value recovered by the creditor as part of the estate on the basis that the principal justification of avoidance proceedings is to return value or assets to the estate for the benefit of all creditors, not to provide a benefit to individual creditors. Other laws provide that whatever is recovered can be applied in the first

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<sup>67</sup> See chapter III.B on the rights and obligations of the insolvency representative.



instance to satisfy the claim of the creditor which takes the action; or that the priority of the claim of the creditor pursuing the action can be modified.

**(b) Funding of avoidance proceedings**

340. The most crucial restriction in a number of countries on the efficacy of avoidance provisions has been the unavailability of funds with which to challenge potentially avoidable transactions. Different approaches to the question of funding have been adopted. Some countries make public funds available to the insolvency representative to commence avoidance proceedings, while other countries require those proceedings to be funded from the insolvency estate. This latter approach may be appropriate where sufficient funds exist but in some circumstances would prevent the recovery of assets that have been removed from the estate with the specific intention of leaving the estate with few assets from which to fund their recovery through an avoidance proceeding. Some insolvency laws allow the insolvency representative to assign the ability to commence proceedings for value to a third party or to approach a lender to advance funds with which to commence the avoidance proceeding. There are clearly significant differences between countries in the availability of public resources to fund avoidance proceedings that may justify use of some of these alternative mechanisms. Where there is no ability to fund avoidance proceedings from the insolvency estate, these alternative approaches may offer, in appropriate situations, an effective means of restoring value to the estate, avoiding abuse, investigating unfair conduct and furthering good governance.

**(c) Time limits for commencement**

341. Some insolvency laws establish specific time periods within which avoidance proceedings should be commenced, while others are silent on this issue. Those laws that do specify time periods provide, for example, that the proceeding should be commenced within a specified period after the date of commencement of proceedings (such as three or twelve months) or no later than a specified time period (for example, six months) after the insolvency representative is able to discover, assess and pursue claims. If an insolvency law is to establish specific time periods, rather than relying on those applicable under general law, an approach that combines different periods, such as a fixed time period after commencement and a fixed time period after the discovery of the transaction by the insolvency representative, would be desirable. Such an approach provides flexibility sufficient to address those transactions that are concealed from the insolvency representative and discovered only after the expiration of the specified time period.

**(d) Satisfying the criteria for avoidance**

342. Insolvency laws adopt different approaches to establishing the elements that have to be proved in order to avoid a particular transaction. The approach adopted will depend upon how the balance is struck between undoing transactions that are unfair or financially harmful to insolvency estate on the one hand and protecting commercial transactions that are not regarded as wrong or harmful outside the insolvency context.

343. In some laws, the onus is on the debtor to prove that the transaction did not fall into any category of avoidable transactions. Other insolvency laws provide that the insolvency representative or other person permitted to challenge the transaction,

such as a creditor, is required to prove that the transactions satisfies the requirements for avoidance. Where these elements include intent, it will often be very difficult to prove and the party with the burden of proof will most often lose. To overcome this difficulty, some laws allow the burden of proof to be shifted to the counterparty where, for example, it is difficult for the insolvency representative to establish that the debtor's actual intent was to defraud creditors except through external indications, objective manifestations, or other circumstantial evidence of such intent, although as a practical matter the debtor's inability to satisfactorily explain the commercial purpose of a particular transaction which extracted value from the estate may point to the requisite intent.

344. Another approach is to provide that the requisite intent or bad faith is deemed or presumed to exist where certain types of transactions are undertaken within the suspect period and the counterparty to the transaction will have the burden of proving otherwise. These types of transactions may include, for example, transactions with related persons, payment of non-matured debts, and payment of gratuitous or onerous transactions. A further approach is to provide that where a certain type of transaction occurred within the suspect period and had a certain effect, such as conferring a preference, a rebuttable presumption as to intention to prefer will arise. Unless the creditor can rebut the presumption, the transaction is avoided and the insolvency representative can recover the assets involved in the transaction or obtain judgement for the value of the asset involved.

345. Where the counterparty's knowledge of the debtor's insolvency is a required element of avoidance, some insolvency laws provide a presumption that the counterparty knew of the poor financial condition of the debtor if the transaction entered into with that person had certain characteristics, such as for repayment of a non-mature debt or repayment in an unusual manner, or where the transaction occurred within a short period before an application for commencement or before commencement.

346. Whichever approach an insolvency law adopts to satisfying the avoidance criteria, it is highly desirable that the law state precisely which parts of the criteria have to be proved by which party, so that it is clear what is required of the insolvency representative in seeking to avoid a particular transaction and what is required of the counterparty seeking to defend a transaction from avoidance.

## **8. Liability of counterparties to avoided transactions**

347. Where a transaction is avoided, there is a question of the effect of avoidance on the counterparty. In most insolvency laws the result of avoidance of a transaction is generally that the transaction will be reversed and the counterparty required to return the assets obtained or make a cash payment for the value of the transaction to the insolvency estate. Some insolvency laws provide that the insolvency representative can be awarded judgement for the value of the property involved. Some insolvency laws also stipulate that the counterparty who has returned assets or value to the estate may make a claim as an unsecured creditor in the insolvency to the extent of the assets returned in the case of a preference and to the extent of the consideration paid in an undervalued transaction. Where the counterparty fails to disgorge assets or return value to the insolvency estate, most of remedies available are under non-insolvency law, but some insolvency laws provide that in addition to avoidance of the transaction, a claim by the counterparty (for amounts owed in

addition to those involved in the voidable transaction) cannot be admitted in the insolvency.

#### 9. Conversion of reorganization to liquidation

348. Where reorganization proceedings are converted to liquidation proceedings, some consideration may need to be given to the effect of that conversion on the exercise of avoidance powers in respect of payments made in the course of the reorganization proceedings and the timing of the suspect period.

### Recommendations

#### Purpose of legislative provisions

The purpose of avoidance provisions is to:

- (a) reconstitute the integrity of the estate and ensure the equitable treatment of creditors;
- (b) provide certainty for third parties by establishing clear rules for the circumstances in which transactions occurring prior to the commencement of insolvency proceedings involving the debtor or the debtor's property may be considered injurious and therefore subject to avoidance;
- (c) enable the commencement of proceedings to avoid those transactions;
- (d) facilitate the recovery of money or assets from persons involved in transactions that have been avoided.

#### Contents of legislative provisions

##### *Avoidable transactions*

(73) The law should include provisions which apply retroactively and are designed to overturn transactions,<sup>68</sup> involving assets of the debtor or the estate and which have the effect of either reducing the value of the estate or upsetting the principle of equitable treatment of creditors. The law should specify the following types of transactions as avoidable:

- (a) transactions intended to defeat, delay or hinder the ability of creditors to collect claims where the purpose of the transaction was to put assets beyond the reach of a creditor or potential creditor or to otherwise prejudice the interests of that creditor and where the counterparty knew or should have known of the debtor's intent;
- (b) transactions where a transfer of an interest in property or the undertaking of an obligation by the debtor was made in exchange for a nominal or less than equivalent value or for inadequate value which occurred at a time when the debtor was insolvent or as a result of which the debtor became insolvent (undervalued transactions); and

<sup>68</sup> The use of the word "transaction" in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, a security, a guarantee, a loan or a release [or an action to make the security interests effective against third parties] and may include a composite series of transactions.

(c) transactions involving creditors where a creditor obtained, or received the benefit of, more than its pro rata share of the debtor's assets which occurred at a time when the debtor was insolvent (preferential transactions).

*Security interests*

(74) The law should specify that:

(a) where a security interest is effective and enforceable under other law, that effectiveness and enforceability will be recognized in insolvency proceedings;

(b) notwithstanding that a security interest is effective and enforceable under other law, it may be subject to the avoidance provisions of the law on the same grounds as other transactions.

*Establishing the suspect period*

(75) The law should specify that the transactions described in recommendation (73)(a)-(c) may be avoided if they occurred within a specified period (the suspect period) calculated retroactively from a specified date, being either the application for or commencement of the insolvency proceedings. The law may specify different suspect periods for different types of transactions.

*Related person transactions*

(76) In relation to avoidable transactions involving related persons, the law may:

(a) specify that the suspect period for those transactions is longer than for transactions with unrelated persons;

(b) establish [evidentiary][rebuttable] presumptions to facilitate avoidance proceedings; and

(c) permit shifts in the burden of proof to facilitate avoidance proceedings.

(77) The law should specify the categories of persons with sufficient connection to the debtor to be treated as related persons.<sup>69</sup>

*Transactions exempt from avoidance actions*

(78) The law should specify the transactions that are exempt from avoidance, including financial contracts.

*Conduct of avoidance proceedings*

(79) The law should specify that:

(a) the insolvency representative has the principal responsibility to commence avoidance proceedings;<sup>70</sup>

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<sup>69</sup> "Related person" is defined in the Glossary.

<sup>70</sup> Issues relevant to avoidance may also arise in proceedings commenced by a person other than the insolvency representative, where the insolvency representative raises avoidance by way of defence against enforcement.

(b) any creditor may commence avoidance proceedings with the agreement of the insolvency representative; or

(c) where the insolvency representative does not agree, the creditor may seek leave of the court.

*- Funding of avoidance proceedings*

(80) The law may provide alternative approaches to address the funding of avoidance proceedings where the insolvency representative elects not to pursue the avoidance of particular transactions on the basis, for example, of an assessment that the transactions are not likely to be avoided or that pursuing those transactions will impose excessive costs<sup>71</sup> upon the insolvency estate.

*- Time limits for commencement of avoidance proceedings*

(81) The law or applicable procedural law should specify the time period within which an avoidance proceeding may be commenced. That time period should begin to run on the commencement of insolvency proceedings. [In respect of transactions referred to in recommendation (73)(a) which have been concealed and which the insolvency representative could not be expected to discover, the law may provide that the time period commences at the time of discovery.]

*Elements of avoidance and defences*

(82) The law should specify the elements to be proved in order to avoid a particular transaction, the party responsible for proving those elements and specific defences to avoidance. Those defences may include that the transaction was entered into in the ordinary course of business prior to commencement of insolvency proceedings, or that the transaction was entered into in the course of reorganization proceedings which were subsequently converted to liquidation proceedings.

*Liability of counterparties to avoided transactions*

(83) The law should specify that a counterparty to a transaction that has been avoided must return to the estate the assets obtained or, if the court so orders, make a cash payment to the estate for the value of the transaction. [The court should determine whether the counterparty to an avoided transaction would have an ordinary unsecured claim.]

(84) The law may specify that where the counterparty does not comply with the court order avoiding the transaction, in addition to avoidance and any other remedy, a claim by the counterparty may be disallowed.

## **G Rights of set-off**

349. The enforcement under insolvency law of rights of set-off of mutual obligations arising out of pre-commencement transactions or activities of the debtor

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<sup>71</sup> This refers to an appraisal of the costs and benefits of an avoidance action and an implicit rule that if the costs of proceedings would exceed the benefits to be recovered for the estate, those proceedings should not go ahead.

is important not only to commercial predictability and the availability of credit, but also because it avoids the strategic misuse of insolvency proceedings. For these reasons, it is highly desirable that an insolvency law affords protection to such set-off rights.

350. In the majority of jurisdictions, set-off rights are not affected by the stay in insolvency and may be exercised after the commencement of insolvency proceedings, irrespective of whether the mutual obligations arose under a single contract or multiple contracts and irrespective of whether the mutual obligations matured before or after commencement of insolvency proceedings. In some jurisdictions a distinction is made; post-commencement set-off of obligations maturing prior to the commencement of insolvency proceedings is permitted, but post-commencement set-off of obligations maturing after the commencement of insolvency proceedings is limited or disallowed.

351. An alternative approach preserves set-off rights regardless of whether the mutual obligations matured prior to or after the commencement of insolvency proceedings, but applies the stay to the exercise of those rights in the same manner as the stay applies to the exercise of rights of secured creditors. In systems adopting this alternative approach, the creditor is treated as secured to the extent of its own valid but unexercised set-off rights and these rights are protected in a manner similar to the protections afforded to security interests.<sup>72</sup>

352. Insolvency laws almost universally include provisions that permit the insolvency representative to seek to avoid the effects of certain pre-commencement actions by creditors designed to enhance set-off rights (such as purchasing claims at a discount with the intention of building up set-off rights). The nature and scope of these provisions varies.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on set-off is to:

- (a) Provide certainty with respect to the effect of the commencement of insolvency proceedings upon the exercise of set-off rights;
- (b) Specify the types of obligations that may be set-off after commencement of insolvency proceedings;
- (c) Specify the effect of other provisions of the law (e.g. avoidance provisions and the stay) on the exercise of rights of set-off.

### **Contents of legislative provisions**

(85) The law should protect a general right of set-off existing under general law that arose prior to the commencement of insolvency proceedings, subject to the application of avoidance provisions.

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<sup>72</sup> See chapter II.B.8.

## H. Financial contracts and netting

353. Financial contracts have become an important component of international capital markets. Among other things, they enhance the availability of credit and are an important means of hedging against exchange rate, interest rate and other market fluctuations. Because of the way these transactions are structured and documented, it is imperative that there be certainty as to what happens when one of the parties to such contracts fails to perform—including for reasons of insolvency.

354. Financial contracts include, among other things, securities contracts, commodities contracts, forward contracts, options, swaps, securities repurchase agreements, master netting agreements and other similar contracts. Debtors often enter into multiple financial contracts with a given counterparty in a single course of dealing, and the availability of credit is enhanced if rights under these contracts are fully enforceable in accordance with their terms, thereby permitting counterparties to extend credit based on their *net exposure* from time to time after taking into account the value of all “open” contracts.

355. Upon commencement of insolvency proceedings, counterparties seek to “close-out” open positions and “net” all obligations arising under financial contracts with the debtor. “Close-out netting” embraces two steps: first, termination of all open contracts as a result of the commencement of insolvency proceedings (close-out); second, the set-off of all obligations arising out of the closed out transactions on an aggregate basis (netting).

356. Permitting “close-out netting” after the commencement of insolvency proceedings is an important factor in mitigating systemic risks that could threaten the stability of financial markets. The value of or exposure under a financial contract may vary significantly from day to day (and sometimes from hour to hour) depending on conditions in the financial markets. Accordingly, the value of these contracts can be highly volatile. Counterparties typically mitigate or hedge the risks associated with these contracts by entering into one or more “matching” or “hedge” contracts with third parties, the value of which fluctuates inversely with the value of the debtor’s contract.<sup>73</sup>

357. Whether or not the debtor performs its contract with the counterparty, the counterparty must perform the hedge contract it enters into with third parties. If the debtor becomes insolvent and cannot perform its contract with the counterparty, the counterparty becomes exposed to market volatility because the counterparty’s hedge positions are no longer “covered” by its contract with the debtor. Under such circumstances, the counterparty typically seeks to “cover” the hedge contracts by entering into one or more new contracts so as to limit its exposure to future market fluctuations. The counterparty cannot, however, cover in this manner until it determines with certainty that it will not be required to perform its contract with the debtor. The counterparty relies on the ability to “close-out” the debtor’s contract, which permits it to “cover” promptly after the commencement of insolvency proceedings.

358. Without the ability to close-out, net and set-off obligations in respect of defaulted contracts promptly after commencement as described above, a debtor’s

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<sup>73</sup> The reference to a “contract” in this section includes the possibility of one or more contracts.

failure to perform its contract (or its decision to perform profitable contracts and not perform unprofitable ones) could lead the counterparty to be unable to perform its related financial contracts with other market participants. The insolvency of a significant market participant could result in a series of defaults in back-to-back transactions, potentially causing financial distress to other market participants and, in the worst case, resulting in the financial collapse of other counterparties, including regulated financial institutions. This domino effect is often referred to as “systemic risk”, and is cited as a significant policy reason for permitting participants to close-out, net and set-off obligations in a way that normally would not be permitted by insolvency law.

359. Systemic risk can also arise from concerns over the finality of payments and settlements of financial contracts that take place in central payment and settlement systems. These systems employ either bilateral or multilateral netting arrangements. The netting of financial contracts through these systems and the finality of clearing and settlement through these systems should be recognized and protected upon the insolvency of one of the participants in the system in order to prevent systemic risk.

360. In many countries, the application of general insolvency rules will allow the financial contracts to be performed in accordance with their terms following commencement of insolvency proceedings by giving effect to contract termination clauses triggered by insolvency (see chapter II.E.2 and recommendations (56)-(57)) and by allowing for the set-off of obligations, whether a claim for breach is based on an automatic termination clause or arises pre-commencement. Other jurisdictions, with insolvency provisions that limit the effect of automatic termination clauses or that stay or limit the exercise of set-off rights and other creditor remedies, require specific exceptions in their insolvency laws to permit full enforcement of remedies in respect of financial contracts. It is also desirable that the exceptions also extend to avoidance provisions that might apply to financial contracts and any restrictions that would limit the extent to which security can be applied to unsatisfied financial contract obligations remaining after offsets are completed.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provision on netting and set-off in the context of financial transactions is to reduce the potential for systemic risk that could threaten the stability of financial markets by providing certainty with respect to the rights of parties to a financial contract when one of those parties fails to perform for reasons of insolvency.

### **Contents of legislative provisions**

(86) The law should recognize contractual termination rights associated with financial contracts that permit the termination of those contracts and the set-off and netting of outstanding obligations under those contracts promptly after the commencement of insolvency proceedings. Where the law stays the termination of contracts or limits the enforceability of automatic termination clauses on



commencement of insolvency proceedings, financial contracts should be exempt from such limitations.<sup>74</sup>

(87) Once the financial contracts of the debtor have been terminated by a counterparty, the law should permit the counterparty to net or set-off obligations under those terminated financial contracts to establish a net exposure position relative to the debtor. This termination and set-off to establish a net exposure should be permitted regardless of whether the termination of the contracts occurs prior to or after the commencement of insolvency proceedings. Where the law limits or stays the exercise of set-off rights upon commencement of insolvency proceedings, set-off and netting of financial contracts should be exempt from such limitations.

(88) Once the financial contracts of the debtor have been terminated, the law should permit counterparties to enforce and apply their security interest to obligations arising out of financial contracts. Financial contracts should be exempt from any stay under the insolvency law that applies to the enforcement of a security interest.

(89) The law should specify that routine pre-bankruptcy transfers consistent with market practice, such as the putting up of margin for financial contracts<sup>75</sup> and transfers to settle financial contract obligations<sup>76</sup> should be exempt from avoidance.

(90) The insolvency law should recognize and protect the finality of the netting, clearing and settlement of financial contracts through payment and settlement systems upon the insolvency of a participant in the system.

(91) Recommendations (86) to (90) should apply to all transactions that are considered to be “financial contracts,” whether or not one of the counterparties is a financial institution.<sup>77</sup>

(92) Financial contracts should be defined broadly enough to encompass existing varieties of financial contracts and to accommodate new types of financial contracts as they appear. [These recommendations are not intended to apply to transactions that are not financial contracts and they would remain subject to the general law applying to set-off and netting.]

<sup>74</sup> This will allow market participants to extend credit based on “net” positions and make it impossible for the debtor to “cherry pick” contracts by performing some and breaching others, which is especially important with regard to financial contracts because of systemic risk.

<sup>75</sup> Margin is the process of posting additional cash or securities as a security for the transactions in accordance with a contractual formula that accounts for fluctuations in the market value of the contract and the existing security. For example, on a swap, a margin of 105 per cent might be required to maintain the termination value of the contract. If the security position falls to 100 per cent, an additional margin might be required to be posted.

<sup>76</sup> In some circumstances, a settlement payment might be viewed as a preference. In the example of a swap, settlement payments are to be made monthly or upon termination of the contract based on the market value of the contract. These payments are not value for value transfers, but rather payment of an accrued debt obligation that has matured. In countries that have a fixed suspect period for all transactions occurring before commencement, such a payment might also be subject to avoidance.

<sup>77</sup> Even if a given financial contract does not involve a financial institution, the impact of the insolvency of a counterparty could entail systemic risk.

### **III. Participants**

#### **A. The debtor<sup>78</sup>**

##### **1. Introduction**

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

##### **2. Continued operation of the debtor's business and the role of the debtor**

###### **(a) Liquidation**

362. Once liquidation proceedings have commenced, the conservation of the estate requires comprehensive measures to protect the estate not only from the actions of creditors (see chapter II.B) but also from the debtor. For this reason, many insolvency laws divest the debtor of all rights to control assets and manage and operate the business in liquidation, and appoint an insolvency representative to assume all responsibilities divested. In addition to the powers relating to use and disposal of assets, these responsibilities may include the right to initiate and defend legal actions on behalf of the estate and the right to receive all payments directed to the debtor. After commencement of the liquidation proceedings, any transaction involving assets of the estate, including transfer of those assets, which is not authorized by the insolvency representative, the court or creditors (depending on the requirements of the insolvency law) generally will be void (or under some laws subject to avoidance), and the assets transferred (or their value) subject to recovery for the benefit of the insolvency estate (see chapter II.E.7, II.F.8).

363. Where it is determined that the most effective means of liquidating the estate is to sell the business as a going concern, some laws provide that the insolvency representative should supervise and have overall control of the business while permitting the debtor to enhance the value of the estate and facilitate the sale of the assets by continuing to serve and advise the insolvency representative. This approach may be supported by the debtor's detailed knowledge of its business and

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<sup>78</sup> Because the insolvency law will cover different types of businesses, whether individuals, partnerships or some form of company, the question of the continuing role of the debtor properly raises questions of the role of the debtor's management or owners, depending upon the circumstances. For ease of reference, the Guide refers only to "the debtor", but it is intended that management and owners should be covered by the use of that term where appropriate.

the relevant market or industry, as well as its ongoing relationship with creditors, suppliers and customers.

**(b) Reorganization**

364. In reorganization proceedings, there is no agreed approach on the extent to which displacement of the debtor is the most appropriate course of action and, where some level of displacement does occur, on the ongoing role that the debtor may perform and the manner in which that role is balanced with the roles of other participants. That ongoing role may depend in large part upon the debtor acting in good faith during the reorganization process; where it does not, its continuing role may be of questionable value. It may also depend upon the existence of a strong, independent governance regime that can address incompetent or self-serving behaviour. Sometimes the advantages of a continuing role may also depend upon whether the debtor commenced the proceedings or whether they were commenced on the application of creditors. In the latter case the debtor may be uncooperative or even hostile to an extent that makes its continued participation pointless. The decision on which approach to take may depend upon a number of factors including local corporate culture; the role of banks; the existence and effectiveness of corporate governance regimes; the effectiveness of insolvency institutions; the level of supervision provided by, or required of, the courts; the effectiveness and accessibility of the courts; and the extent to which incentives to commence insolvency proceedings are determined to be of importance to the design of the insolvency regime.

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

365. There are a number of potential advantages in providing for the debtor to have an ongoing role. In many circumstances, the debtor will have immediate and intimate knowledge of its business and the industry within which it operates. This knowledge is particularly important in the case of individual businesses and small partnerships and may, in the interests of business continuity, provide a basis for the debtor to have a role in making short term and day-to-day management decisions. It may also assist the insolvency representative to perform its functions with a more immediate and complete understanding of the operation of the debtor's business. For similar reasons, the debtor is often well positioned to propose a reorganization plan. In such circumstances, total displacement of the debtor, notwithstanding its role in the financial difficulties of the business, may not only eliminate an incentive for entrepreneurial activity, risk-taking in general and for debtors to commence reorganization procedures at an early stage, but also may undermine the chances of success of the reorganization.

366. The desirability of the debtor having an ongoing role may need to be balanced against a number of possible disadvantages. Creditors may have a lack of confidence in the debtor on account of the financial difficulties of the business (and the role that the debtor may have played in these difficulties) and confidence will need to be rebuilt if the reorganization is to be successful. Permitting the debtor to continue to operate the business with insufficient control over its powers may not only exacerbate the breakdown of confidence but may antagonize creditors further. One factor that may affect creditors' views of this option is the effectiveness of corporate governance regimes and the responsiveness of the debtor to that regime.

Where there are no effective governance regimes, creditors may prefer an appointed insolvency representative to displace the debtor or to have significant supervisory powers over the debtor.

367. A system which is perceived to be excessively pro-debtor may result in creditors being apathetic about the process and unwilling to participate, which in turn may lead to problems of monitoring the conduct of the debtor where the insolvency law requires that role to be played by creditors. It may also encourage an adversarial approach to the insolvency process, adding to costs and delay. A debtor may have its own agenda that clashes with the objectives of the insolvency regime and in particular with the maximization of returns for creditors. Its overriding goal, for example, may be to ensure that it does not lose control of the business rather than to maximize value for the benefit of creditors. Furthermore, the success of reorganization may depend not only upon instituting change that the debtor may not be willing to accept, but also upon the debtor possessing the knowledge and experience to utilise the insolvency law to work through its financial difficulties. A related factor to be considered is whether the insolvency proceedings were commenced on application of the debtor or of creditors (in which case the debtor may be hostile to creditors).

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

369. Insolvency laws adopt different approaches to balancing these competing considerations in reorganization. These vary between displacing the debtor and appointing an insolvency representative, at one end of the scale, and allowing the debtor to remain in control of the business with minimum supervision at the other. Intermediate approaches provide for an insolvency representative to be appointed to exercise some level of supervisory function, as well as for retention of existing management. The choice between these various approaches has implications for the structure of the insolvency regime and in particular for the balance to be achieved between the various participants and the extent to which checks and balances, whether provided by the court or creditors, will apply.

(ii) *Approaches to a continuing role for the debtor*

- *Total displacement of the debtor*

370. This approach follows the same procedure as in liquidation, removing all control of the business from the debtor and appointing an insolvency representative to undertake the debtor's functions with respect to management of the business. As noted above, however, total displacement of the debtor may cause disruption to the business and repercussions detrimental to its continuing operation at a critical point in its survival.

*- Supervision of the debtor by the insolvency representative*

371. Intermediate approaches establish different levels of control between the debtor and the insolvency representative. These generally involve some level of supervision of the debtor by the insolvency representative, such as where the latter broadly supervises the activities of the debtor and approves significant transactions, while the debtor continues to operate the business and take decisions on a day-to-day basis. This approach may need to be supported by relatively precise rules to ensure that the division of responsibility between the insolvency representative and the debtor is clear, and there is certainty as to how the reorganization will proceed. Some insolvency laws, for example, specify that certain transactions, such as entering into new debt, transferring or pledging assets and granting rights to the use of property of the insolvency estate, can be undertaken without the consent of the insolvency representative or the court provided they are undertaken in the ordinary course of business. If they are not in the ordinary course of business, consent is required. Monitoring the cash flow of the debtor's business may be an additional tool for policing the debtor and its transactions.

372. Where the debtor fails to observe the restrictions and enters into contracts requiring consent without first obtaining that consent, the insolvency law may need to address the validity of these transactions and provide appropriate sanctions for the debtor's behaviour. While one insolvency law provides, for example, that in these circumstances the court can discontinue the insolvency proceedings altogether, the appropriateness of this remedy depends not only upon whether the proceedings were commenced on the application of the debtor or creditors (the debtor should not be able to frustrate proceedings commenced on an application by creditors by failing to observe the insolvency law or orders of the court), but also upon what is in the best interests of all parties involved in the proceedings and the availability of other mechanisms in the insolvency law for addressing that type of behaviour by the debtor (including the possibility of converting reorganization proceedings to liquidation).

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

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

375. A different approach to the delineation of powers between the debtor and the insolvency representative is one where the insolvency law does not specify the transactions that the debtor may undertake, but allows the court or the insolvency representative to determine which legal acts management can perform with approval and which it cannot. While allowing some degree of flexibility, this approach may deter debtors from commencing insolvency proceedings as the effect of commencement on their management and control of the business will be unclear.

*- Full control by the debtor*

376. A further approach to the issue of the debtor's ongoing role is one that enables the debtor to retain full control over the operation of the business, with the consequence that the court does not appoint an independent representative once the proceedings commence (often known as "debtor in possession"). That approach may have the advantage of enhancing the chances of a successful reorganization if the debtor can be relied upon to carry on the business in an honest manner and obtain the trust, confidence and cooperation of creditors.

377. There may be, however, disadvantages to this approach which include it being used in situations where the outcome is clearly not likely to be successful; to delay the inevitable with the result that assets continue to be dissipated; the possibility that the debtor may act irresponsibly and even fraudulently during the period of control, undermining the reorganization as well as the confidence of creditors; and the potential for the process to offer a competitive advantage to struggling businesses if they are able to obtain cheap finance, reduced interest payments and other benefits that have the effect of lowering their costs relative to their market rivals. Some of these difficulties may be mitigated by adopting certain protections such as a requirement that the debtor report regularly on the conduct of the proceedings to the court; permitting the court, in certain circumstances, to appoint an insolvency representative to supervise the debtor; giving the creditors a significant role in supervising or overseeing the debtor; or providing for conversion of the proceedings to liquidation. It should be noted that where this approach is adopted, the management of the debtor at the commencement of the proceedings is often not the same management that is charged with implementation of an approved plan, and some of the factors noted above will not be as compelling as they may be where the debtor's management remains in place throughout the proceedings. Nevertheless, the debtor-in-possession approach is a complex one that requires detailed consideration not only because it depends upon strong corporate governance rules and institutional capacity, but also because it affects the design of a number of other provisions of an insolvency regime (e.g. preparation of the reorganization plan, exercise of avoidance powers, treatment of contracts, obtaining post-commencement finance) that are not addressed in detail in this Guide.

### **3. Rights of the debtor**

378. To preserve what are regarded in some countries as fundamental rights of the debtor and to ensure its fair and impartial treatment, and perhaps more importantly to encourage debtor confidence in the insolvency process, it is desirable that the role of the debtor in the insolvency proceedings and the rights it will have with respect to the conduct of the proceedings are clearly enumerated in the insolvency law. In many countries, the rights of a natural person debtor in insolvency proceedings may

be affected by obligations under international and regional treaties such as the International Covenant on Civil and Political Rights (1976) and the European Convention on Human Rights (1950).

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

379. It is desirable, for the reasons indicated above, that the debtor has the right to be heard in the insolvency proceedings and to participate generally in the decision making that is a necessary part of the proceedings, particularly reorganization proceedings. In particular, the debtor should be able to access information relating to the progress of the proceedings in all cases, but especially where the insolvency law provides for some level of displacement of the debtor (whether in liquidation or reorganization) from management and control of the business. This access to information may be particularly important in reorganization where the insolvency law provides for some level of displacement before approval of the plan, but requires the debtor to take responsibility for the plan's implementation. It may also be appropriate, in circumstances where the debtor does not play a role in formulation of the plan, for it to be given an opportunity to express an opinion on the plan before it is submitted for approval. As noted above in chapter II.A.3, where the debtor is a natural person, certain assets are generally excluded from the insolvency estate to enable the debtor to preserve its personal rights and those of its family and it is desirable that the right to retain those excluded assets be made clear in the insolvency law.

380. There may be situations, however, where the exercise or observance of these rights leads to formalities and costs that impede the course of the proceedings without being of any direct benefit to the debtor. It may be the case, for example, that where the debtor is no longer available in the jurisdiction in which the proceedings are being conducted and refuses or fails to respond to all reasonable attempts by the insolvency representative or the court to establish contact, an absolute requirement to be heard could seriously impede progress of the proceedings, if not make them impossible to undertake. Similarly in cases where the debtor is no longer operational and cannot be heard as such, or where the shareholders and owners of the business will not participate in any distribution in the proceedings, an absolute requirement to be heard may not serve any useful purpose. For these reasons, while it is desirable to provide that all reasonable efforts to allow the debtor to be heard should be made, an insolvency law may need to provide some flexibility in exceptional cases to avoid the requirement to observe the right adversely affecting the conduct of the proceedings.

**4. Obligations of the debtor**

381. As noted with respect to the rights of the debtor, it is desirable that the insolvency law clearly identify the obligations of the debtor with respect to the insolvency proceedings, including, as far as possible, the content and terms of the obligations and to whom each obligation is owed. The obligations should arise on the commencement of the proceedings and continue to apply throughout the proceedings. These obligations will need to be adjusted to the role to be played by the debtor in respect of both liquidation and reorganization proceedings, especially with regard to management and control of the business in reorganization. For example, where the debtor remains in control of the business in reorganization, an

obligation to surrender control of the assets of the insolvency estate will not be applicable.

**(a) Cooperation and assistance**

382. To ensure that insolvency proceedings can be conducted effectively and efficiently, some insolvency laws that provide for some level of displacement or supervision of the debtor impose on the debtor a general obligation to cooperate with and assist the insolvency representative in performing its duties, and in some laws to refrain from conduct that might be injurious to the conduct of the proceedings. An essential part of the obligation to cooperate will be to enable the insolvency representative to take effective control of the insolvency estate by surrendering control of assets, business records and books. Where the assets of the debtor are located in a foreign jurisdiction, it may not be possible for the debtor to surrender control of those assets, but the obligation should refer to facilitating or cooperating with the insolvency representative in the recovery of those assets located abroad (see chapter VII on Model Law on Cross-Border Insolvency). The obligation to cooperate may also require the debtor to assist the insolvency representative to prepare a list of creditors and their claims, as well as a list of the debtor's debtors (see chapter III.B.4).

**(b) Provision of information**

383. To facilitate a thorough, independent assessment of the business activities of the debtor, including its immediate liquidity needs and the advisability of post-commencement financing, the prospects for the long term survival of the business, and whether management is qualified to continue to lead the business, information concerning the debtor, its assets and liabilities, financial position and affairs generally will be required. To enable that assessment to be undertaken, it is desirable that in both liquidation and reorganization, but particularly in reorganization and where the business is to be sold as a going concern in liquidation, the debtor has a continuing obligation to disclose detailed information regarding its business and financial affairs over a substantial period, not simply the period in proximity to commencement of proceedings. That detailed information may include information concerning assets and liabilities; income and disbursements; customer lists; projections of profit and loss; details of cash flow; marketing information; industry trends; information thought to concern the causes or reasons for the financial situation of the debtor; disclosure of past transactions that involved the debtor or assets of the debtor, including those that may be capable of avoidance under the avoidance provisions of the insolvency law; and information concerning outstanding contracts, transactions involving related persons and ongoing court, arbitration or administrative proceedings against the debtor or in which the debtor is involved. A number of insolvency laws also require the debtor to provide information concerning its creditors and, as noted above, to prepare, often in cooperation with the insolvency representative, a list of creditors against which claims can be verified, as well as a list of its debtors. The debtor may also be required to update the list from time to time as claims are verified and a decision as to admission is made.

384. Although it may not be necessary for an insolvency law to exhaustively detail the information that is to be provided by the debtor, such an approach may be useful



to provide guidance on the type of information that is expected to be provided. In that regard, some laws have developed standardized information forms that set out the specific information required. These are to be completed by the debtor (with appropriate sanctions for false or misleading information) or by an independent person or administrator.

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

386. The process for eliciting the information outlined above may be central to its ultimate usefulness. If, for example, members of the management of the debtor are responsible for the debtor's current financial situation, they may be unwilling to give full and frank disclosure or to disclose information that may be self-incriminating (although many criminal laws provide that self-incriminating evidence may not be used in subsequent criminal proceedings in order to encourage frank disclosure). Accordingly, in addition to the debtor's obligation to provide information, it may be desirable for an insolvency law to give the insolvency representative and the creditors or the creditor committee the corresponding right to demand and receive information from the debtor, with appropriate sanctions where the requested information is not forthcoming. The debtor's obligation may be supplemented by additional measures that may include appointing an independent examiner or requiring the debtor itself (where it is a natural person) or one or more of the directors of the debtor to be represented at or required to attend a main meeting of creditors to answer questions (except where this is not physically possible for geographical reasons).

**(c) Confidentiality**

387. Often the information to be provided by the debtor will be of a commercially sensitive nature, confidential or subject to obligations owed to other persons (such as trade secrets, lists of customers and suppliers, research and development information) and may either belong to the debtor or to a third party, but be in the control of the debtor. It is desirable that an insolvency law includes provisions to protect these types of information from abuse by creditors or other parties who are in a position to take advantage of it in insolvency. In order to balance the debtor's obligation of protection against its obligation to provide information to the insolvency representative, the court or to creditors, the obligation to observe confidentiality and protect this information may also need to apply to parties connected to the debtor, the insolvency representative, creditors generally, creditor committees and third parties.

**(d) Ancillary obligations**

388. A number of insolvency laws impose additional obligations that are ancillary to the debtor's obligation to cooperate and assist. These may include, for example, an obligation (applying either to a natural person debtor or the managers and directors of a legal person debtor) not to leave their habitual place of residence without the permission of the court or the insolvency representative or to provide

notice to the court or the insolvency representative if they propose or are forced to leave that residence, to disclose all correspondence to the insolvency representative or the court and other limitations touching upon personal freedom. In the case of a legal person debtor, limitations may also apply to movement of the headquarters of that legal person and the insolvency law may require consent of the court or the insolvency representative. These limitations may be crucial to avoid disruption to the insolvency proceedings by the common practice of debtors leaving the place of business and of directors and managers resigning from office upon commencement. Where they are included in an insolvency law, it is desirable that these ancillary duties be proportionate to their underlying purpose and to the overall purpose of the general duty to cooperate; they may also be limited by the application of relevant human rights conventions and agreements as noted above.

389. Some insolvency laws specify these obligations as automatically applicable, while others provide that they may be applied at the discretion of the court where they are determined to be necessary for the administration of the estate. Some laws also distinguish between natural and legal person debtors; where the debtor is a natural person, limitations will only apply by order of the court, but where the debtor is a legal person, some limitations may apply automatically, such as the requirement to disclose correspondence.

**(e) Employment of professionals to assist the debtor**

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

**(f) Failure to observe obligations**

391. Where the debtor fails to comply with its obligations, the insolvency law may need to consider how that failure should be treated, taking into account the different nature of obligations and appropriate sanctions. As noted above, where information is withheld by the debtor, a mechanism to compel the provision of relevant information such as a “public examination” of the debtor by the court or the insolvency representative may be appropriate. In more serious cases of withholding of information a number of countries impose criminal sanctions. Similar approaches may be appropriate for the breach of other obligations. In reorganization, conversion to liquidation (see chapter IV.A.14) may be an appropriate sanction, provided it is in the best interests of creditors; there will be cases where continuation of the reorganization, notwithstanding the debtor’s failure to cooperate or to otherwise observe its obligations, will be in the best interests of creditors.

392. The insolvency law may also need to consider the consequences of actions taken in violation of the obligations and whether or not those actions should be invalid. For example, contracts entered into by the debtor after the commencement of proceedings might be addressed in the context of avoidance proceedings or as unauthorised transactions. Consideration may also need to be given to the parties to whom the sanctions should apply in the case of a legal person debtor for example, any person who generally might be described as being in control of the debtor, including directors and management.

## 5. Debtor's liability

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

### Recommendations

#### Purpose of legislative provisions

The purpose of provisions concerning the debtor is to:

- (a) establish the rights and obligations of the debtor during the insolvency proceedings;
- (b) address the remedies for failure of the debtor to meet its obligations;
- (c) address issues relating to management of the debtor in insolvency proceedings.

#### Content of legislative provisions

##### *Rights*

- *Right to be heard (see recommendation (121))*
- *Right to participate and request information*

(93) The law should specify that the debtor is entitled to participate in the insolvency proceedings, and to obtain information relating to the insolvency proceedings from the insolvency representative and the court.

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

(94) Where the debtor is a natural person, the law should specify that the debtor is entitled to retain those assets excluded from the estate by the law.<sup>79</sup>

<sup>79</sup> See chapter II.A.

*Obligations*

(95) The law should clearly specify the debtor's obligations in respect of insolvency proceedings, which obligations should arise on the commencement of, and continue throughout, those proceedings. The obligations should include:

(a) to cooperate with and assist the insolvency representative to perform its duties;

(b) to provide accurate, reliable and complete information relating to its financial position and business affairs that [reasonably] might be requested by the court, the insolvency representative, creditors and/or the creditor committee, including lists of:<sup>80</sup>

(i) transactions occurring prior to commencement that involved the debtor or the assets of the debtor;

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

(iii) assets, liabilities, income and disbursements;

(iv) debtors and their obligations;

(v) creditors and their claims in cooperation with the insolvency representative and to revise and amend the list as claims are verified and admitted or denied;

(c) [where an insolvency representative is appointed] to enable the insolvency representative to take effective control of the estate and to facilitate or cooperate in the recovery by the insolvency representative of the assets, or control of the assets of the estate, wherever located<sup>81</sup> and business records;

(d) where the debtor is a natural person, to provide notice to the court if it proposes or is forced to leave its habitual place of residence and, where the debtor is a legal person, to obtain the consent of the court or the insolvency representative to the movement of the headquarters of the debtor.

*Confidentiality*

(96) The law should specify protections for information provided by the debtor<sup>82</sup> that is commercially sensitive or confidential.

*The debtor's role in continuation of the business*

(97) The law should specify the role of the debtor in the continuing operation of the business during insolvency proceedings. Different approaches may be taken, including:

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<sup>80</sup> Subject to allowing the debtor the time necessary to collect the relevant information.

<sup>81</sup> See chapter VII—the Model Law on Cross-Border Insolvency and appointment of a foreign representative.

<sup>82</sup> Information provided by the debtor may include information in control of the debtor, owned by the debtor or a third party.

(a) retention of full control of the business (debtor-in-possession), with appropriate protections including varying levels of control of the debtor and provision for displacement of the debtor in specified circumstances;<sup>83</sup>

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

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

*Sanctions for failure to comply*

(98) The law should permit the imposition of sanctions for the failure of the debtor to comply with its obligations under the law.

## **B. The insolvency representative**

### **1. Introduction**

394. Insolvency laws refer to the person responsible for administering the insolvency proceedings by a number of different titles, including administrators, trustees, liquidators, supervisors, receivers, curators, official or judicial managers, or commissioners. The term “insolvency representative” is used in this Guide to refer to the person undertaking the range of functions that may be performed in a broad sense without distinguishing between the different functions that may be performed in different types of proceedings. The insolvency representative may be an individual or, in some jurisdictions, a corporation or other separate legal entity. However appointed the insolvency representative plays a central role in the effective and efficient implementation of the insolvency law, with certain powers over debtors and their assets, a duty to protect those assets and their value, as well as the interests of creditors and employees, and to ensure that the law is applied effectively and impartially. Accordingly it is essential that the insolvency representative be appropriately qualified and possess the knowledge, experience and personal qualities that will ensure not only the effective and efficient conduct of the proceedings and but also that there is confidence in the insolvency system.

### **2. Qualifications**

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

<sup>83</sup> It should be noted that this option relies on a well-developed court structure and the application of protections that operate to displace the debtor in certain circumstances. For a more detailed explanation see chapter III.A.2 (b) (ii).

not be relevant to that appointment (although they may be relevant to the employment of the official by the government agency).

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

**(a) Interim insolvency representative**

397. Where an insolvency representative is appointed on an interim basis by the court before insolvency proceedings commence, the powers and functions of that person generally will be determined by the court. To the extent that they are the same as those of an insolvency representative appointed after commencement of proceedings, the interim insolvency representative should have the same qualifications, as well as liability and rates of remuneration as a representative appointed after commencement.

**(b) Knowledge and experience**

398. The complexity of many insolvency proceedings makes it highly desirable that the insolvency representative be appropriately qualified with knowledge of the law (not only insolvency law, but also relevant commercial, finance and business law), as well as adequate experience in commercial and financial matters, including accounting. The insolvency representative will be required to demonstrate competence in carrying out its assigned functions in a range of different cases and circumstances that are likely to be contentious, in both liquidation and reorganization, where time limits may be imposed by the insolvency law, where commercial requirements have to be balanced against legal considerations, and where there is a need to serve the interests of others, such as creditors and maybe a public interest. If further or more specialized knowledge is required in a particular case, it can always be provided by hired experts. Some insolvency laws also require that a person to be appointed as an insolvency representative in a particular case have expertise and skills suited to that case, such a knowledge of the debtor's particular business, its assets and the type of market in which it operates.

**(c) Ensuring appropriate qualifications**

399. Different approaches are taken to ensuring the appropriate qualification of the insolvency representative, including a requirement for certain professional qualifications and examinations; licensing where the licensing system is administered by a government authority or professional body; specialised training courses and certification examinations; requirements for certain levels of experience (generally specified in numbers of years) in relevant areas, for example, finance, commerce, accounting and law, as well as in the conduct of insolvency proceedings. There may also be requirements for ongoing professional education to ensure familiarity with current developments in relevant areas of law and practice. Those

systems which require some form of licensing or professional qualification and membership of professional associations often also address issues of supervision and discipline, and an insolvency representative may be subject to regulation by the court, a professional association, a corporate regulator or other body, under legislation other than the insolvency law. A number of these systems are relatively complex and it is beyond the scope of the Guide to consider them in any detail.

**(d) Personal qualities**

400. In addition to having the requisite knowledge and experience, it may also be desirable that the insolvency representative possesses certain personal qualities, such as integrity, impartiality and good management. Integrity may require that the insolvency representative have a sound reputation and no criminal record or record of financial wrongdoing, or in some countries, no previous insolvency or removal from a position of public administration. The occurrence of such an event generally would be sufficient to disqualify the proposed appointee from appointment.

**(e) Conflicts of interest**

401. An essential element of these qualities is that the insolvency representative be able to demonstrate independence from vested interests, whether of an economic, familial or other nature. To that end, it is desirable that the insolvency law impose an obligation to disclose existing or potential conflicts of interest, which would apply to a person proposed for appointment as an insolvency representative at the commencement of the proceedings and to the appointed person on a continuing basis throughout the proceedings. The law should specify to whom the disclosure should be made which may vary depending upon the procedure for selection and appointment of the insolvency representative. The circumstances that amount to a conflict of interest vary between laws, as do the consequences of a conflict being disclosed at the commencement of proceedings or discovered at some later stage.

402. A conflict of interest may arise, for example, from a number of prior or existing relationships with the debtor. Prior ownership of the debtor, a prior or existing business relationship with the debtor (including being a party to a transaction with the debtor that may be subject to investigation in the insolvency proceedings and being a creditor or debtor of the debtor), a relationship with a creditor of the debtor, prior engagement as a representative or officer of the debtor, and a relationship with a competitor of the debtor may be sufficient to establish a conflict of interest. In some countries that conflict of interest will preclude the appointment of the person as an insolvency representative, or disqualify an appointee from continuing in that role. In other countries, the person may still be appointed provided the conflict of interest is disclosed on the basis that the disclosure supports their integrity and any impartiality or lack of independence can be assessed against the circumstances disclosed. In order to enhance the transparency, predictability and integrity of the insolvency system, it is desirable that the insolvency law specify the degree of relationship which may give rise to such a conflict of interest. It is generally left to the courts to determine whether or not a conflict of interest or a basis for demonstrating lack of independence exists in a particular case.

### **3. Selection and appointment of the insolvency representative**

403. Insolvency laws adopt a number of different approaches to selection and appointment of an insolvency representative. The insolvency representative can be selected from a number of different backgrounds such as from the ranks of the business community, from the employees of a specialized governmental agency or from a private panel of qualified persons (often lawyers, accountants or other professionals). In some jurisdictions, the insolvency law provides that a particular public official (variously titled the Official Trustee, the Official Receiver, the Official Assignee) automatically will be appointed to all insolvency cases or to certain types of insolvency cases. In many countries, the insolvency representative must be a natural person, but some countries do provide that a legal person may also be eligible for appointment, subject to certain requirements such as that the individuals to undertake the work on behalf of the legal person are appropriately qualified and that the legal person itself is subject to regulation.

#### **(a) Court selection and appointment**

404. In many jurisdictions, it is the court that selects, appoints and supervises the insolvency representative. The selection may be made from a list of appropriately qualified professionals at the discretion of the court, it may be made by reference to a roster or rotation system or by some other means, such as the recommendation of the creditors or the debtor. While ensuring fair and impartial distribution of cases, one possible disadvantage of a roster system is that it may not ensure the appointment of the person most qualified to conduct the particular case. That may depend, of course, upon the manner in which the roster list is compiled and upon the qualifications required of insolvency professionals in order to be included on that list. That disadvantage may not be perceived to be an important issue where the estate does not have sufficient assets to fund the cost of the administration.

#### **(b) Independent appointing authorities**

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

#### **(c) Role of creditors**

406. Another approach allows creditors to play a role in recommending and selecting the insolvency representative to be appointed, provided that that person meets the qualifications for serving in the specific case. The approaches that rely upon the independent appointing authority and the creditor committee may serve to avoid perceptions of bias and assist in reducing the supervisory burden placed upon



the courts. A different approach permits the debtor to appoint the insolvency representative in those cases where reorganization proceedings are commenced by the debtor. This approach allows discussions to take place between the debtor and other parties, such as secured creditors, before commencement of the proceedings to familiarise the prospective representative with the business and allows the debtor to select an insolvency representative that it considers will be best able to conduct the reorganization. Concerns may be raised, however, as to the independence of the insolvency representative. These may be addressed by permitting creditors, in appropriate circumstances, to replace an insolvency representative appointed by the debtor.

#### **4. Oversight of the insolvency representative**

407. In addition to the requirements for qualifications and personal qualities applicable on appointment, oversight of the insolvency representative's performance of its functions (and its demonstration of the qualities indicated above), can occur in respect of individual cases through the design of the insolvency law and the respective roles assigned to participants. [232] Insolvency laws adopt a variety of approaches, for example, to the relationship between the insolvency representative and the court and, in particular, to the delineation of powers between them, as well as to the role that creditors might play in overseeing certain decisions of the insolvency representative and on other issues, such as remuneration and even removal from office. Since it normally has the most information regarding the situation of the debtor, the insolvency representative often is in the best position to make informed decisions about the conduct of the insolvency proceedings. That does not mean, however, that the insolvency representative can act as a substitute for the court. Notice may be required to be given to the court or to creditors before the insolvency representative takes certain decisions, the insolvency representative may be required to report to the court and to creditors on a regular basis or in respect of certain activities, the court would generally be required to adjudicate disputes arising in the conduct of the proceedings and its approval is often required at a number of stages of the proceedings. Even in countries where the court plays a more limited role in insolvency, there is a limit to the amount of authority that would normally be conferred upon an insolvency representative.

#### **5. Duties and functions of the insolvency representative**

408. Insolvency laws often specify the duties and functions that the insolvency representative will have to perform in the proceedings and it is important that the insolvency law provide the insolvency representative with the powers necessary to carry out these duties and functions efficiently and effectively. Although some of those noted below may be more relevant to liquidation than to reorganization, the insolvency representative's duties and functions with respect to the administration of the proceedings and preservation and protection of the estate may generally include those set out below. This list is not intended to be exhaustive and in some cases the different functions will overlap or may not be relevant because of the design of the insolvency law.

- (i) taking immediate control of the assets comprising the insolvency estate and the debtor's business records;
- (ii) representing the insolvency estate;

- (iii) obtaining post-commencement finance;
- (iv) exercising rights for the benefit of the insolvency estate in respect of court, arbitration or administration proceedings underway;
- (v) taking all steps necessary to protect and preserve the assets of the insolvency estate and the debtor's business, including preventing unauthorised disposal of those assets and exercising avoidance powers to pursue the recovery of assets disposed of improperly to defeat creditors;
- (vi) registering rights of the estate (where registration is necessary to perfect the rights of the estate against bona fide purchasers);
- (vii) appointing and remunerating accountants, attorneys and other professionals that may be necessary to assist the insolvency representative in performing its functions;
- (viii) obtaining information concerning the debtor, its assets, liabilities and past transactions (especially those taking place during the suspect period) including examining the debtor and any third person having had dealings with the debtor;
- (ix) examination of contracts that are not fully performed with a view to deciding whether to continue performance or reject;
- (x) dealing with employees and their rights and entitlements, including pension rights;
- (xi) in liquidation, realizing the assets of the insolvency estate;
- (xii) verifying and admitting claims and maintaining an updated list of claims verified and admitted;
- (xiii) periodically providing information to the court and to creditors detailing the conduct of the proceedings. The information should include, for example, details of the assets sold during the period in question, the prices realized, the expenses of sale and such information as the court may require or the creditors' committee may reasonably require; receipts and disbursements; assets remaining to be administered;;
- (xiv) attending meetings of creditors;
- (xv) managing the business in reorganization and in liquidation where the business is to be sold as a going concern;
- (xvi) in reorganization, preparing or assisting to prepare a plan of reorganization or a report as to why reorganization is not possible (where this function is to be carried out by the insolvency representative);
- (xvii) supervising approval of the reorganization plan and, where required, the implementation of the plan;
- (xviii) distributing the proceeds of realization of the estate in liquidation and closing the estate promptly, efficiently and in accordance with the best interests of the various constituencies in the case;
- (xix) submitting a final report and accounting of the insolvency estate's administration to the court or the creditors, as required;

(xx) any other matters that may be referred to the insolvency representative by the creditors or determined by the court.

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

410. Where reorganization involves a debtor-in-possession and no insolvency representative is appointed, many of these functions will be performed by the debtor, with varying degrees of supervision by the court or by creditors.

## **6. Confidentiality**

411. The need to impose an obligation of confidentiality on the debtor has been noted above. It may also be appropriate for the insolvency law to impose a duty of confidentiality on the insolvency representative as much of the information that will be obtained concerning the debtor's affairs will be of a commercially sensitive nature, confidential or subject to obligations owed to other persons (such as trade secrets, research and development information and customer information) and should not be disclosed to third parties who may be in a position to take unfair advantage of it. Where the information is to be disclosed to creditors, those creditors should be under the same obligation of confidentiality as the insolvency representative. Observation of confidentiality may be particularly important where the insolvency representative has the power to compel disclosure of information and documents in the course of an examination of the debtor. Some of this information may come from third parties and be subject to privacy protection provisions and secrecy provisions, such as those applicable to banks. It is desirable that the insolvency representative be permitted to use that information only for the purposes of the insolvency proceedings in the context of which the examination was permitted, unless the court decides otherwise. This issue may also be relevant to the provision and obtaining of information in the context of criminal proceedings against the debtor. A similar obligation of confidentiality should apply to agents and employees of the insolvency representative (see section 8 below) and to other parties as ordered by the court.

## **7. Remuneration of the insolvency representative**

### **(a) Determination of quantum**

412. In addition to the reimbursement of the proper expenses incurred in the course of administration of the estate, the insolvency representative will be entitled to receive remuneration for its services. That remuneration should be commensurate with the qualifications of the insolvency representative and the tasks it is required to perform, and achieve a balance between risk and reward in order to attract appropriately qualified professionals. Several methods are adopted for calculating that remuneration. It may be fixed by reference to an approved scale of fees set by a government agency or professional association; determined by the general body of creditors, the court or some other administrative body or tribunal in a particular case; based upon the time properly spent by the insolvency representative (and the various categories of person who are likely to work on the insolvency

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

**(b) Means of payment**

417. Payment of the remuneration of the insolvency representative is often a source of complaint from unsecured creditors; the most common source of available funds is often unencumbered assets and payment may result in nothing being left for distribution to those creditors. While it would be unfair to draw the conclusion that the costs of administration were excessive simply because they exceeded the unencumbered assets available to pay them, the occurrence of unsecured creditors seeing most, if not all of the available assets being used to cover the costs of the administration, and perceptions of unfairness relating to the total cost of administration compared to the value of assets recovered, do point to the need to give this issue careful consideration. Different approaches can be taken to payment of the insolvency representative. For example, where the estate includes unencumbered assets, remuneration could be paid from these; a surcharge could be levied against assets to pay for the administration or sale of those assets where the administration or sale was of benefit to the creditors; a surcharge also could be levied on creditors making an application to cover at least initial costs and performance of basic functions; or encumbered assets may be subject to payment of a proportionate or defined share of remuneration (see chapter VI Priorities). Another approach is to pay the insolvency representative from a fund maintained for that purpose by the State, an approach that may be particularly relevant in the case of debtors with insufficient assets to pay for administration of the estate (see chapter I.B.6).<sup>84</sup>

**(c) Review of remuneration**

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

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<sup>84</sup> Such a fund may be financed by a number of means, for example payments by the directors of debtors being liquidated, increased filing fees for insolvency applications, requiring all monies realized in liquidation to be deposited into a common account, with interest going to the fund, levies on lodgement of annual corporate returns.

## **8. Liability of the insolvency representative**

419. The standard of care to be employed by the insolvency representative and its personal liability are important to the conduct of insolvency proceedings. Establishing a measure for the care, diligence and skill with which the insolvency representative is to carry out its duties and functions requires that the difficult circumstances in which the insolvency representative finds itself when fulfilling its duties are taken into account and balanced against payment of an appropriate level of remuneration and the need to attract qualified persons to act as insolvency representatives. A balance is also desirable between a standard that will ensure competent performance of the duties of the insolvency representative and one that is so stringent it invites law suits against the insolvency representative and raises the costs of its services. The insolvency law will also need to take into consideration the fact that the liability of the insolvency representative may often involve the application of law outside of insolvency, or where the insolvency representative is a member of a professional organization, the relevant professional standards of the organization.

420. Under many legal systems, the insolvency representative will be liable in a civil action for damages arising from its misfeasance or malfeasance, although different approaches are taken to setting the standard required. To some extent, the measure adopted will depend upon the how the insolvency representative is appointed and the nature of the appointment (e.g. a private practitioner as opposed to a government employee). One approach may be to require the insolvency representative to observe a standard no more stringent than would be expected to apply to the debtor in undertaking its normal business activities in a state of solvency, that of a prudent person in that position. Some countries, however, may require a higher standard of prudence in such a case because the insolvency representative is dealing with assets belonging to another person, not its own assets. A different formulation is one based upon an expectation that the insolvency representative act in good faith for proper purposes. A further approach may be based upon the standard of care required to determine negligence.

421. One means of addressing the issue of liability for damages may be to require the insolvency representative to post a bond or take out insurance to cover loss of assets of the estate or possible damages payable as a result of a breach of its duties. A number of insolvency laws require both payment of a bond and insurance where the bond will cover one kind of damage and the insurance another, while others require only insurance. In some cases the level of the bond required relates to the book value of the assets of the insolvency estate, in others both the value of the bond and the amount of insurance cover required are established in the rules of the relevant professional association or regulatory body, or even in the insolvency law. A further distinction between the two approaches may relate to the procedure for making a claim for damages and whether it is different for claiming against a bond or against insurance. Paying a bond or obtaining personal indemnity insurance however, may not be possible in all countries and other solutions will be needed. In designing the solution to this issue, a balance may be desirable between controlling the costs of the service provided by insolvency representatives and distributing the risks of the insolvency process among the participants, rather than placing it entirely upon the insolvency representative on the basis of availability of personal indemnity insurance.

422. Another issue may be the personal liability of the insolvency representative for obligations incurred in the ordinary course of insolvency proceedings, particularly in reorganization, such as those relating to the ongoing operation of the business. The advantages of adopting an approach that makes the insolvency representative personally liable would be that it creates certainty for suppliers to the debtor and may operate as a check to the incurring of debt. At the same time, however, it may also operate as a disincentive if the risk of personal liability far exceeds the fees that may be earned. One solution is to make only the assets of the estate liable, rather than the personal assets of the insolvency representative.

423. A further issue of liability relates to liability of the insolvency representative for wrongful acts of the debtor depending upon the level of control the insolvency representative exercises over the debtor's activities. Under some laws the insolvency representative may be made liable for the wrongful acts of the debtor during the period of its control, but it is not desirable that the insolvency representative be liable for acts of the debtor, such as environmental damage, occurring prior to its appointment as insolvency representative.

424. Where an action is commenced against the insolvency representative in its official capacity, consideration may need to be given to determining which court will have jurisdiction over the action. To avoid uncertainty and confusion, it may be desirable to ensure that it is the same court that appointed the insolvency representative (where the court plays a role in such appointment).

## **9. Agents and employees of the insolvency representative**

425. Some insolvency laws require court authorization for the insolvency representative to retain accountants, attorneys, appraisers and other professionals that may be necessary to assist the insolvency representative in carrying out its duties. Other laws do not require court authorization. It is desirable that an insolvency law establishes some criteria relating to the employment of such professionals in terms of their experience, knowledge and reputation, as well as the need for their services to be of benefit to the estate. The requirements for disclosure of conflicts of interest or circumstance giving rise to a lack of independence that apply to the insolvency representative are also relevant to professionals employed or proposed for employment by the insolvency representative, as are obligations of confidentiality.

### **(a) Liability for acts or omissions**

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

### **(b) Remuneration**

427. Different approaches may be adopted towards payment of the professionals employed by the insolvency representative. Some laws require an application to and approval by the court of the amount of the remuneration, while another approach may be to require approval by the creditor body. Professionals may be paid periodically during the proceedings, or may be required to wait until the

proceedings are completed. In terms of how they are to be paid, some insolvency laws provide that the insolvency representative will pay the professional and seek reimbursement from the estate, while under other laws the professional will have an administrative claim against the estate.

#### **10. Review of insolvency representative's administration**

428. The grounds upon which creditors may question either the decisions or administration of an insolvency representative and the decisions that may be subject to such questioning should be expressly stated in an insolvency law. The grounds for creditor action under existing laws can be divided into two main categories.

429. In the first category are those laws under which creditors are given certain rights where the insolvency representative can be shown to have committed some wrong. That wrong may include actual wrongdoing, such as the misappropriation of funds or assets or obtaining creditors' approval by improper means; procedural errors, such as a failure to seek a necessary approval of creditors or a creditors committee, or to undertake another act required by law; or negligence by the insolvency representative in the performance of its duties. Some jurisdictions limit a creditor's right to challenge the insolvency representative to some, if not all, of these situations.

430. In the second category are those laws which provide, normally in addition to the grounds related to specific wrongdoing, that creditors can test (typically in the courts) any decision, act or omission of the insolvency representative which they individually or collectively object to or disapprove of. The basis of a successful action will normally be grounds similar to those already mentioned above, but may also include proof that the decision, act or omission was contrary to the interests of creditors. To prevent unreasonable disruption of the administration of an estate, an insolvency law may adopt appropriate limitations such as adjusting the standard of proof to be met in order for the court to uphold the creditors' appeal or protecting certain aspects of an administration against appeal, e.g. excluding actions concerning commencement of insolvency proceedings.

431. Most laws provide the courts, in reviewing an insolvency administration and enforcing the substantive rights of creditors, a number of powers. At one level, a court may direct an insolvency representative to take, or refrain from taking, a particular action related to the creditor's objection. The court may also have powers to confirm, reverse or modify decisions of the insolvency representative or to remove the insolvency representative whether at the direct request of the objecting creditor or on the motion of the court (see chapter IV.B.9). Many insolvency laws provide that the insolvency representative is personally liable for damages intentionally or negligently caused to creditors through the performance of the insolvency representative's duties. Some insolvency laws also provide that in those circumstances the court may impose a monetary penalty on the insolvency representative.

#### **11. Removal of the insolvency representative**

432. Some insolvency laws permit the insolvency representative to be removed in certain circumstances which may include that the insolvency representative had violated or failed to comply with its legal duties under the insolvency law; had demonstrated gross incompetence or gross negligence; had not disclosed a conflict of interest; had engaged in illegal conduct; or for less serious reasons such as that

the proceedings require a particular or different competency that the appointed representative does not possess. The latter may occur, for example, where the proceedings are converted from liquidation to reorganization, which requires skills the insolvency representative may not have or, in the case of a debtor-in-possession reorganization, which do not require an insolvency representative to be appointed. Different approaches provide that removal may occur on the basis of a decision of the court, acting on its own motion or at the request of an interested party, or a decision taken by an appropriate majority of unsecured creditors. Whichever approach is adopted, removal operates as a sanction against the insolvency representative and it is therefore appropriate that the insolvency representative have the right to be heard and to present its case. In cases where the insolvency representative is subject to professional or regulatory supervision, they may be removed as the result of an investigation and review, which may also result in a licence or other authorization being taken away.

## 12. Replacement of the insolvency representative

433. In the event of the resignation or removal of the insolvency representative or the occurrence of any other event which might cause the insolvency representative to be unable to perform its duties, such as death or serious illness, disruption of the proceedings and the delay that may be occasioned by failure to provide for succession may be avoided by providing for the appointment of a successor insolvency representative, either by the court or by creditors. Some insolvency laws require the courts also to approve the resignation of the insolvency representative, while other laws do not. Where an insolvency law provides for replacement of the insolvency representative, it may also need to address issues relating to substitution and succession to either title or control (as appropriate) of the assets of the estate (see chapter II.A) as well as handing over to the successor the books, records and other information relating to the debtor. An insolvency law may also need to consider the issue of the validity of the acts undertaken in the conduct of the proceedings by the insolvency representative that has been replaced.

## Recommendations

### Purpose of legislative provisions

The purpose of provisions concerning the insolvency representative is to:

- (a) specify qualifications required for appointment ;
- (b) establish a mechanism for selection and appointment;
- (c) specify powers and functions ;
- (d) provide for remuneration, liability, removal and replacement.

### Contents of legislative provisions

#### *Qualifications*

(99) The law should specify the qualifications and qualities required for appointment as an insolvency representative, including integrity, independence, impartiality, requisite knowledge of relevant commercial law and experience in



commercial and business matters. The law should also specify the grounds upon which a proposed insolvency representative may be disqualified from appointment.

*Conflict of interest*

(100) The law should require the disclosure of a conflict of interest, a lack of independence or circumstances that may lead to a conflict of interest or lack of independence by:

(a) a person proposed for appointment as an insolvency representative ;

(b) persons proposed for employment by the insolvency representative or the estate including professionals.

(101) The law should specify that the obligation to disclose set forth in recommendation (100) should continue throughout the insolvency proceedings. The law should specify the consequences of a conflict of interest or lack of independence.

*Appointment*

(102) The law should establish a mechanism for selection and appointment of an insolvency representative. Different approaches may be taken, including appointment by the court; by an independent appointing authority; on the basis of a recommendation by creditors or the creditor committee; by the debtor; or by operation of law, where the insolvency representative is a government or administrative agency or official.

*Remuneration*

(103) The law should establish a mechanism for fixing the remuneration of the insolvency representative and establish priority for payment of that remuneration.

*Duties and functions of the insolvency representative*

(104) The law should specify that the insolvency representative has an obligation to protect and preserve the assets of the estate. The law should specify the insolvency representative's duties and functions with respect to the administration of the proceedings and preservation and protection of the estate.

*Right to be heard (see recommendation (121))*

*Liability*

(105) The law should specify the consequences of the insolvency representative's failure to perform, or to properly perform, its duties and functions under the law and the possible liability arising in each instance..

*Removal and replacement*

(106) The law should establish the grounds and procedure for removal of the insolvency representative. The grounds may include:

(a) incompetence, failure to perform or failure to exercise the proper degree of care in the performance of its powers and functions;

- (b) inability to perform;
  - (c) lack of a particular or specialized qualification required by a specific case;
  - (d) engaging in illegal acts or conduct;
  - (e) conflict of interest or a lack of independence that would justify removal;
- or
- (f) where the function of the insolvency representative changes.<sup>85</sup>

(107) The law should establish a mechanism for removal of the insolvency representative that reflects the manner in which the insolvency representative was appointed and provides a right for the insolvency representative to be heard.

(108) In the event of the death, resignation, or removal of the insolvency representative, the law should establish a mechanism for appointment of a replacement and specify whether or not court approval of the replacement is necessary.

*Estates with insufficient assets to meet costs of administering insolvency proceedings*

(109) Where the law provides for appointment of an insolvency representative to administer an estate with insufficient assets to meet the costs of administering the insolvency proceedings, the law should also establish a mechanism for appointment and remuneration of that representative.

## C. Creditors—participation in insolvency proceedings

### 1. Introduction

434. Creditors have a significant interest in the debtor's business once insolvency proceedings are commenced. As a general proposition, these interests are safeguarded by the appointment of an insolvency representative, but for a number of different reasons, many insolvency laws provide for creditors to be directly involved in the proceedings. As the party with the primary economic stake in the outcome of the proceedings they may lose confidence in a process where key decisions are made without consulting them by individuals who may be perceived by creditors as having limited experience or expertise in the debtor's type of business or a lack of independence, depending upon the manner in which the representative is appointed. Creditors are often in a good position to provide advice and assistance with respect to the debtor's business and to monitor the actions of the insolvency representative, providing a check against possible abuse of the insolvency process and excessive administrative costs, as well as a means for processing and distributing information. Against the desirability of facilitating creditor participation must be balanced the need to ensure the creditor representation mechanism remains effective and cost-effective and avoids creditors involving themselves in matters that will not impact on their interests (although it may be difficult to draw a clear distinction between those matters that do have such an impact and those that do not).

<sup>85</sup> Such as where the proceedings are converted from liquidation to reorganization.

435. Where the insolvency law does provide for creditors to participate in the proceedings, that participation may take different forms. Under some laws it includes only the right to be heard and to appear in the proceedings, while under others it also includes the right to vote on specified matters, the provision of advice to the insolvency representative as required or on specified matters, and other functions and duties as determined by the insolvency law, the courts or the insolvency representative.

**2. Extent of involvement of creditors in the decision-making process**

**(a) Levels of participation**

436. There are varying possible degrees of involvement of creditors in decision-making in insolvency proceedings and insolvency laws adopt a wide range of approaches and mechanisms for creditor participation. An approach which allows only a low level of participation is reflected in those insolvency laws which provide that the insolvency representative makes all key decisions on uncontested general matters of administration, with creditors playing a marginal role and having little influence. Lack of creditor participation in this model may be balanced against the key obligations of the insolvency representative one of which is to protect the value of the insolvency estate, ultimately for the benefit of creditors generally. Such an approach may be effective where an experienced insolvency representative is appointed to the proceedings because it avoids potential delays and the costs involved in managing the participation of creditors, and where the insolvency system provides a high level of regulation of the process and its participants.

437. Other approaches afford creditors greater participation in the proceedings. This participation may range from participation at an initial meeting where certain matters are considered, to an ongoing role which may require creditors to perform only an advisory function or to approve certain acts and decisions of the insolvency representative. These acts and decisions generally involve administration of the proceedings and issues which affect the interests of creditors and may include the sale of significant assets, verification of claims, approval of administrative expenses and remuneration of the insolvency representative and approval of the insolvency representative's final report and accounting on the estate, and even primary responsibility for carrying out some administrative functions. Creditors may also have functions with respect to selection and appointment of the insolvency representative, as well as being able to seek the dismissal and replacement of the insolvency representative by the court for failure to perform its functions and duties or for negligence. Creditors may also have a role in requesting or recommending action from the court, for example, a recommendation that the reorganization be converted to liquidation or that an avoidance action be commenced by the insolvency estate or by creditors on behalf of the estate. It should be noted, however, that in considering the extent of the powers to be given to creditors to object to acts or decisions of the insolvency representative some level of disagreement is almost impossible to avoid, particularly as the insolvency representative will be required to act for the benefit of all creditors and to take action that individual creditors may not support or agree with. In the normal course of events, however, such dissatisfaction would not give the court cause to replace the insolvency representative or give the creditor grounds for an action against the insolvency representative. To some extent, the different approaches reflect different insolvency

cultures and traditions and in particular, different expectations on the part of creditors as to their participation in insolvency proceedings. However creditor participation is increasingly regarded as an important element of an insolvency law, particularly as a balance to the roles assigned other participants under the law and as an important means of safeguarding creditor interests.

**(b) Participation in liquidation and reorganization**

438. Some insolvency laws draw a distinction between liquidation and reorganization in setting the level of creditor participation. In liquidation, although generally it may not be important for creditors to intervene in the process or participate in decision making, they can provide a valuable source of expert advice and information on the debtor's business, particularly where it is to be sold as a going concern. It may be desirable for creditors to receive reports on the conduct of the liquidation to ensure their confidence in the process, as well as its transparency. In reorganization, however, the input of creditors is both useful and necessary, as they will generally determine whether a proposed reorganization plan will be supported and its implementation successful.

**(c) Mechanisms to facilitate participation**

439. In terms of the mechanisms for participation, some insolvency laws provide for full meetings of creditors to be convened at key points of the proceedings, while other laws provide for the formation of a committee (on which creditors sometimes may share representation with shareholders and possibly other interested parties) comprising a small number of creditors (which number may be specified in the insolvency law) to facilitate the participation in the administration of the estate. The former approach is most useful in cases with small numbers of creditors or where creditors are located in the same geographical region. The latter may be more useful where there are large numbers of creditors or creditors are located in different regions or even countries. Where a committee is appointed it should have the right to act independently of the insolvency representative, in order to ensure fair and unbiased representation of creditors' interests.

440. A further approach is to provide for the appointment (whether by creditors or by the court at the request of creditors) of a single person (in some laws referred to as an intervenor or inspector) to represent certain creditors or groups of creditors (for example, those holding at least ten percent of the debt). In one law where this approach has been adopted the rationale was to facilitate more orderly and timely participation by creditors and avoid the delays and disputes that previously had been encountered. The representative fulfils a role analogous to that of the creditor committee, acting on behalf of the creditors, for example, to monitor the administration of the estate by the insolvency representative or the debtor, request hearings, bring actions against the debtor, request provision of information on issues affecting the creditor's interests, or call for meetings of creditors. Under some laws, creditors are required to cover the fees of that representative in order to avoid excessive charges to the estate, while others make provision for those fees to be paid by the estate.

441. The choice between these different approaches may involve balancing factors such as time, cost, efficiency, transparency and democracy. The approach of appointing a representative, for example, may be more efficient and cost effective

and lead to more orderly proceedings with fewer disputes than the creditor committee approach. The latter approach, however, may be more transparent and a more democratic means of representing creditor interests. A further relevant factor may be the availability of well-trained insolvency professionals and effective institutional infrastructure to assist the insolvency process and a greater role may be accorded to creditors where these professionals are scarce or institutional capacity is weak.

**(d) Encouraging creditor participation**

442. An important issue that may need to be considered where an insolvency law allows creditors to participate actively in the process is how to overcome creditor apathy and encourage participation in the proceedings. It is not uncommon for creditors to adopt the view, even where the insolvency law provides for active participation, that nothing will be gained from such participation, especially where the return to creditors is unlikely to be significant and where participation may in fact require further expenditure of time and money. This common concern can be addressed to some extent by the overall balance that an insolvency law strikes between the different interests of the parties involved in the proceedings (see for example, chapter III.A.2) and by specific measures relating, for example, to selection of the creditor committee and the functions to be performed by that committee (or by creditors generally where there is no committee) (see below), as well as use of electronic means to facilitate communication and voting where required. A further concern may relate to possible liability for participating in the proceedings, particularly as a member of a creditor committee. This concern can be addressed by providing immunity from liability except in clearly defined circumstances, such as fraudulent or wilful behaviour (see below).

**(e) Need for information and notice**

443. It will be essential, in order to enable creditors to perform specific functions, that they be provided, either directly or through a creditor committee, with relevant, current and accurate information on the debtor's business and financial affairs, and be provided with notice of issues that affect their interests and on which they may be required to decide or advise. Issues of confidentiality, as noted above with respect to the debtor and the insolvency representative, will also be relevant to creditors or the creditor committee where they are provided with such information.

**(f) Secured creditors**

444. It is desirable that an insolvency law determines the extent to which secured creditors can or should participate at meetings of creditors or in a creditor committee. As a general rule, secured creditors are not represented on a creditor committee if they are fully secured or over-secured. In these cases, their interests are significantly different from those of unsecured creditors and their ability to participate in and potentially alter the outcome of decisions by creditors may not be in the best interests of all creditors. Recognizing this divergence of interests, some insolvency laws require secured creditors to surrender their security before they can participate in the proceedings and vote as a member of the creditor body. Where they are under-secured, however, their interests are more likely to align with those of unsecured creditors and their participation in the committee or in voting by the

creditor body may be appropriate, at least to the extent that they are under-secured. In proceedings such as reorganization, secured creditors will have an interest in negotiating with the debtor and other parties, particularly where their rights may be modified by a reorganization plan, or where the encumbered asset will be key to the successful implementation of the plan.

### **3. Functions to be performed by creditors**

445. As noted above, the functions to be performed by creditors vary widely between insolvency laws. In general, a determination as to which functions should be given to creditors involves a consideration of the overall design of the insolvency law and the balance to be achieved between the roles of the court, the insolvency representative, the debtor and creditors, particularly in terms of oversight and supervision.

446. In some cases, creditors perform a general advisory function and the insolvency representative may refer matters to the creditors, but will not be bound by any decision they take. Under other laws, the creditors may have specific functions to perform with regard to the conduct of the proceedings, which may involve cooperation and coordination with the insolvency representative. The insolvency representative may be required to consult with creditors on those matters before taking its decision or the decision-making power may reside with creditors. Other functions require the creditors to oversee the acts and decisions of the insolvency representative. Some of the issues in respect of which creditors may have an interest may include some or all of the following: continuation of the business in liquidation; post commencement financing; verification of claims; compensation of professionals, including the insolvency representative; exercise of avoidance powers; treatment of judicial proceedings to which the debtor was a party at the time of commencement; consideration and approval of a reorganization plan; appointing a committee or representatives of creditors; supervising the acts of the insolvency representative; distribution of assets; and consideration (and approval) of the insolvency representative's final report and accounting.

447. Where the insolvency representative is not bound to follow the decision of creditors, insolvency laws often provide that for certain acts the insolvency representative must seek the prior approval of the court, or that creditors may apply to the court to give binding instructions to the insolvency representative (or to seek replacement of the insolvency representative where the insolvency representative fails to meet its obligations or otherwise acts to the detriment of creditors). In the event of a dispute between the creditors and the insolvency representative, many laws give precedence to the decision taken at a meeting of creditors. A similar intention is found in the requirements for creditors to be consulted on any decisions that require court approval.

448. Where the insolvency law does provide creditors with the power to object to acts or decisions of the insolvency representative and where the insolvency representative does not agree with or accept such an objection, the course of action available to creditors and the applicable procedural and evidential requirements generally depend largely on the role assigned to creditors in a particular insolvency regime.

449. Where the regime provides for the actions or decisions of the insolvency representative to be supervised or approved by the general body of creditors or the creditor committee, a high level of creditor protection may ensue. Where that supervision or approval adds steps to the administration of the insolvency estate, however, it has the potential to affect the cost and efficiency of the administrative process. For these reasons an insolvency regime will need to balance the extent to which supervision or approval by creditors is required (including defining both the acts and decision that require approval and the procedure for obtaining that approval) against the independence of the insolvency representative and the desirability of speed and cost effectiveness in the conduct of the insolvency proceedings. Regimes vary in the balance reached between these possibly competing factors. Further relevant factors that may need to be taken into account include the extent to which the court plays a role in supervising the proceedings and the insolvency representative, and the manner in which the insolvency regime balances that role against the participation of creditors.

450. Whatever functions are to be performed by the creditors, it is desirable that an insolvency law clearly states whether creditors are required to undertake each of the specified functions, or whether certain functions are discretionary, and the manner in which creditors are to interact with the insolvency representative in the performance of those functions.

#### **4. Creditor meetings**

451. Many insolvency laws provide for the functions of creditors to be undertaken via general meetings of creditors. As noted above (see chapter I.B), an insolvency law should require creditors to be notified (whether by personal notice, advertisement or some other means) of the commencement of insolvency proceedings and for that notification to include advice on a number of matters, which may include details of an initial meeting of creditors, to be convened by the court or the insolvency representative within a prescribed period of time after commencement (examples of time limits included in insolvency laws range from five days to one month from the date of commencement). Under a number of insolvency laws, that initial meeting is the only meeting of all creditors that will take place. However, not all insolvency laws require such a meeting to be convened.

452. Where the insolvency laws provide for subsequent meetings of creditors to be held, different approaches are taken. Under some laws further meetings are to be convened by the court or the insolvency representative for specific purposes, while other laws include provision for creditors or the insolvency representative, and in some limited cases the debtor, to convene meetings on an ad hoc basis, as required. Where the insolvency law allows creditors to convene a meeting, the law may include certain limitations on when a meeting can be called or the conditions that must be fulfilled before a meeting can be called. These conditions may include the passing of a defined period of time after a certain step in the proceedings was to be taken, or upon the completion of defined acts or decisions of the insolvency representative or where the insolvency representative fails to act. Some laws also provide that only creditors holding a specified percentage of the total claims are entitled to call a meeting (examples include ten percent of creditors by value, creditors with no less than 25 percent of total claims or at least 25 percent of unsecured claims). A further approach allows any interested party the right to apply to the court to summon a meeting of creditors.

453. It is desirable that all creditors have the right to be heard on matters to be discussed at a creditor meeting. Where a vote of creditors is required, it is desirable that an insolvency law establishes the eligibility to vote and the voting mechanism, including in particular whether creditors are required to attend in person to vote or whether proxies and other means, such as email or the internet, can be used. Where certain kinds of creditors are included amongst a debtor's creditors, such as public bondholders, special rules may be required to facilitate their participation in the proceedings, especially where there are large number of them. It may be appropriate, for example, to permit duly authorized representatives to count towards requirements for the participation of specified numbers or percentages of creditors at a general meeting of creditors. The same considerations would also apply to requirement for voting; requirements for participation and voting in person could significantly complicate insolvency proceedings where the debtor's liabilities include publicly traded bonds.

454. It may also be desirable for an insolvency law to permit creditors to establish rules governing the conduct of creditor meetings to facilitate creditor participation, and where it would be appropriate to the role to be played by creditors in the proceedings. Issues to be covered by such rules may include eligibility to attend and participate, quorum, chairing and general conduct of the meeting.

#### **5. Creditor committee**

455. Under some insolvency laws, the formation of a creditor committee or the election or appointment of a creditor representative is designed to facilitate active creditor participation in insolvency proceedings, whether liquidation or reorganization. A creditor committee or other form of creditor representation may not be required in all insolvency cases, but may be appropriate where, for example, there is a very large number of creditors, where creditors have very diverse interests, or where other features of the case indicate that such an approach is desirable or necessary (e.g. to limit time and monetary costs). Some insolvency laws provide for creditors to determine whether or not they will appoint a committee or representative, while other laws provide for the court to appoint a committee or representative to help supervise the acts of the insolvency representative. However appointed, the creditor committee should be able to act independently of the insolvency representative to ensure fair and unbiased representation of creditors' interests.

456. Where a creditor committee is formed, it will be necessary to consider the extent to which the insolvency estate will pay the costs of the committee; some insolvency laws allow creditors to form unofficial committees which are not formally recognized by the court or the insolvency representative and whose costs are not reimbursed by the insolvency estate but must be by the creditors; other laws provide that the costs of the creditor committee are to be paid by the estate. The question of who should pay is closely linked to the role of the committee, the extent to which the functions specified under the insolvency law to be performed by the creditors can be performed by a committee and the factors determining whether a committee is to be formed in any particular proceeding. Where the costs are to be borne by the estate, it is desirable that the court have the authority to limit excessive costs.



**(a) Creditors that may be appointed to a committee**

457. An insolvency law that provides for the formation of a creditor committee will need to consider which creditors will be entitled to be appointed to that committee. Different approaches are taken to that issue. Some insolvency laws provide, for example, that only creditors whose claims have been admitted (by the court or the insolvency representative, depending upon the admission procedure) can be appointed, while other laws provide for appointment of a provisional committee, for which all creditors are eligible, until all claims have been verified and admitted. Other insolvency laws impose restrictions on the location of creditors who may serve on a creditors committee. To ensure equality of treatment of creditors, however, it is desirable that creditors such as those whose claims have only been provisionally admitted and foreign creditors are eligible for appointment to the committee.

458. A second issue relates to the types of creditors to be represented. Although creditor committees generally represent only unsecured creditors, some laws recognize that there may be cases where a separate committee of secured creditors is justified. Those systems base this approach on the fact that the interests of the different types of creditors do not always converge and the ability of secured creditors to participate in, and potentially affect, the outcome of decisions by the committee may not always be appropriate or in the best interests of other creditors. Nevertheless, it is also recognized that in certain circumstances, as noted above (see (b)(vi)), the participation of secured creditors will be appropriate.

459. Other insolvency laws provide for both types of creditors to be represented on the same committee. The rationale of this approach is that since the creditor committee is responsible for participating in the decision-making process and for making important decisions, secured creditors should participate otherwise they are excluded from the making of important decisions which may affect their interests (particularly where they are not fully secured). A further approach may be for an insolvency law not to specify which creditors should be represented in a given case, but to allow creditors to collectively choose their own representatives on the basis of willingness to serve (to address the common problem of creditor apathy) and to provide for enlargement or reduction of the size of the committee as required. Where the types of creditors requiring representation are too diverse to accommodate their interests within a single committee, as may be the case for special interest groups such as tort claimants and shareholders, an insolvency law could provide for different committees to represent different interests. It is desirable, however, that this mechanism only be used in special cases, in order to avoid unnecessary costs and the possibility of the creditor representation mechanism becoming unwieldy.

460. The participation of equity holders and creditors related to the debtor may be controversial, especially where the creditor committee has the power to affect the rights of secured creditors or where the equity holders are involved with the management of the debtor. There will be cases, however, where those parties have no direct knowledge of, or involvement with, the management of the debtor, such as where they are investors with no direct association with or access to management. In such cases, there may be compelling reasons for allowing them to participate through their own committee. Other creditors who may have a conflict of interest (such as competitors of the debtor who may have a personal interest with the potential to affect their impartiality in carrying out the functions of the committee)

may also need to be excluded from participation in a committee in order to ensure that the committee is able to perform its functions on behalf of the creditor body impartially and independently.

461. A similar question of participation may arise in respect of parties who purchase the claims of creditors. Such purchasers may be related to the debtor or may be third parties who have no particular interest in the business of the debtor. Third party purchases may give rise to concerns about access to sensitive, confidential information that may be of value in the secondary debt market, while related party purchases raise the question of whether the related party should be entitled to claim the original face value of the claim or only the amount actually paid for it (where there is a difference between the two), which may affect the ability to vote where it is directly related to the value of claims.

462. To address any potential problem, an insolvency law could adopt the approach of stipulating which parties are not entitled to participate in a creditor committee or vote on particular matters, such as selection of an insolvency representative or approval of a reorganization plan.

**(b) Formation of a creditor committee**

463. Where the law provides for the formation of a creditor committee, details of the manner in which the committee is to be formed, the scope and extent of its duties, its governance and operation, including voting eligibility and powers, quorum and conduct of meetings, as well as replacement and substitution of members are often also addressed. It may be desirable to include such provisions on some of these issues, particularly with respect to voting eligibility, duties and replacement and substitution of members, in an insolvency law not only to avoid disputes and ensure confidentiality, but also to provide transparent and predictable procedures. Other issues, can be addressed in procedural rules adopted by the committee, including rules on voting procedures and majorities; meeting procedure; election of a chairperson; and resolution of disputes.

464. A number of different approaches are taken to appointing the members of the committee, which depend to a large extent on the functions to be performed by the particular committee. In many cases, creditors are responsible for appointing the committee, normally at the initial meeting of creditors, or upon the provision by the insolvency representative of preliminary information regarding the debtor. Appointment of the committee by creditors may encourage both creditor confidence and participation in the insolvency process. Some jurisdictions allow the court to appoint a creditor committee, either at its own instigation or upon application by creditors or the insolvency representative. This approach may have a number of disadvantages, including that it has the potential for perceptions of bias, and a lack of equity and transparency; creditors may not have confidence in a system that does not encourage or allow them to play a role in selecting their own representatives; and it may not serve to overcome the widespread problems of creditor apathy. On the other hand, such an approach may serve to simplify the procedure for establishing a creditor committee and reduce the scope for disputes between creditors that can lead to delay and cost. The choice between these different approaches may depend upon the extent to which the court supervises the insolvency proceedings and is involved on a day-to-day basis, and the extent to

which creditors are required to undertake an active role in performing functions that require more than the provision of advice to the insolvency representative.

465. To facilitate administration of the committee, some insolvency laws specify the size of the committee—generally an odd number in order to ensure the achievement of a majority vote, and in some cases no more than three or five persons. Where the committee represents only unsecured creditors, membership of the committee is sometimes limited to the largest unsecured creditors. These creditors can be identified by a number of means, including requiring the debtor to prepare a listing of its largest creditors or by reference to the list of creditors to be prepared by the debtor. To ensure that it fulfils its duty to fairly represent creditors, oversight of the committee may be desirable where the insolvency law provides for the committee to undertake a significant role and could be undertaken by the insolvency representative, or by the court.

**(c) Functions of a creditor committee**

466. As a general proposition, a creditor committee will perform its functions on behalf of the creditors and those functions will therefore be related directly to the general functions given to creditors as noted above. The powers and functions given to a creditor committee, however, should not impair the rights of creditors as a whole to continue to participate or otherwise act in the insolvency proceeding. With respect to decision-making, the creditor committee generally will play an advisory role, making recommendations to creditors on how key issues should be decided, but it would not usually have the authority to make major decisions on behalf of creditors. While the creditor committee will interact with the insolvency representative, where one is appointed, or with the debtor-in-possession where the insolvency law adopts that approach to reorganization, the committee should be able to act independently of those parties in representing the interests of creditors.

467. Insolvency laws provide for a creditor committee to undertake a range of functions which may include advising the insolvency representative the wishes of creditors on issues such as the sale of significant assets and formulation of the reorganization plan, consulting with the insolvency representative and other principals in the proceeding, such as the existing management of the debtor, participating in the development of a reorganization plan or possibly supervising the insolvency representative. These functions may be established by the insolvency law, directed by the court or determined in cooperation with the insolvency representative.

468. As noted above with respect to creditors generally, the committee will need to be able to access up-to-date information on the debtor and its financial affairs from the insolvency representative and be able to express its views and those of creditors on matters falling within those functions or on matters in which affect the interests of creditors. To perform its functions, the committee may also require administrative and expert assistance, although the need for such assistance should be clearly linked to the functions to be performed by the committee. The committee may be required under the law to seek permission from the insolvency representative or the court to hire a secretary and, if circumstances warrant, consultants and professionals. Some insolvency laws provide that the costs of hiring assistants, including their remuneration, will be paid by the insolvency estate, while other laws provide that creditors must meet their own costs of participation in the insolvency proceedings. Where the costs are to be paid by the estate, it is desirable that the court has some

control not only over the decision to hire such professional, but also over the associated costs and charges.

**(d) Liability of the creditor committee**

469. The committee's duty would be owed to creditors generally. It would not have any liability or fiduciary duty to the owners of the insolvent business. It may be desirable for the insolvency law to require the committee to act in good faith and to provide that members of the committee would be immune from liability in respect of actions and decisions taken by them as members of the committee unless they were found to have acted fraudulently or wilfully or to have breached a fiduciary duty to the creditors they represent. This might include, for example, deriving profit from the administration of the estate; or acquiring assets forming part of the estate without prior approval of the court. The standard of liability for the committee can be distinguished from that of the insolvency representative, as committee members are not required to satisfy any requirements as to knowledge of expertise and are acting in a voluntary capacity without remuneration. In considering the question of the liability of the committee, a balance may need to be struck between setting too high a level of responsibility that will promote creditor apathy and effectively discourage creditors from participating, and too low a level that may lead to abuse and prevent the committee from functioning efficiently as a representative body.

**(e) Removal and replacement of members of the committee**

470. An insolvency law may need to give some consideration to the grounds upon which removal of a member of the creditor committee might be justified and to establishing a mechanism for replacement. Those grounds might include gross negligence, lack of the necessary skills, incompetence, inefficiency, lack of independence or conflict of interest. The procedure for such removal and replacement generally will depend upon the procedure for appointment of a creditor committee, whether by the court or election by creditors. A mechanism for replacement of members of the committee will also be relevant where members of the committee resign or are unable to continue performing the required functions, such as in cases of serious illness or death.

**6. Matters requiring a vote by creditors**

471. An insolvency law will need to identify the matters on which a vote of the creditors is required as well as to establish the applicable voting requirements in each case.

472. Where actions to be taken in the course of the proceedings will have a significant impact on the creditor body, it is desirable that all creditors (as opposed to just the creditor committee) are entitled to receive notice of, and to vote on, those actions. These actions may include voting to select the insolvency representative where an insolvency law provides creditors with this role; approval of the reorganization plan; approval of post-commencement finance; and on other significant events such as sale of substantial assets.

473. A number of different approaches can be taken with respect to achieving that vote, depending upon the nature of the matter to be decided. Some laws provide that voting should occur in person at a meeting of creditors, while other laws provide that where a large number of creditors are involved or where creditors are not local

residents, voting may take place by mail or by proxy. The practicality of requirements for voting in person will clearly be challenged where there are large numbers of creditors, and especially of certain kinds of creditors such as public bondholders. It will be increasingly desirable to permit voting to take place using electronic means, including email and the internet, which can be subject to appropriate security measures.

474. Different approaches are taken to the type of voting result that is required to bind creditors to different decisions, with some insolvency laws distinguishing between different types of decisions to be made. More important decisions, such as approval of a reorganization plan, may require a vote that includes both a proportion of value of claims as well as a number of creditors (see part two, chapter IV). Some laws require a majority in value for most decisions and for decisions such as election or removal of the insolvency representative and hiring of particular professionals by the insolvency representative, a majority in value and number is required. Other laws provide that a simple majority is sufficient on issues such as election or removal of the insolvency representative. Some laws also distinguish between matters requiring the support of both secured and unsecured creditors; secured creditors will only participate in the vote on specified matters such as selection of the insolvency representative and matters affecting their security.

#### **7. Confidentiality**

475. As noted above (chapter III.A and B), it is desirable that an insolvency law imposes obligations of confidentiality on both the debtor and the insolvency representative. For similar reasons, it may be appropriate to also consider the circumstances in which creditors should be required to observe confidentiality. In the course of the administration of an insolvency proceeding, creditors generally will be in a position to obtain significant amounts of information concerning the debtor and its business, much of which may be commercially sensitive. While the consequences of liquidation suggest that there may not be much opportunity for creditors to take unfair advantage of that information (or that harm to the debtor will result), that may not be true of reorganization, and there may be circumstances where creditors can use that information to affect the successful implementation of an agreed plan. For these reasons, it may be appropriate to impose on creditors and the creditor committee (and any professionals employed by it) an obligation of confidentiality that permits the use of information obtained in the course of the proceedings only for the purposes of administration of the proceedings, unless the court decides otherwise. In cases where a creditor committee is appointed (and the committee hires professional advisors), the obligation may be given effect by requiring members of the committee (and the professional advisors) to sign confidentiality agreements.

### **Recommendations**

#### **Purpose of legislative provisions**

The purpose of provisions on participation of creditors in insolvency proceedings is to:

- (a) facilitate participation of creditors in insolvency proceedings;

(b) provide a mechanism for the appointment of a creditor committee or other creditor representative where to do so would facilitate the participation of creditors in the insolvency proceedings;

(c) ensure the right of creditors to access information on the insolvency proceedings;

(d) specify the functions and responsibilities of the creditor committee.

### **Contents of legislative provisions**

*Right to be heard (see recommendation (121))*

*Participation by creditors*

(110) The law should specify that creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and identify what that participation may involve in terms of the functions that may be performed.

*Voting by creditors*

(111) The law should specify the matters on which a vote of creditors is required and establish the relevant eligibility and voting requirements. In particular, the law should require the vote of creditors to approve or reject a reorganization plan.

*Convening meetings of creditors*

(112) The law may require a first meeting of creditors to be convened within a specified time period after commencement to discuss certain matters. The law may also permit the court, the insolvency representative or creditors holding (*specify a percentage of the total value of*) unsecured] claims to request the convening of a meeting of creditors generally. The law should specify the party responsible for giving notice to creditors of such a meeting. The law may specify the circumstances in which such a meeting of creditors may be convened.

*Creditor representation*

(113) The law should facilitate the active participation of creditors in insolvency proceedings such as through a creditor committee or other mechanism for representation.<sup>86</sup> The law should specify whether a committee or other representation is required in all insolvency proceedings. Where the interests and categories of creditors involved in insolvency proceedings are diverse and participation will not be facilitated by the appointment of a single committee or representative, the law may provide for the appointment of different creditor committees or representatives.

(114) Where the law permits a creditor committee or representative to be appointed the relationship between the creditors and the creditor committee or representative

<sup>86</sup> See recommendation (97) and the continuing role of the debtor in reorganization. Where the debtor remains in possession of the business, a creditor committee will have an important role to play in overseeing and, where necessary, reporting on the activities of the debtor.

should be clearly specified.<sup>87</sup> The law should specify how the costs of the creditor committee would be paid.

*- Creditors that may be appointed to a creditor committee*

(115) The law should specify the creditors that are eligible to be appointed to a committee. The creditors who may not be appointed to the creditor committee would include related persons and others who for any reason might not be impartial. The law should specify whether or not a creditor's claim must be admitted [whether provisionally or otherwise] before the creditor is entitled to be appointed to a committee.

*- Mechanism for appointment to a creditor committee*

(116) The law should establish a mechanism for appointment of a creditor committee. Different approaches may include selection of the creditor committee by creditors or appointment by the court or other administrative body.

*- Rights and functions of a creditor committee*

(117) The law should specify the rights and functions of the creditor committee in insolvency proceedings, which may include:

(a) providing advice and assistance to the insolvency representative or the debtor-in-possession;

(b) participating in development of the reorganization plan, the sale of significant assets and in other matters in which their class has an interest as directed by the court or determined in cooperation with the insolvency representative;

(c) the right to hear the insolvency representative at any time.

*- Employment and remuneration of professionals by a creditor committee*

(118) The law should permit a creditor committee, subject to approval by the court to select, employ and remunerate professionals that may be needed to assist the creditor committee to perform its functions. The law should specify how the costs and remuneration of those professionals would be paid.

*- Liability of members of a creditor committee*

(119) The law should specify that members of a creditor committee are exempt from liability for their actions in their capacity as members of the committee unless they are found to have acted fraudulently or to be guilty of wilful misconduct.

*- Removal and replacement of members of a creditor committee*

(120) The law should specify the grounds for removal of members of a creditor committee and provide for their replacement.<sup>88</sup>

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<sup>87</sup> In particular, the law should specify: the distribution of functions and powers between the creditors and the creditor committee, and the mechanism for resolution of disputes between the creditors and the creditor committee.

<sup>88</sup> Exercise of the power to remove will depend on the method of appointment of the committee.

## **D. Party in interest's right to be heard and to appeal**

### **1. Right to be heard**

476. Most regimes provide creditors, as the primary beneficiaries of the estate, and other parties in interest with some ability to scrutinize both the administration of the estate and the conduct of the insolvency representative in performing its duties. The insolvency representative, the debtor, a creditor, a creditor committee or another party in interest may wish to request relief under the insolvency law or may oppose requests of others for such relief. Each of those parties should have a right to be heard when their rights, interests in property or duties under the insolvency law are affected. Where decisions relating to administration of the estate are to be made by the courts, those decisions generally may be appealed to a higher court by a party whose interests are affected, although some insolvency laws do exempt certain decisions from appeal (e.g. the decision appointing the supervising judge or commencing the proceedings).

### **2. Review procedures**

477. Procedural approaches to the administration of an estate are largely determined by the rules governing the duties of the insolvency representative, the rights and duties of the debtor under the insolvency law and the active role, if any, of creditors, either separately or through a creditor committee, in the administration. For example, in those laws which require the insolvency representative to gain the approval of creditors, or their representatives, before undertaking certain acts, direct involvement of creditors in the decision-making process will normally preclude the need for a review procedure by creditors with respect to those acts, apart from those situations where the insolvency representative has misled creditors.

478. Where acts of the insolvency representative are not subject to the prior approval of creditors, there may be a need for a formal review procedure by creditors. A formal review procedure may be appropriate for other parties in interest when acts of the insolvency representative affect them.

479. Most insolvency laws require a party in interest to raise its requests for relief or objections through a court action. Some insolvency laws allow individual creditors to bring an action, while others require the objecting creditor or creditors to represent a certain number of creditors or percentage of the debt to have legal standing to proceed with the action, or even require the action to be brought by the creditors committee or the creditors generally. Such requirements may depend upon the grounds of the objection raised. Other parties in interest may have legal standing to raise an objection or request relief when their rights, interests in property or duties under the insolvency law are affected. As discussed above, the right to be heard must be balanced with the need for efficient administration of the insolvency proceedings.

### **3. Right of appeal**

480. A party in interest who has requested relief and been denied, or who has unsuccessfully opposed a request or act of another party should have a right to appeal to a higher court if it believes that the court was in error. Most judicial systems establish a hierarchy of courts for appellate review and procedures to invoke that review. A similar structure should apply to the court that administers the insolvency law and to orders entered by that court.



## **Recommendations**

### *Right to be heard*

(121) The law should specify that a party in interest has a right to be heard on any issue in the insolvency proceedings that affects its rights, obligations or interests. For example, a party in interest should be entitled to:

- (a) object to any act that requires court approval;
- (b) request review by the court of any act for which court approval was not required or not requested;
- (c) request any relief available to it in insolvency proceedings.

### *Right of Appeal<sup>89</sup>*

(122) The law should specify that a party in interest may appeal from any order of the court in the insolvency proceedings that affects its rights, obligations or interests.

## **IV. Reorganization**

### **A. The reorganization plan**

#### **1. Introduction**

481. Insolvency laws generally address a number of issues in relation to the reorganization plan, such as the nature or form of the plan; when the plan is to be prepared; who is able to prepare the plan; what is to be included in the plan; how the plan is to be approved by creditors (and confirmed by the court where that is a requirement); the effect of the plan and how it is to be implemented.

482. Reorganization plans perform different functions in different types of proceedings. In some, the plan may be the tailpiece of the reorganization proceedings, dealing with the pay-out of a dividend in full and final settlement of all claims (also referred to as a composition or a scheme of arrangement) and the final structure of the business after the reorganization is complete. In others, the plan may be proposed at the commencement of the proceedings and set out the way the debtor and the business should be dealt with during the reorganization period, much like a business plan, as well as expected dividends and dates of payment. There may also be circumstances where a plan, like a plan of reorganization, is prepared in liquidation where the business is to be sold as a going concern. Such a plan may address issues such as the timing and mechanics for interim distributions. The following discussion focuses upon the issues that would be relevant to a plan proposed at some time after the proceedings have commenced, addressing the conduct of the business in reorganization and the transformation of legal rights

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<sup>89</sup> In accordance with the key objectives, the insolvency law should provide that appeals in insolvency proceedings should not have suspensive effect unless otherwise determined by the court, in order to ensure that insolvency can be addressed and resolved in an orderly, quick and efficient manner without undue disruption. Time limits for appeal should be in accordance with generally applicable law, but in insolvency need to be shorter than otherwise to avoid interrupting insolvency proceedings.

proposed to address the debtor's financial situation. These considerations will also be relevant, although not necessarily in their entirety, to other types of plans.

## **2. Nature or form of a plan**

483. The purpose of reorganization is to maximize the possible eventual return to creditors, providing a better result than if the debtor were to be liquidated and to preserve viable businesses as a means of preserving jobs for employees and trade for suppliers. With different constituents involved in the reorganization process, each may have different views of how the various objectives can best be achieved. Some creditors, such as major customers or suppliers, may prefer continued business with the debtor to rapid repayment of their debt. Some creditors may prefer an equity stake in the business, while others will not. Typically, therefore, there is a range of options from which to select in a given case and if an insolvency law adopts a prescriptive approach to the range of options available or to the choice to be made in a particular case, it is likely to be too constrictive. It is desirable that the law does not, for example, permit a plan that is designed only to fully rehabilitate the debtor; nor provide that debt cannot be written off; nor provide that a minimum amount must eventually be paid to creditors; nor prohibit exchange of debt for equity. A non-intrusive approach that does not adopt such limitations is likely to provide the flexibility sufficient to allow the most suitable of a range of possibilities to be chosen for a particular debtor.

484. Some insolvency laws adopt an illustrative approach, listing some of the possibilities that may be adopted, but it is not intended that the list be exhaustive or exclusive of other approaches. These possibilities could include a choice of a simple composition (an agreement to pay creditors a percentage of their claims, usually over time); the continued trading of the business and its eventual sale as a going concern (and for the debtor to then be liquidated); transfer of all or part of the assets of the estate to one or more existing businesses or to businesses that will be established; a merger or consolidation of the debtor with one or more other business entities; a sophisticated form of restructuring of debt and equity; or some other solution. The determination of what is the most appropriate solution may best be left to the market place, where an effective one exists, or at least to negotiations among the debtor, the insolvency representative, creditors and other persons with economic interests.

485. Even if it does not adopt a prescriptive approach to the form or nature of the plan, an insolvency law may establish some limits, such as that the priorities afforded to creditors in liquidation should be maintained in reorganization, that the effect of the plan should not be such that the debtor remains insolvent and is returned to the market place in that condition, and that the reorganization plan comply with limitations set forth in other laws (where the insolvency law does not amend those limitations), for example foreign exchange controls.

## **3. Proposal of a reorganization plan**

486. Two important issues to be considered in relation to the proposal of a reorganization plan are the stage of the proceedings at which it should be proposed and the party or parties that would be capable of proposing, or could be authorized to propose, a plan. A number of different approaches can be taken to each of these issues.

**(a) Timing of proposal**

487. As to the first issue, timing of proposal, the approach adopted may depend upon the purpose or objective of the particular reorganization, or relate to the manner in which the reorganization proceedings commenced. Some laws, for example, provide that the plan for reorganization should be filed with the application for reorganization proceedings (where the application may be called a “proposal” for reorganization) where those proceedings are proceedings commenced by the debtor.<sup>90</sup> Potential difficulties with this approach may include delaying the debtor’s ability to commence proceedings and obtain timely relief by way of the stay; the difficulty of knowing, at this early stage, exactly what the plan should accomplish; and if the plan has been prepared without consultation with creditors and other interested parties but is intended to be a final, definitive plan, it may not be a plan that could feasibly be implemented and could thus operate to pre-empt the proceedings and also cause delay. Many other laws provide for the plan to be negotiated and proposed after commencement of reorganization proceedings. This may be a more flexible option, allowing consultation and negotiation of an acceptable reorganization plan while the debtor has the protection of the stay. These benefits may need to be balanced against possible misuse of the insolvency regime by debtors who have no intention of, or ability to, propose a plan but are seeking to obtain only the benefits of the stay. Issues of timing of proposal of the plan may also arise where proceedings are converted from liquidation to reorganization (see 14 below).

**(b) Parties permitted to propose a plan**

488. With regard to the second issue, participants in the reorganization proceedings may have different capabilities and responsibilities with regard to negotiation and proposal of a reorganization plan, depending upon the manner in which the insolvency law is designed and in particular the respective roles assigned to the insolvency representative, debtor and creditors. For example, in some insolvency laws, these parties have a positive obligation to cooperate in negotiating and proposing a plan. In determining which party should be permitted to propose, or which parties are capable of proposing, a plan, a balance may be desirable between the freedom accorded to the different parties to propose a plan (e.g. should all parties be able to propose a plan, should they be able to do so at the same time or should proposal by different parties be sequential and dependant upon the acceptability of a plan proposed), and the restraints necessarily attached to the process in terms of approval (voting) requirements (e.g. should all creditors play a role in formulating a plan they have to approve), time limits for negotiation and proposal, provision in the insolvency law for amendment of the plan and other procedural considerations. A flexible approach, as opposed to a prescriptive approach, is likely to ensure that this balance is achieved, although in the interests of efficiency, certainty and predictability and the timely progress of the proceedings, it is desirable that an insolvency law provide sufficient guidance to ensure that a viable plan is proposed.

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<sup>90</sup> This type of approach is not to be confused with an application for an expedited proceeding which would be accompanied by the plan approved by creditors, see chapter IV.B.

(i) *Proposal by the debtor*

489. Where the plan is to be proposed before commencement, it would generally be proposed by the debtor, but may involve negotiation with one or more classes of creditors, not necessarily all, who may negotiate and agree on a plan, subject to its acceptance by other creditors or its imposition on remaining classes. Where the plan is to be proposed after the commencement of proceedings, some insolvency laws provide that the debtor should propose a plan, sometimes specifying that it should do so in cooperation with other parties such as the insolvency representative, the creditors, an attorney, an accountant or other financial advisors. An approach which involves the debtor may have the advantage of encouraging debtors to commence reorganization proceedings at an early stage and, where the plan envisages the ongoing operation of the debtor's business, of making the best use of the debtor's familiarity with its business and knowledge of the steps necessary to make the insolvent business viable (although the freedom accorded to the debtor may need to be balanced against the need to ensure creditor confidence in the debtor and its proposal). The benefits of such an approach also may be clear where key management personnel of the debtor are necessary to the success of the business (such as for reasons of its complexity) or will be difficult to replace in the short term.

490. Some insolvency laws provide that the opportunity given to the debtor is exclusive. Other laws adopt a staged approach, with the opportunity for proposal by the debtor being exclusive only for a specified period. The court may have the power to extend the period if the debtor can show the delay is justified and there is a real prospect of a successful reorganization, and another party is able to propose a plan where the debtor's exclusive period expires without a plan being proposed.

(ii) *Proposal by creditors*

491. Where creditor approval of the plan is required, there is always a risk that reorganization will fail if the plan presented by the debtor is not acceptable. For example, creditors may only wish to approve a plan that deprives the debtor's shareholders of a controlling equity interest in the debtor's business and may also deprive the incumbent management of any management responsibilities. If the debtor has an exclusive opportunity to propose the plan and refuses to consider such an arrangement, there is a danger that the reorganization will fail, to the detriment of the creditors, the employees, and the debtor itself. To address that situation, some insolvency laws provide that, in preparing its plan, the debtor should cooperate and negotiate with creditors and if the debtor fails to propose an acceptable plan before the end of an exclusive period, the creditors are given the opportunity to propose a plan (which could be achieved through a creditor committee (see chapter III.C)). This option may provide the leverage necessary to reach a compromise between the participating parties.

(iii) *Proposal by the insolvency representative*

492. Another approach adopted by many insolvency laws is to give the insolvency representative an opportunity to propose a plan, either as an alternative to proposal by the debtor or the creditors or as a supplementary measure. Given that the insolvency representative will have had some opportunity to become knowledgeable about the debtor's business after commencement of the proceedings, it may be well

placed to determine what measures are necessary for the business to be viable. It may also be well placed to facilitate negotiations on the plan between the debtor and creditors. The importance of providing for participation by the insolvency representative depends upon the design of the law and, in particular, requirements for approval of the plan by creditors or the court. Where approval by creditors is required, a plan that takes account of proposals that will be acceptable to creditors has a greater likelihood of being approved than one which does not. This consideration may not apply where creditor approval is not necessary or where the court has the power to decline to confirm an approved plan for reasons other than procedural fairness, for example, economic feasibility. Where the plan is only to be approved by the court, substantial legal input may be required to ensure that the plan presented will be approved. Where the insolvency representative is not given the opportunity to negotiate and propose a plan or to participate in that process, it may be desirable to provide an opportunity for the insolvency representative to consider the plan proposed before it is submitted for approval.

(iv) *Proposal by multiple parties*

493. Some insolvency laws provide that a number of parties have the opportunity to propose a plan. These may include the debtor the insolvency representative, and creditors or the creditors committee. It may be desirable where such a provision is included that some procedure is adopted to ensure that a number of competing plans are not proposed simultaneously. Although in some cases this competitive approach may promote the proposal of a mutually acceptable plan, it may also have the potential to complicate the process and lead to confusion, inefficiency and delay.

494. Some laws provide for the court to consider the opinions of third parties on the plan, such as governmental agencies and labour unions. Although including these parties in plan negotiation in particular cases may assist in the proposal of an acceptable plan, it also has the potential, if adopted as a general principle, to complicate and lengthen the duration of the process. It may be desirable only if it is likely to be beneficial in a particular case where the interests of those parties are central to the reorganization plan, and where the negotiation process is carefully monitored and time limits are specified.

(c) **Time limits for proposal of a plan**

495. Some insolvency laws specify a time period after commencement within which a plan is to be proposed. This limit may apply specifically to proposal of a plan by the debtor or generally. One law, for example, provides a 120-day limit for proposal of a plan by the debtor; once that has expired any other party may propose a plan without any time limit being imposed. Examples of time limits generally applicable to negotiation and proposal of a plan range from 35 to 120 days from commencement, with some laws including provision for that time limit to be extended or shortened by the court in certain circumstances. Although the imposition of time limits may be helpful in ensuring that the reorganization proceeds without delay, that advantage may need to be balanced against the risk that the deadline may be too inflexible and impose an arbitrary restraint, particularly in large cases where negotiation and proposal of a plan may take significantly longer, such as more than 12 months; that the limits will not be observed, especially in the absence of appropriate sanctions; or that the insolvency infrastructure is unable to

manage deadlines (for reasons such as lack of resources). One means of addressing the concern of inflexibility is to provide for the time period to be extended by the court, provided the extension is for a further limited period and that an unlimited number of extensions is not available. An advantage of that approach is that it requires the party seeking an extension to demonstrate to the court that the extension is warranted—that is, for example, that there is no improper reason for the delay (e.g. it is because of a need for further consultations with creditors or there has been a delay in receiving assessments or reports from professional advisors), that the delay will not be harmful to the interests of the other parties, and that, if the extension is granted, there is a real prospect for proposal of a plan that will be approved by creditors.

496. Where an insolvency law includes time periods for the negotiation and proposal of a plan, consideration will need to be given to those proceedings that are converted from liquidation. The standard time periods that would be applicable by reference to commencement of proceedings (i.e. the liquidation proceedings) may not easily be applied in those cases that rely on the original application for commencement and treat the conversion as a continuation of those proceedings.

#### **4. The plan**

497. The outcome of the plan rests on what is feasible, in other words whether, on the basis of known facts and circumstances and reasonable assumptions, the plan and the debtor are more likely than not to succeed. Determination of whether a plan is likely to succeed raises two related issues. The first is the content of the plan itself, or in other words what is proposed by the plan. The second is the manner in which those proposals are presented and explained to creditors in order to elicit their support.

##### **(a) Content of a plan**

498. The question of what is to be included in the plan is closely related to the procedure for approval of the plan (for example, which creditors are required to approve the plan, the level of support required for approval and the procedure for court confirmation, if any), and the effect of the plan once approved (and confirmed by the court, where required) (for example, will it bind dissenting creditors and secured creditors and who will be responsible for implementation of the plan and for ongoing management of the debtor) and whether or not there is a requirement for court confirmation. Many insolvency laws include provisions addressing the content of the reorganization plan. Some laws address the content of the plan by reference to general criteria, such as requirements that the reorganization plan should adequately and clearly disclose to all parties information regarding both the financial condition of the debtor and the transformation of legal rights that is being proposed in the plan, or by reference to minimal requirements such as that the plan must make provision for payment of certain preferred claims. It should be noted that a plan need not alter or otherwise effect the rights of every class of creditor.

499. Other laws set out more specific requirements as to what information is required in relation to the debtor's financial situation and the proposals included in the plan. Information on the financial situation of the debtor may include asset and liability statements; cash flow statements; and information relating to the causes or reasons for the financial situation of the debtor. Information relating to what is

proposed by the plan may include, depending upon the objective of the plan and the circumstances of a particular debtor, details of classes of claims; claims impaired under the plan and the treatment to be accorded to each class under the plan; the continuation or rejection of contracts that are not fully executed; the treatment of un-expired leases; measures and arrangements for dealing with the debtor's assets (e.g. transfer, liquidation, retention); the sale or other treatment of secured assets; the disclosure and acceptance procedure; the rights of disputed claims to take part in the voting process and provisions for disputed claims to be resolved; arrangements concerning personnel of the debtor; remuneration of management of the debtor; financing implementation of the plan; extension of the maturity date or a change in the interest rate or other term of outstanding security interests; the role to be played by the debtor in implementation of the plan and identification of those to be responsible for future management of the debtor's business; the settlement of claims and how the amount that creditors will receive will be more than they would have received in liquidation; payment of interest on claims; distribution of all or any part of the assets of the estate among those having an interest in those assets; possible changes to the instrument or organic document constituting the debtor (changes to by-laws, articles of association etc.) or the capital structure of the debtor or merger or consolidation of the debtor with one or more persons; the basis upon which the business will be able to keep trading and can be successfully reorganized; supervision of the implementation of plan; and the period of implementation of the plan, including in some cases a statutory maximum period.

500. Rather than specifying a wide range of detailed information to be included in a plan, it may be desirable for the insolvency law to identify the minimum content of a plan, focussing upon the key objectives of the plan and procedures for implementation. For example, the insolvency law may require the plan to detail the classes of creditors and the treatment each is to be accorded in the plan; the terms and conditions of the plan (such as treatment of contracts and the ongoing role of the debtor); and what is required for implementation of the plan (such as sale of assets or parts of the business, extension of maturity dates, changes to capital structure of the business and supervision of implementation).

501. The content of the plan also raises issues related to other laws. For example, to the extent that national law precludes debt-for-equity conversions, a plan that provides for such a conversion could not be approved. Since debt-for-equity conversion can be an important feature of reorganization, it would be necessary to eliminate the prohibition, at least in the insolvency context, if such provisions were to be included in a plan and approved. Similarly, if a plan is limited by the operation of other law to providing only for debt forgiveness or the extension of maturity dates, it may be difficult to obtain creditor approval. Some insolvency cases raise similarly straightforward and uncontroversial issues of the relationship between the insolvency law and other laws. Other cases may raise more complicated questions. These may include limits on foreign investment and foreign exchange controls (especially in cases where many of the creditors are non-residents), or the treatment of employees under relevant employment laws where, for example, the reorganization may raise questions of modification of collective bargaining agreements, or questions related to taxation law.

502. Approaches to these issues vary. In some countries, the insolvency law will be subject to these types of limitations, with the consequence that options for

reorganization may be restricted. Other insolvency laws allow certain limitations contained in other laws, for example those relating to disposition of the debtor's assets and priority of distribution, to be overruled in specified circumstances, such as where creditors agree. It is desirable that restrictions in other laws that will impact on the insolvency law be considered in designing the insolvency law and that, in order to ensure transparency and predictability, an insolvency law specifically address the question of its relationship with other laws, where possible noting the impact of those other laws in the insolvency law.

**(b) Information to accompany the plan**

503. When voting on a plan, creditors and other relevant interested parties, such as equity holders, who may be required to vote on the plan, need to be able to assure themselves that what is proposed by the plan is feasible and not based, for example, on faulty assumptions, and that implementation of the plan will not leave the debtor overburdened with debt. To facilitate that evaluation, creditors and other relevant interested parties will need to be provided with information explaining what the plan proposes and the impact of those proposals on the debtor, creditors and other affected parties. For these purposes, the plan can be submitted to creditors and others together with a disclosure statement providing a full disclosure of information that will enable all parties to properly evaluate the plan. That statement may be prepared by a qualified professional who can be expected to provide a credible and unbiased assessment of the measures proposed by the plan or by the same party as proposes the plan, with or without professional advice. Where the insolvency representative is not involved in the proposal of a plan or preparation of the statement, it may be desirable to require it to comment on both instruments. Where creditors and other relevant interested parties do not agree with the professional evaluation, or do not believe that the disclosed information is persuasive, those views could be taken into account either in voting on the plan, by a mechanism allowing for amendment of the plan, or by the court when it confirms the plan (where that is a required element of the process).

504. A number of insolvency laws include provisions specifying the information that is to be provided to creditors and other interested parties to enable them to properly assess the plan, whether it is to be included in the plan itself or in a separate statement. A requirement to provide this information, supported by appropriate mechanisms for obtaining relevant information satisfies the key objective of transparency and can assist in ensuring creditor confidence in the insolvency process. It may need to be balanced, however, against confidentiality concerns arising from access to potentially sensitive financial and commercial information relating to the debtor, even where that information may ultimately enter the public domain through approval or confirmation of the plan by a court. This concern can be addressed in the law by including obligations to observe confidentiality that will apply to the debtor, creditors, the insolvency representative and other interested parties. The requirement may also need to be balanced against the provision of information that is irrelevant to the purpose of evaluating the plan; the focus should be upon the information required in a particular case to evaluate the specific proposals contained in the plan.

505. It is desirable that an insolvency law specifies the minimum information to be provided in a disclosure statement. This could include information relating to the



financial situation of the debtor, including asset and liability and cash flow statements; a comparison of the treatment afforded to creditors by the proposed plan and what they could be expected to receive in liquidation; the basis upon which the debtor's business would be able to keep trading and be successfully reorganized; information on voting mechanisms applicable to approval of the plan; information showing that, having regard to the effect of the plan, adequate provision has been made for satisfaction of all obligations provided for in the plan and that the debtor is expected to have the cash flow to pay its debts as provided in the plan.

#### **5. Approval of a plan**

506. Designing the provisions of an insolvency law on approval of the plan requires a balance to be achieved between a number of competing considerations, such as whether or not creditors should vote on approval of the plan in classes and the manner in which dissenting creditors will be treated. A underlying principle is that creditors can only be bound by a plan if they have been given the opportunity to vote on that plan. The primary purpose for classifying claims is to satisfy the requirements to provide fair and equitable treatment to creditors, treating similarly situated claims in the same manner and ensuring that all creditors in a particular class are offered the same menu of terms by the reorganization plan. It is one way to ensure that priority or preferential claims are treated in accordance with the priority established under the insolvency law. It may also make it easier to treat the claims of major creditors who can be persuaded to receive different treatment from the general class of unsecured creditors, where that treatment may be necessary to make the plan feasible. Classification can, however, increase the complexity and costs of the insolvency proceedings, depending upon how many different classes are identified. An alternative approach to ensuring that creditors who should receive special treatment are not oppressed by the majority is to give those groups the opportunity to challenge the decision of the majority in court if they have not been treated in a fair and equitable manner. The fact that such a facility exists may operate to discourage majorities from making proposals that would unfairly disadvantage preferential creditors.

507. As to the treatment of dissenting creditors, it will be essential to provide a way of imposing an agreed plan upon a minority of dissenting creditors within a class in order to increase the chances of success of the reorganization. It may also be necessary, depending upon the mechanism that is chosen for voting on the plan and whether creditors vote in classes, to consider whether the plan can be made binding upon dissenting classes of creditors and other affected parties.

508. To the extent that a plan can be approved and enforced upon dissenting parties, there may be a need to ensure that the content of the plan provides appropriate protection for those dissenting parties and, in particular, that their rights cannot be unfairly affected. So, for example, the law might provide that a dissenting class could not be bound unless assured of certain treatment. If the creditors are secured, the treatment required may be that the creditor receives payment of the value of its security interest, while in the case of unsecured creditors it may be that any junior interests, including equity holders, receive nothing. To the extent that the approval procedure results in a significant impairment of the claims of creditors and other affected parties without their consent (particularly secured creditors), there is a risk that the willingness of creditors to provide credit in the future may be undermined.

The mechanism for approval of the plan, and the availability of appropriate safeguards, is therefore of considerable importance to the protection of these interests.

**(a) Procedures for approval**

509. Many insolvency laws provide for a special meeting of creditors to be called for the purpose of voting on the reorganization plan, and require that the plan (and the information or disclosure statement where that document is also to be provided) be made available to the creditors and other interested parties who are entitled to vote within a certain period of time before that meeting is called. Some laws provide that voting should occur in person at a meeting of creditors, while other laws also provide that voting may take place by mail or by proxy. To facilitate voting and recognize the increasing use of electronic means of communication, it may be desirable to permit voting to take place in person, by proxy and by electronic means.

510. Other issues to be considered with regard to approval of the plan include whether creditors and other interested parties should vote in classes according to their respective rights; the types of claims (in terms of admission or provisional admission of those claims) that will be considered in determining whether the requisite voting majority has been reached, whether secured creditors are required to vote; whether the votes of priority claims will be considered in determining the requisite majority; which interested parties other than creditors are entitled to vote on the plan; and the manner in which abstaining or non-participating creditors will be treated. These issues are discussed in the following paragraphs. With respect to the last issue, some laws, for example, treat abstaining or non-participating voters as votes not to accept a plan. Such an approach may have the effect of disenfranchising those creditors who did participate and vote on approval of the plan, and may in practice make it very difficult to obtain approval of a plan. As an alternative, many countries adopt the approach of calculating the percentage of support on the basis of those parties actually participating in the voting on the basis that absentees and abstaining voters can be considered to have little interest in the proceedings. This approach may result in a potentially small and unrepresentative group of creditors affecting the course of the reorganization, particularly in view of the prevalence of creditor apathy. A balanced approach that facilitates approval of the plan, ensures a sufficient level of creditor support to enable implementation and avoids abuse is required. This can be facilitated, whichever of the approaches discussed above is adopted, by requiring provision of adequate notice, to creditors and other interested parties, especially where they are non-residents, as well as by adopting mechanisms for voting that do not require personal attendance, such as the use of proxies and electronic means.

511. Some insolvency laws also make use of presumptions to simplify voting procedures. Where, for example, a plan cancels a creditor's claim or an owner's equity interest (and that party receives nothing under the plan), a vote by that party against the plan can be presumed. In contrast, where a plan leaves a claim unimpaired or provides that it will be paid in full, a vote in favour of the plan can be presumed. The use of such presumptions may also reduce the need to provide notice and information to relevant creditors and other interested parties.

**(b) Approval by secured and priority creditors**

512. In many cases of insolvency, secured claims will represent a significant portion of the value of the debt owed by the debtor and different approaches can be taken to approval of the plan by secured and priority creditors. As a general principle, however, the extent to which a secured creditor is required to vote will depend upon the manner in which the insolvency regime treats secured creditors, the extent to which a reorganization plan can affect the security interest of the secured creditor, and the extent to which the value of encumbered assets will satisfy the secured creditor's claim.

513. Under one approach, where the insolvency law does not affect secured creditors and, in particular, does not preclude them from exercising their rights against the encumbered assets, there is no need to give these creditors the right to vote since their security interests will not be impaired by the plan. Priority creditors are in a similar position under this approach—the plan cannot impair the value of their claims and they are entitled to receive full payment. The limitation of this approach, however, is that it may reduce the chances for a successful reorganization, especially where the encumbered assets are vital to the success of the plan. If the secured creditor is not bound by the plan, the election by the secured creditor to exercise its rights, such as by repossessing and selling the encumbered asset, may make reorganization of the business impossible to implement. Similarly, in certain circumstances, the only way in which the plan may succeed is to provide that priority creditors receive less than the full value of their claims upon approval of the plan. Thus, the prospects for reorganization may improve if priority creditors will accept payment over time and if secured creditors will acquiesce when the terms of the secured debt are modified over time. If they are not included in the plan and required to vote on proposals affecting their rights, modification of those rights cannot be achieved.

514. To the extent that the value of the encumbered asset will not satisfy the full amount of the secured creditor's claim, a number of insolvency laws provide for those secured creditors to vote with ordinary unsecured creditors in respect of the unsatisfied portion of the claim. In some legal systems, this raises difficult questions of valuation in order to determine whether and to what extent a secured creditor is in fact secured. For example, where three creditors hold security over the same asset, the value of that asset may only support the claim first in priority and part of the second in priority. The second creditor therefore may have a right to vote only in respect of the unsecured portion of its claim, while the third creditor will be totally unsecured. The valuation of the asset is therefore crucial to determining the extent to which secured creditors are secured and thus whether or not they are required to vote as unsecured creditors with respect to any portion of their claim.

515. There are a variety of different approaches to secured creditor voting on a reorganization plan. Some insolvency laws provide for secured and priority creditors to vote as separate classes on a plan that would impair the terms of their claims, or provide for them to otherwise consent to be bound by the plan. Adopting an approach that allows for secured creditors to vote as a separate class recognises that the respective rights and interests of secured creditors differ from those of unsecured creditors. The same rationale is true for priority creditors. In many cases, however, the rights of secured creditors will differ from each other and it may not be feasible to require all secured creditors to vote in a single class. In such cases,

some laws provide that each secured creditor forms a class of its own. Where secured creditors do vote, the requisite majority of a class of secured creditors would generally be the same as that required for approval by unsecured creditors, although there are examples of laws that require different majorities depending upon the manner in which secured creditors rights are to be affected by the plan (e.g. a three-quarter majority is required where the maturity date is to be extended and a four-fifths majority where the rights are otherwise to be impaired).

516. Where secured creditors vote in classes, some insolvency laws provide that to the extent that the requisite majority of the class votes to approve the plan, dissenting members of the class will be bound by the terms of the plan, subject to certain protections. Under those laws, the protections available to dissenting secured creditors may include that they are entitled to receive at least as much as they would have received in liquidation and only where that occurs can they be bound by the plan, or that they may be bound if the plan makes provision for them to be paid in full to the extent of the value of their security interest, with interest at a market rate, within a certain period of time. Some insolvency laws also provide that the court has the power to order that secured creditors are bound by the plan, provided it is satisfied as to certain conditions. These conditions may include that enforcement of the security interest by the secured creditor will have a material adverse effect on achieving the purposes of the plan; that the security interests of the secured creditor will be sufficiently protected under the plan; and that the position of the secured creditor will not further deteriorate under or as a result of the plan (for example, payments of future interest will be made and the value of the encumbered asset securing the security interest will not be affected). Other insolvency laws provide that the plan cannot be imposed upon any secured creditors unless they consent to such imposition.

517. In determining which approach should be taken to this issue, it will be important to assess the effect of the desired approach upon the availability and cost of secured transaction financing and to provide as much certainty and predictability as possible, balancing this against the objectives of insolvency law and the benefits to an economy of successful reorganization.

**(c) Approval by ordinary unsecured creditors**

518. Different mechanisms may be used to ensure that ordinary unsecured creditors have an effective means for voting on a plan. Whichever mechanism is chosen it is desirable that it be as simple as possible and be clearly set out in the insolvency law to ensure predictability and transparency.

*(i) Classes of unsecured creditors*

519. A number of insolvency laws do not provide for unsecured creditors to be divided into different classes, rather they vote together as a single group.

520. Countries that have established classes for secured and priority creditors often also provide for the division of ordinary unsecured creditors into different classes based upon their varying economic interests. The creation of these classes is designed to enhance the prospects of reorganization in at least three respects by providing: a useful means of identifying the varying economic interests of unsecured creditors; a framework for structuring the terms of the plan; and a means for the court to utilize

the requisite majority support of one class to make the plan binding on other classes which do not support the plan. Since the creation of different classes has the potential to complicate the voting procedure, it may be desirable only where there are compelling reasons for special treatment of some ordinary unsecured creditors, such as a large number of creditors that lack a common economic interest. Criteria that may be relevant in determining commonality of interest may include: the nature of the debts giving rise to the claims; and the remedies available to the creditors in the absence of the reorganization plan, including the extent to which the creditors could recover their claims by exercising those remedies. Where there is a small number of unsecured creditors or where their interests are similar, there may be no need for creditors to vote on approval of the plan in different classes, thus simplifying the voting procedure.

(ii) *Determination of classes*

521. Some insolvency laws specify the manner in which classes of ordinary unsecured creditors or claims are determined for the purposes of approval of the reorganization plan. One approach is for the plan to place claims or interests into a particular class on the basis of common interest or substantial similarity or on the basis of the value of the claim. Where the test is commonality or similarity of interest, the party proposing the plan may have some flexibility in assigning claims to a particular group. Other approaches provide for the insolvency representative to make recommendations to the court before the creditors vote on approval, or for the classes to be determined in the first instance by the debtor, who will have some limited flexibility as to the composition of each class; unsecured creditors who are dissatisfied with the composition of the class can seek to have the issue determined by the court.

(d) **Approval by equity holders**

522. Some insolvency laws provide for the approval of reorganization plans by equity holders, at least where the corporate form, the capital structure or the membership of the debtor will be affected by the plan. Equity holders may also be expected to vote in cases where they will receive a distribution under the plan. Where the debtor's management proposes a plan, the terms of the plan may already have been approved by the equity holders (depending upon the structure of the debtor in question, this may be required under its constitutive instrument). This is often the case where the plan directly affects equity holders, such as by providing for debt-for-equity conversions, either through the transfer of existing shares or the issuance of new shares.

523. In circumstances where the insolvency law permits creditors or an insolvency representative to propose a plan, and the plan contemplates debt-for-equity conversion, some countries allow the plan to be approved by creditors over the objection of equity holders, irrespective of the terms of the constitutive instrument of the debtor. Such plans may result in the interests of existing equity holders being entirely displaced in the new business without their consent.

(e) **Related persons**

524. Some insolvency laws provide that related persons should not vote with other creditors on approval of the plan or that their votes will not count for certain purposes, such as determining that an impaired class of creditors has accepted the

plan (when that is a requirement of approval). Many insolvency laws, however, do not include provisions dealing specifically with this issue of related persons. Where the insolvency law makes no special provision, related persons should vote in the same manner as other creditors. They will generally, however, be subject to the provisions of non-insolvency law in respect of their personal dealings with the debtor and its business.

**(f) Requirements for approval of the plan**

525. Many insolvency laws identify the minimum threshold of support required from creditors for a plan to be approved. The requisite majority can be calculated in a number of different ways, depending upon whether or not creditors vote in classes, and how those classes are treated in determining the majority, and as discussed above (II.5(a)), whether the insolvency law requires a majority of creditors voting or of all creditors.

*(i) Where voting is not conducted in classes*

526. Where creditors do not vote in classes, the majority may be fixed by reference to the support of a proportion or percentage of the value of claims or a number of creditors, or a combination of both. Some laws require, for example, that a plan be supported by at least two-thirds or three-quarters of the total value of the debt and more than one-half or two-thirds of the number of creditors. While these proportions generally apply to those creditors actually voting on approval of the plan, there are laws which determine these proportions by reference to the total value of debt and total number of creditors, irrespective of whether or not they vote. Other combinations are also used.

*(ii) Where voting is conducted by class*

527. Where creditors do vote in classes, a wide variety of different approaches are taken to determining when a plan will be approved. These approaches can be somewhat complex, involving requirements both for approval by a particular class and for approval among all the classes, with majorities determined by reference, in some cases, only to those creditors actually voting, and in others to the total number of creditors, whether voting or not (see 5(a) above).

*- Majority within a particular class*

528. Some insolvency laws require approval by a majority of creditors of a class, where the requisite majority is based upon a percentage or proportion of the value of claims or a number of creditors, or a combination of both. Although increasing the difficulty of achieving approval, a procedure which includes both value of claims and number of creditors may be justified on the basis that it protects the collective nature of the proceedings. For example, if a single creditor holds a majority of the value, such a rule prevents that creditor from imposing the plan on all other creditors against their will. Equally, such a provision may prevent a large creditor from imposing its lack of support for the plan on other creditors to their detriment, although there are examples of laws that do provide creditors holding more than a certain percentage of the total value of claims with a power to veto approval or to force an improvement of the terms of the plan that will benefit all creditors. A voting procedure which combines the value of claims with a number of creditors

will also prevent a large number of very small creditors from imposing their decision on a few creditors who hold very large claims. Some insolvency laws include provisions to the effect that even where a majority of the number of creditors support a plan, where those creditors represent less than a certain percentage of value of the total claims (e.g. around 25 or 30 percent), the court will be reluctant to confirm the plan. This procedure may also be justified on the basis that it helps to ensure the support for the plan is sufficient to enable it to be successfully implemented.

*- Majority of classes*

529. Some laws require that all classes of creditors must support the plan for it to be approved. A few laws, however, enable support by some classes to make the plan binding on other classes that do not support the plan. For example, a simple majority of the classes may be required or, where less than a majority of classes support the plan, the plan may nevertheless be made binding on a dissenting class that does not support the plan, provided the court is satisfied certain conditions are met. One law, for example divides claims into three classes and provides that the plan must be approved by at least two of those classes, and that at least one of the approving classes would not recover the full amount of their claims if the debtor were to be liquidated. Another variation requires that at least one of the classes approving the plan will have its rights impaired under the plan, to ensure that the plan is not only supported by those creditors whose rights are not impaired. Other laws provide that support by classes of unsecured creditors cannot force approval of plan if secured creditors oppose the plan. This is discussed further under 7 and 8 below.

**6. Where a proposed plan cannot be approved**

**(a) Modification of a proposed plan**

530. Whichever voting mechanism is chosen, it is desirable that the insolvency law be sufficiently flexible to allow a plan submitted for approval of creditors and other interested parties, to be negotiated by those parties in the course of the voting procedure with a view to achieving wide support. Where such negotiation is not possible and creditors and other interested parties are restricted to voting on the plan as proposed without the possibility of change, the chances of achieving approval of that plan may be reduced. One approach to achieving this flexibility may be to allow a majority of creditors to vote to adjourn the decision meeting to enable further disclosure, if it appears that some further negotiation on a plan may produce a favourable result or to address unresolved disputes and issues. As with many other provisions of the insolvency law, however, it is desirable that that adjournment be available in limited circumstances or at least a limited number of times, with perhaps time limits being included to facilitate speedy resolution of the renegotiations and avoid abuse.

**(b) Failure to approve a plan**

531. In cases where a reorganization plan is not approved and re-negotiation and modification of the plan will not resolve the difficulties encountered, an insolvency law may adopt different approaches to the further conduct of the proceedings. Some insolvency laws provide that the failure by creditors to approve the plan should be

taken as an indication that they favour liquidation and the reorganization proceedings can be converted to liquidation (see also part one, chapter II.D; part two, chapter IV.A.14). This approach may operate to encourage debtors to propose an acceptable plan, subject to safeguards to prevent abuse in cases where liquidation is not in the interests of all creditors may be appropriate. Other insolvency laws provide that the reorganization proceedings should be dismissed. This approach has the disadvantage of leaving the debtor in a state of financial difficulty, where further debts may accrue and the value of the assets diminish, and postponing the commencement of the liquidation proceedings that may be inevitable.

#### **7. Binding dissenting classes of creditors**

532. As noted above, a few countries that provide for voting on approval of a plan by secured and priority creditors and for the creation of different classes of unsecured creditors also include a mechanism that will enable the support of one or more classes to make the plan binding on other classes (including, under some laws, classes of secured and priority creditors) which do not support the plan. This is sometimes referred to as a “cram-down” provision. Where such provisions are incorporated in the insolvency law, the law also generally includes conditions that are aimed at ensuring the protection of the interests of those dissenting classes of creditors. Since it is generally the court that is required to consider whether these conditions have been satisfied, they are discussed in the following section.

#### **8. Court confirmation of a plan**

533. Not all countries require the court to confirm a plan that has been approved by creditors; approval by the requisite majority of creditors is all that is required for the plan to be effective and dissenting creditors will be bound by virtue of the operation of the insolvency law. In those systems, the court will still have a role to play with regard to review of the plan where minority creditors or other interested parties, including the debtor, challenge the plan itself or the means by which it was procured. Other countries do require court confirmation of the approval for the plan to be effective and binding.

##### **(a) Challenges to approval of the plan**

534. Many insolvency laws provide for the approval of the plan by creditors to be challenged in the court. The manner in which a challenge will be heard may depend upon the mechanism for making the plan effective. If court confirmation of the plan is not required, for example, minority creditors or other interested parties, including the debtor, may raise their challenge with the court after the vote on approval. Where the insolvency law requires court confirmation of an approved plan, a challenge may be made at the confirmation hearing. The law will also need to address the parties that may challenge approval of the plan, and the timing of any challenge, particularly where the basis of the challenge is fraud and any time limits may need to be established by reference to the time of discovery of the fraud. The law will also need to address the consequences of a successful challenge to the plan, such as permitting further opportunities for consideration and approval of a plan, depending upon the basis on which the challenge succeeded, or converting the proceedings to liquidation.



535. A number of insolvency laws establish the grounds for challenging approval of the plan. These may include that approval of the plan was obtained by fraud (e.g. false or misleading information was given to creditors and other interested parties or material information was withheld with respect to the reorganization plan or the financial affairs of the debtor); that there was some irregularity in the voting procedure (e.g. related persons participated where this is not permitted under the insolvency law or the resolution approving the plan was not consistent with the interests of creditors generally); that there was some irregularity in the organization or conduct of the meeting at which the vote was taken (e.g. adequate notice of the meeting was not given); that the proposals contained in the plan were put forward for an improper purpose or that the plan contains provisions contrary to law; that the plan is not feasible (e.g. secured assets are required for successful implementation of the plan, but secured creditors are not bound by the plan and no agreement has been reached with relevant secured creditors concerning enforcement of their security interests); that the plan does not satisfy the requirements for protection of dissenting creditors within a class (e.g. they will not receive as much under the plan as they would have received in liquidation); that the proposals unfairly prejudice the interests of the objector; or that the treatment of claims in the plan does not conform to the ranking of claims under the insolvency law (unless there has been agreement to vary that ranking).

536. Since all creditors are likely to be prejudiced to some degree by reorganization proceedings, a level of prejudice or harm that exceeds the prejudice or harm suffered by other creditors or classes of creditors would generally be required to enable a creditor to successfully challenge approval. Where the creditor challenging the plan voted in favour of the plan, the grounds for challenge may be limited, for example, to fraud and other impropriety.

**(b) Steps required for court confirmation**

537. Where the insolvency law requires the court (or in some countries an administrative authority) to confirm a plan, it would normally be expected to confirm a plan that has been approved by the requisite majority of creditors (whether voting in classes or otherwise). Many countries enable the courts to play an active role in “binding in” creditors by making the plan enforceable upon a class of creditors that has not approved the plan. This may require the court to undertake a role that is in the nature of a legal formality; it does not require the court to examine the commercial basis upon which the plan was approved but rather to ensure that the approval of the plan was properly obtained (i.e., there is no evidence of fraud in the approval process) and that certain conditions were satisfied. These conditions may be similar to or the same as those relevant to a challenge to the plan, for example, that those classes of creditors objecting to the plan will share in the economic benefits of the plan; that dissenting classes of creditors will receive as much under the plan as they would have received in liquidation; that no creditor will receive more than the full value of their claim; that normal ranking of claims under the insolvency law is recognized by the plan; and that similarly ranked creditors are treated equally. Some insolvency laws permit classes of unsecured creditors that are not entitled to priority to consent, by vote of the requisite majority of the class, to ranking different from that applying to distribution in a liquidation under the insolvency law. A class of ordinary unsecured creditors that will not be paid in full might consent, for example, to a distribution to a class of subordinated claims or

equity holders. Claims and expenses which are administrative claims or are entitled to be paid in priority generally are required to be paid in full for a reorganization plan to be confirmed, except to the extent that the holder of the claim or expense agrees to different treatment. Some laws require the court to assess additional matters, such as whether the plan can be considered to be fair in respect of those classes whose interests are impaired by the plan but which nevertheless have accepted the plan.

538. Some insolvency laws also give the court the authority to reject a plan on the grounds that it is not feasible or impossible to implement from a practical rather than an economic point of view. Such an approach may be justified, for example, where secured creditors are not bound by the plan, but the plan does not provide for full satisfaction of their secured claims. The court may reject the plan in such a case if it considers that secured creditors will exercise their rights against the encumbered assets, thus rendering the plan impossible to perform. The risk of this occurring should be addressed in provisions relating to preparation and approval of the plan.

539. The more complex the decisions the court is required to make in terms of approval or confirmation, the more relevant knowledge and expertise is required of the judges, and the greater the potential for judges to interfere in what are essentially commercial decisions of creditors to accept or reject a plan. It is desirable, in particular, that the court not be asked to review the economic and commercial basis of the decision of creditors (including issues of fairness that do not relate to the approval procedure, but rather to the substance of what has been agreed) nor that it be asked to review particular aspects of the plan in terms of their economic feasibility unless it has the competence and experience to do so. For these reasons, it is desirable that the requirements for approval by creditors and confirmation by the court (where this is required) of the plan are carefully designed to minimise potential problems of the kind discussed here.

#### **9. Effect of an approved [and confirmed] plan**

540. Where the plan is approved by the requisite majority of creditors and, where required, confirmed by the court, insolvency laws generally provide that it will be binding upon all affected ordinary unsecured creditors, including creditors who voted in support of the plan, dissenting creditors and creditors who did not vote on the plan. Some insolvency laws also provide that the plan will bind directors, shareholders and members of the debtor, and other parties as determined by the court. Some insolvency laws stipulate that the parties who are bound will be prevented from applying to the court to have the debtor liquidated (except, in specific circumstances, such as where implementation fails or the debtor fails to perform its obligations as required under the plan), to start or continue legal proceedings against the debtor or to pursue enforcement without approval of the court. Some laws also provide that once the plan is approved by creditors and confirmed by the court (where that is required), the property of the insolvency estate returns to the control of the debtor for implementation of the plan and a debtor may obtain a discharge from debts and claims pursuant to the plan.

#### **10. Challenges to a plan after court confirmation**

541. Many of those insolvency laws that require confirmation by the court provide for the plan to be challenged in the court subsequent to the confirmation hearing (in

some cases within a specified time period). On the basis that the court is required to be satisfied as to a number of conditions before confirming a plan, the grounds for challenge after confirmation could be narrower than the grounds for challenge at the time of confirmation and be limited, for example, to fraud. Where an insolvency law permits such a challenge after confirmation, it may be desirable to specify a time period after discovery of the fraud within which such a challenge can be brought, and to specify who may bring such a challenge. Where a challenge to a plan that has already been confirmed is successful, an insolvency law may adopt different options. For example the plan may be set aside and the proceedings converted to liquidation or the debtor be left in its state of financial difficulty and the assets returned to its control. The latter approach does not resolve the debtor's financial difficulty and may simply delay commencement of liquidation proceedings, leading to further diminution of the value of the debtor's assets before those proceedings are finally commenced. In determining the most appropriate action to be taken in circumstances where a challenge is successful, consideration will need to be given to the extent to which the plan has already been implemented and how steps taken in the implementation, such as payments to creditors, are to be treated.

**11. Amendment of a plan after approval by creditors**

542. An insolvency law may include limited provision for a plan to be modified after it has been approved by creditors (and both before and after confirmation where that is required) if its implementation breaks down or it is found to be incapable of performance, whether in whole or in part, and if the specific problem can be remedied. Of those insolvency laws that allow modification, some provide for the plan to be modified only if the modifications proposed will be in the best interests of creditors. Other laws provide that the plan can be modified if circumstances warrant the modification and if the plan, as modified, continues to satisfy the requirements of the insolvency law concerning, for example, content, classes of creditors and notice to creditors. Generally, any party in interest will be permitted to propose modification of a plan at any time. The only limitation that may apply in terms of timing relates to court approval of a modification. Such a requirement necessitates that the proceedings are still open and the court has jurisdiction. If proceedings are concluded after approval (and confirmation) of a plan, approval of the proposed amendment by affected creditors may be sufficient, unless some other requirement is imposed.

543. Depending upon the nature of the modification it may not be necessary to obtain the approval of all classes of creditors since in some cases obtaining this approval may prove difficult. Alternative approaches may include permitting small modifications to be approved by the court or by the creditors affected by the modification; providing that creditors who supported approval of the plan be notified of the proposed modification and permitted to object to that modification within a specified time period or otherwise be deemed to have accepted the modification. The same approach may be taken to creditors who did not approve of the plan. Where the modification proposed is significant, the approval of all creditors may be required. Those insolvency laws that require court confirmation of the plan may also require modifications to satisfy the rules or conditions relating to confirmation.

544. Whichever approach is adopted, it is desirable that the insolvency law not only require the giving of notice to relevant creditors (whether all creditors or only affected creditors) and specify the party responsible for giving that notice, but also the disclosure of information relevant to the failure of the plan and the proposed modification. Where the court has confirmed the original plan, it may also be required to confirm the modification to the plan. Where the requisite approval for the proposed modifications is not or cannot be obtained, it is desirable that the insolvency law addresses the consequences. These might be similar to those discussed above in respect of failure of creditors to approve the plan and successful challenges to the plan, taking into account the steps that already may have been taken in implementing the plan and the treatment to be afforded to payments made, contracts continued and so forth.

## 12. Implementation of a plan

545. Many plans can be executed by the debtor without the need for further intervention by the court or the insolvency representative. This is particularly so in the case of a debtor-in-possession reorganization, and under those laws that provide for the proceedings to conclude once a plan becomes effective. Under other laws that do not provide for the proceedings to conclude at that time, but rather when the plan has been fully implemented, it may sometimes be necessary for the implementation to be supervised or controlled by an independent person. Several insolvency laws provide that the court has an ongoing role in supervision of the debtor after approval and confirmation of the plan, pending completion of implementation of the plan. This may be important where issues of interpretation of the performance or obligations of the debtor or others arise. Some countries provide for the court to authorize continued supervision of the affairs of the debtor, to varying degrees, by a supervisor or insolvency representative after approval of the plan. A further approach permits creditors to appoint a supervisor or representative to oversee implementation of the plan.

## 13. Where implementation fails

546. Where the debtor defaults in performing its obligations under the plan or implementation of the plan breaks down for some other reason, insolvency laws adopt a number of different approaches to the consequences. Some insolvency laws provide that the court can terminate the plan and convert the proceedings to liquidation. Other laws provide that the plan will only be terminated in respect of the specific obligation breached (it otherwise remains valid). The creditor in question will not be bound by the plan and will have its claim restored (in the event that it had agreed to receive a lesser amount under the plan) to the full amount. In some cases, this will only occur where the debtor has fallen significantly into arrears<sup>91</sup> in the performance of its obligations under the plan. In some countries, the consequences of default may be set out in the plan itself.

547. A further approach may be to regard the insolvency proceedings as at an end and allow creditors to pursue the remedies otherwise available under the law. As already discussed, this approach does not resolve the financial difficulties of the

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<sup>91</sup> In one law, this requires a demand from the creditor for payment of the due liability and failure by the debtor to comply within a minimum period of time of at least two weeks.

debtor and could lead to a race for assets that the commencement of collective proceedings was intended to avoid. A compromise approach may be to allow the proposal of a different plan by creditors within a specified deadline and only in situations where no acceptable plan can be prepared within that deadline would liquidation follow. It must be recognized that at some point the balance between achieving the best outcome for all creditors and achieving what is feasible tips in favour of pursuing what is feasible, and it is desirable that an insolvency law be sufficiently flexible to allow this to occur.

#### **14. Conversion to liquidation**

548. A number of circumstances may arise in the course of a reorganization proceeding where it will be desirable for an insolvency law to provide a mechanism to convert the proceedings into liquidation. The principal grounds for conversion would be failure to propose or approve a reorganization plan or to approve proposed modifications to the plan; failure to obtain confirmation (where confirmation by the court is required); a successful challenge to an approved or confirmed plan; a majority vote by creditors to terminate a reorganization at a meeting of creditors; or material or substantial default by the debtor of its obligations under the plan. It may also be appropriate to consider conversion where it is determined that there is no reasonable likelihood of the business being successfully reorganized; where it is apparent that the debtor is misusing the reorganization process either by not cooperating with the insolvency representative or the court (e.g. withholding information) or otherwise acting in bad faith (e.g. making fraudulent transfers); where the business continues to incur losses during the reorganization period; or where administrative expenses are not paid (see also chapter I.B.8). Some laws also impose an obligation on the insolvency representative to terminate its mandate to administer reorganization proceedings as soon as it is evident that reorganization will not be possible, in order to preserve value for creditors. Making provision in the insolvency law for reorganization proceedings to be converted to liquidation will provide predictability as to the ultimate resolution of the proceedings, although it may lead to further delay and diminution of value if the liquidation proceedings are required to commence as if they were new proceedings, rather than being based on the original application.

549. Where reorganization proceedings are converted to liquidation, an insolvency law will also need to consider the status of any actions taken by the insolvency representative prior to approval of the plan; the continued application of the stay, particularly to secured creditors when the insolvency law contains a time limit relevant to commencement (see chapter II.B.3(c)); the treatment of payments made in the course of the implementation of the plan prior to a conversion; and the treatment of creditor claims that have been compromised in the reorganization. Payments made in the course of the reorganization may need to be protected from the operation of avoidance provisions. Claims that have been compromised in the reorganization may be reinstated to full value in any subsequent liquidation. The issue of failure of implementation may also be addressed in the reorganization plan, which may specify the rights of creditors in that event. Such an approach simplifies the question of treatment of those claims and avoids potentially difficult issues of applicable law.

550. Where the insolvency law permits conversion, a related question is how conversion can be triggered; whether it should be automatic once certain conditions are fulfilled or require application to the court by the insolvency representative or creditors. Because it is the party that, after the debtor or its management, has the greatest knowledge of the debtor's business, and so often learns at an early stage whether or not the debtor's business is viable, the insolvency representative can play a key role in the conversion process. In addition, it may be reasonable to allow creditors or the creditor committee (where one has been appointed), to request the court to convert the proceedings on similar grounds. The court could also be given the power to convert on its own motion where certain conditions are met.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions relating to the reorganization plan is to:

- (a) facilitate the rescue of businesses subject to the law, thereby preserving employment and, in appropriate cases, protecting investment;
- (b) identify those businesses that are capable of reorganization;
- (c) maximize the value of the estate;
- (d) facilitate the negotiation and approval of a reorganization plan and establish the effect of approval, including a mechanism to make a plan binding on the debtor, all creditors and other interested parties;
- (e) address the consequences of a failure to propose an acceptable reorganization plan or to secure approval of the plan by creditors, including conversion of the proceedings to liquidation in certain circumstances;
- (f) provide for the implementation of the reorganization plan and the consequences of failure of implementation.

### **Contents of legislative provisions**

#### *Preparation of the plan—timing*

(123)(a) Where a plan is required, the law should specify that the plan is proposed on or after the making of an application to commence insolvency proceedings, or within a specified time period after commencement of the insolvency proceedings:

- (i) the time period should be fixed by the law.
- (ii) the court should be authorized to extend the time period in appropriate circumstances.

(b) The law should also address the issue of timing where liquidation proceedings are converted to reorganization proceedings.

#### *Proposal of the plan—parties permitted*

(124) The law should identify the parties permitted to propose a plan for approval.

(125) In providing for the proposal of a plan, the law should adopt a flexible approach that potentially involves all parties central to the insolvency proceedings, i.e. the debtor, the creditors and the insolvency representative. The law may combine different elements:

(a) An exclusive period may be given to one party to propose a plan. To encourage debtors to apply for commencement of proceedings at an early stage of financial difficulty, it should be the debtor that is given that opportunity. That party may be required to consult with other parties in order to ensure proposal of an acceptable plan;

(b) Where no plan is forthcoming within the exclusive period, other parties, such as the insolvency representative, creditors or the creditors committee in collaboration with the insolvency representative, may be given the opportunity to propose a plan, or the court may extend the exclusive period if the party which has the exclusive period can show that an extension is warranted.

*Preparation of a disclosure statement*

(126) The law should require a plan submitted for the consideration of creditors and equity holders to be accompanied by a disclosure statement that will enable an informed decision about the plan to be made. The statement should be prepared by the same party that proposes the plan and be submitted to creditors and equity holders at the same time as submission of the plan.

*Submission of the plan and disclosure statement*

(127) The law should provide a mechanism for submission of the plan and disclosure statement to creditors and equity holders required to approve the plan.

*Content of the plan*

(128) The law should specify the minimum contents of a plan, which may include:

- (a) detail as to the classes of creditors and the treatment provided for each class by the plan (e.g. how much they will receive and the timing of payment);
- (b) the terms and conditions of the plan, including;
  - [(i) treatment of encumbered assets;]
  - (ii) treatment of contracts, including labour contracts;
  - (iii) the debtor's role in implementation of the plan, including control over assets;
- (c) means for the implementation of the plan which may include:
  - (i) the possibility of sale of all or any part of the debtor's business;
  - (ii) proposed changes in the capital structure of the debtor's business;
  - (iii) amendment of the instrument constituting the debtor;
  - (iv) merger or consolidation of the debtor with one or more persons;
  - (v) [modification of terms of security interests, including] extension of a maturity date or a change in an interest rate or other term;

- [(vi) continued use of encumbered assets;]
- (vii) distribution of all or any part of the assets of the estate among those having an interest in those assets;
- (viii) identification of those responsible for future management of the debtor;
- (ix) supervision of the implementation of the plan.

*Content of disclosure statement*

(129) The law should specify that the disclosure statement include:<sup>92</sup>

- (a) information relating to the financial situation of the debtor including asset and liability and cash flow statements;
- (b) a comparison of the treatment afforded to creditors by the plan and what they would otherwise receive in liquidation;
- (c) the basis upon which the business would be able to keep trading and could be successfully reorganized;
- (d) information showing that, having regard to the effect of the plan, the assets of the debtor will exceed its liabilities and that adequate provision has been made for satisfaction of all obligations provided for in the plan; and
- (e) information on the voting mechanisms applicable to approval of the plan.

*Voting mechanisms*

(130) The law should establish a mechanism for voting on approval of the plan. The mechanism should address the creditors who are entitled to vote on the plan; the manner in which the vote will be conducted, either at a meeting convened for that purpose or by mail or other means, including electronic means and the use of proxies; and whether or not creditors should vote in classes according to their respective rights. The law should permit a plan that is submitted to creditors for approval to be negotiated in the course of that approval process.

*Approval of the plan by members of a particular class*

(131) The law should specify the majority required for approval of the plan by a particular class of creditors. Where the required majority supports the plan, that class will be regarded as approving the plan. The majority should be calculated by reference to those actually voting, whether in person, by proxy or by other means.

(132) A majority based on unanimity or a simple majority of the number of those voting is not recommended. Alternative approaches may include requiring a combination of the number of those voting and the amount of claims, in proportions such as a simple majority of the number of those voting combined with a simple or greater (for example, two-thirds) majority in amount of the claims of those voting.

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<sup>92</sup> Where the insolvency representative does not prepare, or is not involved in the preparation of, the plan and the statement, the insolvency representative should be required to comment on both instruments.



*Approval by classes*

(133) Where voting on approval of the plan is conducted by reference to classes, the law should specify how the vote achieved in each class would be treated for the purposes of approval of the plan. [Different approaches may be taken, including requiring approval by a specified majority of the classes or approval by all classes.]

(134) Where the law does not require approval by all classes, the law should address the treatment of those classes that do not vote in support of a plan that is otherwise approved by the requisite [classes] [majority of classes].

*Failure to approve a plan*

(135) The law should specify the consequences of a failure to secure approval of a plan by the requisite majority of creditors.

*Binding effect of a plan*

(136) The law should specify that a plan will bind the debtor, creditors, and other interested parties, on the basis of either:

- (a) approval by the requisite majority of creditors; or
- (b) approval under (a) and confirmation of the approved plan by the court.

*Continuing use of encumbered assets*

[(137) The law may provide that if secured creditors do not support a plan and the encumbered assets are required for the reorganization, the court may order that the assets may continue to be used in the reorganization, subject to protection of the interests of the secured creditor.]

*Confirmation of an approved plan*

(138) Where the law requires court confirmation of an approved plan, the court should confirm the plan if:

- (a) the approval process was properly conducted;
- [(b) creditors have been treated fairly and equitably;]
- (c) creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;
- (d) the plan does not contain provisions contrary to the general law;
- [(e) administrative claims and expenses and claims which are entitled to priority will be paid in full except to the extent that the holder of the claim or expense agrees to different treatment;]and
- [(f) the treatment of claims<sup>93</sup> in the plan conforms to the ranking of claims under the law, except to the extent that affected creditors have agreed to vary that ranking.<sup>94</sup>]

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<sup>93</sup> Including for administrative costs and expenses.

*Challenges to approval (where there is no requirement for confirmation)*

(139) Where a plan becomes binding on approval by creditors, without requiring confirmation by the court, the law should permit interested parties, including the debtor, to challenge the approval of the plan. The law should specify criteria against which a challenge can be assessed which should include:

- (a) whether the grounds set forth in recommendation (142) are satisfied; and
- (b) fraud, in which case paragraphs (a) to (c) of recommendation (144) should apply.

*Challenges to a confirmed plan*

(140) The law should permit a confirmed plan to be challenged on the basis of fraud. The law should specify:

- (a) a time limit for bringing such a challenge by reference to the time of discovery of the fraud;
- (b) the party that may bring such a challenge; and
- (c) that the challenge should be brought to the court.

(141) The law should specify the consequences of a successful challenge under recommendations (139) and (140).

*Amendment of the plan*

(142) The law should permit amendment of a binding plan and specify the parties that may propose amendments and the time at which the plan may be amended.

*Approval of amendments*

(143) The law should establish the mechanism for approval of amendments to the plan. That mechanism should require notice to be given to creditors and other affected parties; specify the party required to give notice; require the approval of affected creditors and require the satisfaction of the rules for confirmation (where confirmation is required). The law should also specify the consequences of failure to secure approval of proposed amendments.

*Supervision of implementation*

(144) The law may establish a mechanism for supervising implementation of the plan, which may include supervision by the court, by a court appointed supervisor, by the insolvency representative, or by a creditor-appointed supervisor.<sup>95</sup>

<sup>94</sup> The court should satisfy itself that if one or more creditors are to receive less favourable treatment than prescribed for their rank under the law, those creditors have consented to that treatment.

<sup>95</sup> Where the proceedings involve a debtor-in-possession, or where the proceedings conclude on approval of the plan, it may not be necessary to appoint a supervisor.

*Conversion to liquidation*

(145) The law should provide that the court may convert reorganization proceedings to liquidation where:

- [(a) a plan is not proposed within any time limit specified by the law and no extension of time is approved by the court;]
- [(b) an application for conversion is made by the insolvency representative or creditors;]
- (c) a proposed plan is not approved;
- (d) an approved plan is not confirmed (where the law requires confirmation);
- (e) an approved or a confirmed plan is successfully challenged;
- (f) there is substantial breach of the terms of the plan.

## **B. Expedited reorganization proceedings**

### **1. Introduction**

551. As discussed above in part one of the Guide, reorganization can take one of several forms including reorganization conducted under the formal supervision of a court or administrative body (the main form of reorganization discussed in the Guide) and informal (i.e. in the sense of being conducted out-of-court) negotiation and acceptance of a plan (referred to in this discussion as voluntary restructuring negotiations and agreements) which requires little or no court involvement and essentially depend upon the agreement of the parties involved. Because many of the costs, delays and procedural and legal requirements of formal reorganization proceedings can be avoided where voluntary restructuring negotiations are used, this type of negotiation often can be the most cost efficient means of resolving a debtor's financial difficulties, although it may not be effective in all instances of financial difficulty because it depends upon certain pre-conditions, discussed below. Nevertheless, these negotiations can be a valuable tool in the range of insolvency solutions available to a country's commercial and business sector. Encouraging the use of such negotiated solutions need not stem from the fact that a country's formal insolvency system is poor, inefficient or unreliable, but rather from the advantages such solutions can offer as an adjunct to a formal insolvency system which delivers fairness and certainty.

552. Reaching agreement through voluntary restructuring negotiations is often impeded by the ability of individual creditors to take enforcement action and by the need for unanimous creditor consent to alter the repayment terms of certain existing classes of debt. These problems are magnified in the context of complex, multinational businesses, where it is especially difficult to obtain consents from all relevant parties. To facilitate the successful outcome of these negotiations, the International Federation of Insolvency Professionals (INSOL) developed the *Principles for a Global Approach to Multi-Creditor Workouts*. The *Principles* are designed to expedite negotiation and increase the prospects of success by providing guidance to diverse creditor groups about how to proceed on the basis of some common agreed rules.

553. Voluntary restructuring negotiations can also be impeded by a minority of affected creditors who may refuse to agree to a solution that is in the best interests of most creditors in order to take advantage of their position to extract better terms for themselves at the expense of other parties (often referred to as “holding out”). Where these hold-outs occur, the voluntary agreement can only be implemented if by some means the contractual rights of these dissenting creditors can be modified without their consent. Under most existing legal systems, such a modification of contractual rights requires the voluntary agreement to be converted to full court-supervised reorganization proceedings under the insolvency law, involving all creditors and including standards of treatment that appropriately protect the interests of dissenting creditors. Timing is typically critical in business restructuring and delay (usually inherent in full court-supervised insolvency proceedings) can frequently be costly or even fatal to an effective solution. It is therefore important that the court be able to take advantage of the voluntary negotiations and consents to a restructuring plan obtained prior to the commencement of reorganization proceedings under the insolvency law and that the insolvency law permits the court to expedite those reorganization proceedings, referred to in this section as expedited reorganization proceedings.

## **2. Creditors typically involved in voluntary restructuring negotiations**

554. Voluntary restructuring negotiations typically involve the debtor and one or more classes of creditors, such as lenders, bondholders and shareholders. They also frequently involve major non-institutional creditors, typically where such creditors’ involvement is so considerable that an effective restructuring is not possible without their participation. These types of creditors often find it advantageous to participate in these negotiations because there is a potential to reduce the loss that they would otherwise suffer under full court-supervised insolvency proceedings.

555. The limited classes of creditors that would normally participate in voluntary restructuring negotiations, and thus in an expedited proceeding, makes an agreement easier to accomplish than full court-supervised reorganization, which typically affects all claims. It is usual in voluntary restructuring negotiations for these types of non-institutional creditors to continue to be paid in the ordinary course of business. On that basis, these creditors are not likely to have any objection to the proposed restructuring. Where, however, the rights of those creditors are to be modified, their agreement to the proposed modifications would be required.

## **3. Proceedings to implement a voluntary restructuring agreement**

556. An insolvency law can provide for recognition of a plan negotiated and agreed before commencement of reorganization proceedings under the insolvency law and for expedition of those proceedings. Where it does so, consideration will need to be given to defining the debtors to whom it might apply and the parties that can be affected by such proceedings.

### **(a) Eligible debtors**

557. Expedited reorganization proceedings may be available on the application of any debtor eligible to commence proceedings under the general reorganization provisions of an insolvency law.

558. Where the insolvency law establishes an obligation to commence insolvency proceedings if the debtor meets specified criteria concerning its financial position (e.g. that it is insolvent), it may be necessary to provide specifically that the commencement of expedited proceedings satisfies this obligation. Alternatively the insolvency law may provide a temporary moratorium which will enable the debtor to avoid meeting those criteria (and thus avoid the sanctions for failure to meet the obligation to apply for commencement).

**(b) Obligations affected**

559. As noted above, the types of obligations typically involved in voluntary restructuring negotiations relate to borrowed money indebtedness, both institutional and public, whether secured or unsecured, and other similar financial obligations. Secured debt could also be included in such negotiations with the agreement of the secured creditors. Indebtedness held by other creditors, such as trade creditors, preferential creditors such as tax and social security authorities, and employees, generally is not included because of the difficulty of obtaining necessary approvals to adjustment of their claims<sup>96</sup> and these creditors continue to be paid in the ordinary course of business. However, such creditors could be included, particularly where their rights are to be modified in the reorganization, provided all the relevant safeguards applicable under the insolvency law were observed. The specific obligations to be affected in any given case would be those identified in the plan which is to be confirmed under this type of proceeding.

**(c) Application of the insolvency law**

560. In addition to identifying eligible debtors and determining who may apply for commencement of this type of proceeding, an insolvency regime that permits expedited proceedings will need to identify those provisions of the insolvency law applicable to full court-supervised proceedings that will apply to these proceedings, particularly if any changes are to be made in the manner in which they apply. So, for example, the provisions which would generally apply to this type of proceedings in the same manner as for full court-supervised proceedings (unless specifically modified) might include provisions on: application procedures; commencement; application of the stay; requirements for preparation of a list of all creditors (in order to inform the court, and provide notice and certainty as to who is affected by the plan and who is not); requirements for approval of the plan (including notice to affected creditors, determination of classes of creditors, creditor committees, criteria and majorities required for approval); effect and confirmation of the plan; issues relating to implementation of the plan and discharge of claims. Where implementation of a plan confirmed under an expedited proceeding fails, the insolvency law will need to consider the consequences of that failure and in particular, whether they should be the same as for failure of plan approved in formal proceedings, (discussed in chapter IV.A.13 and 14), and whether special provision should be made in respect of payments already made in the course of implementation.

561. Provisions of the insolvency law that might not apply to expedited proceedings would include those relating to the requirement for general cessation of payments or

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<sup>96</sup> These trade claims could be restructured if the necessary majority approval could be obtained.

insolvency; appointment of the insolvency representative, unless the plan specifically provides for that appointment; submission of claims; requirements for notice and time periods for plan approval (where such provisions are included in the insolvency law); and voting on the plan. A further and important exception to the application of the insolvency law would be that, upon a showing of a likelihood of successful confirmation of the reorganization plan, the court could authorize creditors not affected by the plan to continue, during the proceedings, to be paid in the ordinary course of business.

562. The application for commencement of expedited proceedings may need to be somewhat different to an application for full court-supervised proceedings to take account of the different background considerations. The application could include, for example, additional information concerning the negotiations that have already been conducted and the pre-commencement solicitation and voting of affected classes of creditors, as well as the protections afforded to dissenting creditors within accepting classes. An insolvency law may also need to address the question of whether the application will function as an automatic commencement of the proceedings or whether the court will be required to consider the application; if court consideration is required, it is desirable that the time for such consideration be as brief as possible, particularly because the application is based upon negotiation and agreement and delay is detrimental not only to the debtor's business but also to implementation of the plan.

**(d) Expedition of the proceedings**

563. In order to take full advantage of the negotiated agreement and avoid the delays that may make that agreement impossible to implement, an insolvency law may need to consider how this type of proceeding can be handled more quickly than full court-supervised reorganization proceedings. For example, if a plan and other documentation that complies with the formal requirements of the insolvency law has been negotiated and is supported by a substantial majority, it may be possible for the court to order an immediate meeting or hearing as applicable, saving time and expense. It may also be possible for an exemption to be granted from part of the formal proceedings. For example, if a negotiated restructuring plan has been agreed to by a majority of creditors of a particular class—typically the institutional creditors—sufficient to satisfy the voting requirements of the insolvency law for approval of a reorganization plan and the rights of other creditors will not be impaired by the implementation of the plan, it might be possible for the court to order a meeting or hearing of that particular approving class of creditors only. Similarly, if the solicitation of votes of affected classes of creditors has been conducted in compliance with applicable laws governing such solicitation (including the disclosure requirements of applicable securities laws) it should be possible for the court to dispense with post-commencement solicitation procedures.

564. Even where the insolvency law provides for eligible cases to be treated expeditiously, it is highly desirable that it does not afford less protection for dissenting creditors and other parties than the insolvency law provides for dissenting creditors in full court-supervised reorganization proceedings. The procedural requirements for such expedited reorganization proceedings would therefore include substantially the same safeguards and protections as provided in full court-supervised reorganization proceedings.

565. Other laws may need to be modified to encourage or accommodate both voluntary restructuring negotiations and this type of expedited reorganization proceedings. Examples of those laws might include that expose directors to liability for trading during the conduct of informal reorganization negotiations; that do not recognize obligations for credit extended during such a period or subject those obligations to avoidance provisions; and that restrict conversion of debt to equity.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions relating to insolvency procedures which combine voluntary restructuring negotiations and acceptance of a plan with an expedited procedure conducted under the law for court approval of that plan is to:

- (a) recognize that voluntary restructuring negotiations, which typically involve restructuring of the debt due to lenders and other institutional creditors and major non-institutional creditors where their participation is crucial to the restructuring, but not involving all categories of creditors, is a cost effective, efficient tool for the rescue of financially troubled businesses;
- (b) encourage and facilitate the use of informal negotiation;
- (c) develop a procedure under the law that will:
  - (i) preserve the benefits of voluntary restructuring negotiations where a majority of each affected class of creditors agree to a plan;
  - (ii) minimize time delays and expense and ensure that the plan negotiated and agreed in voluntary restructuring negotiations is not lost;
  - (iii) bind those minority members of each affected class of creditors and shareholders who do not accept the negotiated plan ;
  - (iv) be based upon the same substantive requirements, but shortened time periods, as reorganization proceedings under the law, including essentially the same safeguards;
- (d) suspend, with appropriate safeguards, requirements in other laws that may prevent or inhibit the use of processes which delay the invocation of the law.<sup>97</sup>

### **Contents of legislative provisions**

#### *Commencement of expedited reorganization proceedings*

- (146) The law should specify that expedited proceedings can be commenced on the application of any debtor that:

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<sup>97</sup> [from purpose clause (d)] For example, requirements for unanimous consent for adjustment of indebtedness outside of insolvency proceedings, liability for directors where the debtor continues to trade during the period when the out-of-court negotiations are being conducted, that do not recognize obligations for credit extended during such a period, and that restrict conversion of debt to equity.

[(a) is likely to be generally unable to pay its debts as they mature [or whose liabilities are likely to exceed its assets]] [is eligible to commence reorganization proceedings under the provisions of the insolvency law];

(b) has negotiated a plan and had it accepted by [the vote, solicited in accordance with applicable non-insolvency laws of a requisite majority of] each affected class of creditors and by each affected creditor not part of a voting class; and

(c) satisfies the jurisdictional requirements for commencement of full reorganization proceedings under the law.

*Application requirements*

(147) The law should specify that an application for commencement of an expedited reorganization proceeding should be accompanied by the following additional materials:

(a) the plan and disclosure statement;

(b) a description of the voluntary restructuring negotiations that preceded the making of the application for commencement, including the information provided to affected creditors to enable them to make an informed decision about the plan [or a summary of that information];

(c) certification that unaffected creditors are being paid in the ordinary course of business and that the plan does not modify or impair the rights or claims of preferential creditors, such as tax or social security authorities or employees without their agreement;

(d) a report of the votes of affected classes of creditors demonstrating that those classes have accepted the plan by the majorities specified in the law;

(e) a report of the acceptance of any individual creditors whose rights are modified by the plan;

(f) a financial analysis or other evidence which demonstrates that the plan satisfies all applicable requirements for reorganization; and

(g) a list of the members of any creditor committee formed during the course of the informal negotiations.

*Commencement*

(148) The law should specify that the application for commencement will automatically commence the proceedings or that the court will be required to promptly determine whether proceedings should commence.

*Effect of commencement*

(149) The law should specify that:

(a) provisions of the law that apply to full reorganization proceedings will also apply to expedited proceedings unless specified as not applicable;<sup>98</sup>

<sup>98</sup> Provisions of the law that generally would not be applicable would include: full claim filing;



(b) [unless otherwise determined by the court] the effects of commencement should be limited to the debtor, individual creditors and classes of creditors and shareholders whose rights are modified or who are affected by the plan;

(c) any creditor committee formed during the course of the voluntary restructuring negotiations should be treated as a creditor committee appointed under the law; and

(d) a hearing on the confirmation of the plan should be held as expeditiously as possible.

*Notice of commencement*

(150) The law should specify that notice of the commencement of expedited proceedings be given to creditors and equity holders individually. The notice should specify:

(a) the amount of each affected creditor's claim according to the debtor;

(b) the time period for submitting a claim in a different amount if the affected creditor disagrees with the debtor's statement of the claim, and the place where the claim can be submitted;

(c) the time and procedure for challenging claims submitted by other parties;

(d) the time and place for the hearing on confirmation of the plan, and for the submission of any objection to confirmation; and

(e) the impact of the plan on shareholders.

*Confirmation of the plan*

(151) The law should specify that the court will confirm the plan if:

(a) the plan satisfies the substantive requirements for confirmation of a plan in full reorganization proceedings, in so far as those requirements apply to affected creditors and equity holders;

(b) the notice given and the information provided to affected creditors and equity holders during the voluntary restructuring negotiations was sufficient to enable them to make an informed decision about the plan [and any pre-commencement solicitation of acceptances to the plan complied with applicable law];

(c) unaffected creditors are being paid in the ordinary course of business and the plan does not modify or impair the rights or claims of priority creditors, such as tax or social security authorities or employees without their agreement;

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notice and time periods for plan approval; the post-commencement mechanics of providing the plan and disclosure statement to creditors and other interested parties and for solicitation of votes and voting on the plan; appointment of an insolvency representative (who generally would not be appointed unless required by the plan); provisions on amendment of the plan after confirmation. An exception to the provisions of the law applicable to full reorganization proceedings would be that creditors not affected by the plan would be paid in the ordinary course of business during the implementation of the plan.

(d) the financial analysis submitted with the application demonstrates that the plan satisfies all applicable requirements for reorganization .

*Effect of a confirmed plan*

(152) The law should specify that the effect of a confirmed plan should be limited to the debtor and those creditors and equity holders affected by the plan.

*Failure of implementation of a confirmed plan*

(153) The law should specify that where there is a substantial breach of the terms of the plan confirmed in accordance with recommendation (150), the proceedings may be [closed and creditors may exercise their rights at law] [converted to liquidation].

## **V. Management of proceedings**

### **A. Treatment of creditor claims**

#### **1. Introduction**

566. Claims by creditors operate at two levels in insolvency proceedings—firstly, for purposes of determining which creditors may vote in the proceedings and how they may vote (according to the class into which they fall and the value of their claim, where that is a relevant factor) and secondly, for purposes of distribution (see chapter V.B). The procedure for submission of claims and their admission is therefore a key part of the insolvency proceedings and consideration should be given to determining which creditors should be required to submit claims, the procedures applicable to the submission, verification and admission or denial of claims, the consequences of failure to submit a claim, and review of decisions concerning the admission or denial of claims. An insolvency law should also address the effect of submission and admission of claims, as this will be key to creditor participation. For example, submission of a claim may entitle a creditor to participate at the first meeting of creditors, while admission, or at least provisional admission, may be essential to enable a creditor to vote on various matters in the proceedings.

#### **2. Submission of creditor claims**

##### **(a) Creditors who may be required to submit claims**

567. The principal issue with regard to deciding which creditors will be required to submit a claim relates to the treatment of secured creditors, since unsecured creditors (irrespective of whether the debt is contingent or liquidated) are generally required to submit a claim (unless of course, the claims procedure provides an alternative mechanism for verification and admission of claims that does not require all creditors to submit claims—discussed below).

568. Under those insolvency laws which do not include encumbered assets in the insolvency estate and allow secured creditors to freely enforce their secured interest against the encumbered assets, secured creditors may be excluded from the requirements to submit a claim to the extent that their claim will be met from the value of the sale of the encumbered asset. To the extent that the value of the

encumbered asset is less than the amount of the secured creditor's claim, the creditor may be required to submit a claim for the unsecured portion as an ordinary unsecured creditor. The value of the unsecured claim thus depends upon the value of the encumbered asset and the time at which that value is determined and the method of valuation used. Unless clear rules apply to valuation, there is the potential for some uncertainty, particularly in terms of deciding voting rights where they are calculated by reference to the value of claims.<sup>99</sup>

569. Another approach requires secured creditors to submit a claim for the total value of their security interest irrespective of whether any part of the claim is undersecured, a requirement which in some laws is limited to the holders of certain types of security interest, such as floating charges, bills of sale, or security over chattels. Some of those jurisdictions requiring all secured creditors to submit a claim include serious consequences for those failing to do so (discussed below). Some insolvency laws also permit secured creditors to surrender their security interest to the insolvency representative and to submit a claim for the total value of the security interest.

570. Where secured creditors are required to submit a claim, the procedures for submission and verification are generally the same as for unsecured creditors. The rationale of requiring secured creditors to submit claims is that it will provide information to the insolvency representative as to existence of all claims, the extent of the secured debt and the assets that might be subject to a security interest, as well as the total amount of the outstanding debt. Whichever approach is chosen, it is desirable that an insolvency law includes clear rules on the treatment of secured creditors for the purposes of submission of claims. It is also important, particularly where an insolvency law provides that the claims procedure can affect the security rights of a secured creditor, that notification of the commencement of proceedings include information regarding the submission, or failure to submit, secured claims.

**(b) Limitations on claims that can be submitted**

571. It has not been unusual in the past for insolvency laws to limit the types of claims that could be submitted, excluding, for example, unliquidated tort claims. More recently, however, there has been a trend towards widening the definition of claims that can be submitted to include those unliquidated tort and contract claims, as well as contingent claims. If such claims are not included in the insolvency proceedings, the creditors holding those claims cannot participate and have no recourse for collecting their debt from the debtor. It is therefore desirable for an insolvency law to adopt a broad definition of claims that can be submitted. It should be noted, however, that expanding that definition has the potential to make the insolvency proceedings more complicated, particularly when those claims have to be valued to enable submission and admission, even on a provisional basis.

*(i) Post-commencement debt*

572. As a general principle, claims can only be submitted in respect of debt incurred prior to commencement. How debt incurred after commencement is treated will depend on the nature of the proceedings and the provisions of the insolvency

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<sup>99</sup> On the valuation of encumbered assets, see chapter II.B.8.

law—many laws provide that such debts are payable in full as costs of the proceedings (see chapter V.B).

(ii) *Types of excluded claims*

573. For a variety of public policy reasons, an insolvency law may seek to exclude certain types of claims from the insolvency proceedings. Examples include foreign tax claims, fines and penalties, claims relating to personal injury, claims relating to negligence, and gambling debts. Some insolvency laws provide that those claims can be submitted, but that they may be subject to special treatment, such as subordination to other unsecured claims. It is highly desirable that an insolvency law identifies those claims that are to be excluded from the insolvency process (or subjected to special treatment—see chapter V.B).

- *Foreign tax claims*

574. Foreign tax claims are currently excluded by many countries, and it is generally recognized that such an exclusion does not violate the objective of equal treatment of foreign and domestic creditors. Despite this general view, however, there are no compelling reasons why such claims cannot be admitted if a country wishes to do so. Where foreign tax claims are admitted, they can be treated in the same manner as domestic tax claims or as ordinary unsecured claims. Article 13(2) of the UNCITRAL Model Law on Cross-Border Insolvency recognizes these different approaches, providing that the principle of equal treatment of foreign and domestic creditors is not affected by the exclusion of foreign tax and social security claims or by their ranking on the same level as general non-preference claims or lower if equivalent local claims have that lower ranking.

- *Claims arising from illegal activity*

575. Where gambling debts are treated as excluded claims it is generally on the basis that they arise from an activity that is itself illegal. Rather than focussing upon specific examples of claims that may be excluded as illegal, an insolvency law may exclude, as a general category, those claims that arise from illegal activity and are unenforceable.

- *Fines and penalties*

576. With respect to fines and penalties, an insolvency law may distinguish between those which are of a strictly administrative or punitive nature (such as a fine imposed as the result of an administrative or criminal violation) and those of a compensatory nature. It may be argued that the first category of fines and penalties should be excluded on the basis that they arise from some wrongdoing on the part of the debtor and unsecured creditors should not be made to bear the burden of that wrongdoing by seeing a reduction in the assets available for distribution. In comparison, there would seem to be no compelling reason for excluding the second category, particularly where it relates to recompense for damage suffered by another party, except to the extent that exclusion may also be justified as a means of increasing the assets available to unsecured creditors. An alternative approach would be to admit claims based on fines and penalties because otherwise they will remain uncollected.

**(c) Procedure for submission of claims**

*(i) Timing of submission of claims*

577. To ensure that claims are submitted in a timely fashion and that the insolvency proceedings are not unnecessarily prolonged, deadlines for submission of claims can be specified. Some insolvency laws specify that claims are to be submitted within a certain period after commencement of proceedings or by reference to some other specified event in the proceedings. Other laws provide for determination of the deadline by the court or insolvency representative and require that deadline to be within a range specified in the insolvency law, with examples ranging from 10 days to three months after a specified event, such as commencement. Other insolvency laws do not establish any deadlines for submission, and leave it up to the insolvency representative to determine the timing of submission of claims, or provide for claims to be submitted at any time up until some specified point in the proceedings, such as the final report and accounting by the insolvency representative. Some insolvency laws also establish different time limits depending upon the method of notification of commencement; where the creditor is a known creditor and receives personal notification of the commencement of proceedings the time limit may be shorter than where the creditor has to rely on public notification of commencement. A key factor in determining any deadline for submission will be the procedure for verification and admission of claims. If that process is required to take place at a court hearing or a meeting of creditors convened for that purpose, there is likely to be less flexibility with respect to the timing of the submission of claims, and claims not submitted by the specified date before that meeting or hearing will require a special hearing or meeting to be convened. Where verification and admission is conducted by the insolvency representative, greater flexibility will be possible since there will not be the same need to satisfy procedural requirements associated with convening meetings of creditors or court hearings.

578. While deadlines may assist in ensuring that the claims process does not impose unnecessary delay on the proceedings, they may operate to disadvantage foreign creditors who in many cases may not be able to meet the same deadlines as domestic creditors. To ensure the equal treatment of domestic and foreign creditors, and to take account of the international trend of abolishing discrimination based upon the nationality of the creditor, it may be possible to adopt an approach that either allows claims to be submitted at any time prior to distribution or some other specified event, or sets a time limit which can be extended or waived where a creditor has good reason for not complying with the deadline, or where the deadline operates as a serious impediment to a creditor.

579. Where a deadline is established (whether by the insolvency law, the court or insolvency representative) and the claim is submitted late causing costs to be incurred, those costs could be borne by the creditor. Where claims can be submitted at an advanced stage of the proceedings, an associated question to be addressed is whether interim distributions can be made before all claims have been submitted and, if so, whether creditors submitting their claims after a distribution has been made nevertheless can participate in that distribution. Some insolvency laws provide that such a creditor can only participate in distributions occurring after submission, while others require the insolvency representative to make provision for creditors that have not submitted their claims at the time of the distribution.

(ii) *Burden of submitting and proving claims*

580. Many insolvency laws place the burden of submitting and proving a claim upon creditors. Generally they will be required to produce evidence, in some cases by way of a standard claim form accompanied by supporting documentation, as to the amount of the claim, the basis of the debt and any preferences or security claimed. . Many laws provide that the insolvency representative is entitled to request the creditor to provide additional information or documentation to prove their claim; some laws also permit claims that have not been properly proved to be rejected. Admission may be assisted in some jurisdictions by requiring claims to be submitted in the form of a declaration, such as an affidavit, to which sanctions would attach in the event of fraud; the formalities associated with such declarations in some jurisdictions has led to that practice being abandoned.

581. A number of insolvency laws permit claims to be admitted without the creditor having to submit and prove a claim in circumstances such as where the insolvency representative is able to ascertain, from the debtor's books and records, which creditors are entitled to payment and the amount of the debt. Although in many insolvency cases the books and records of the debtor may not be completely reliable, this method of admission has the advantage of reducing formalities associated with verification and admission of claims and may be appropriate where the claims are not disputed (discussed further below). This approach may be facilitated by requiring, as an initial step in the proceedings, preparation of a list of creditors and claims.. Preparation of such a list by the debtor takes advantage of the debtor's knowledge about its creditors and their claims and can give the insolvency representative an early indication of the state of the business. An alternative approach could require the insolvency representative to assist the debtor to prepare that list or the insolvency representative to prepare the list. While the latter approach may serve to reduce the formalities associated with the process of verification of claims, it may add to costs and delay, since it relies upon the insolvency representative being able to obtain accurate and relevant information from the debtor. Once the list is prepared, it could be used to assess which creditors claims could be admitted without formal proof and which creditors should be invited to make their claims to the insolvency representative for purposes of verification, as well as for the purposes of ensuring that all relevant creditors have submitted claims. The list could also be revised and updated over time to provide not only an accurate indication of the level of the debtor's indebtedness, but also the status of verification and admission of claims.

582. It is desirable that an insolvency law addresses the question of false claims and provide appropriate sanctions for creditors and others who lodge claims that prove to be false.

(iii) *Formalities for submission of foreign claims*

583. An issue of particular importance to foreign creditors is whether the claim must be submitted in the language of the jurisdiction in which the insolvency proceedings have commenced, and whether the claim is subject to certain formalities, such as notarization. To facilitate the access of foreign creditors, it is desirable that consideration is given to whether these requirements are essential or may be relaxed as in the case of other procedural formalities discussed in respect of

article 14 of the UNCITRAL Model Law on Cross-Border Insolvency (see chapter VII).

(iv) *Conversion of foreign currency claims*

584. Where the debtor has business activities in different countries, creditors may have debt denominated in currencies other than that of the country of the insolvency proceedings. For verification and distribution purposes, these claims are normally converted into the domestic currency, although circumstances may exist in which conversion is not required. The date of conversion may have been agreed in the contract between the debtor and creditor, or it may be set by the insolvency law by reference to a fixed time, such as commencement or other point of the proceedings. Where there is a time difference between the date of conversion and the date of distribution (which could occur at a significantly later time), there is the potential for the currency to depreciate or appreciate in that period and thus for the amount of the claim also to fluctuate. Where the currency is relatively stable, this fluctuation may not be significant. In times of severe currency instability, however, the fluctuation could result in a creditor being significantly disadvantaged in favour of other creditors or advantaged at the expense of other creditors. In such circumstances, an insolvency law might provide that a provisional conversion is made at the time of commencement for the purposes of voting, and where the exchange rate fluctuates more than a given percentage (which is stipulated in the insolvency law) in the period before distribution, the conversion will be made at the time of distribution or an appropriate adjustment can be made to the earlier calculation.

(v) *Party authorized to receive claims*

585. Insolvency laws generally adopt one of two approaches to the question of to whom claims should be submitted. Some laws require the claim to be submitted to the court, while others provide for claims to be submitted to the insolvency representative, where the basis for the difference generally relates to the process of verification and the respective roles of the court and the insolvency representative. Where the insolvency representative is responsible for verification and admission of claims, creditors would generally have a right of recourse to the court to dispute issues relating to the value or priority accorded to the admitted claim or to the denial of the claim (see below).

**(d) Failure to submit claims**

(i) *Failure to submit within a stipulated time period*

586. Insolvency laws adopt different approaches to those claims not submitted within any specified time limit. Some laws adopt a flexible approach providing that notwithstanding the application of a deadline, claims still can be submitted at any time up to, for example, the insolvency representative's final report and accounting in liquidation, but the creditor must bear any additional costs associated with late submission. One consequence of late submission may be that the creditor cannot participate in interim distributions occurring before submission (or admission) of the claim, although as noted above there are examples of laws which permit the creditor to receive previous interim dividends once the claim has been admitted. A

further consequence is the loss of the right to vote at meetings of creditors, where submission of a claim is a pre-requisite to that participation.

587. Another approach to submission of claims adheres strictly to submission deadlines, and some laws provide that failure to submit a claim may result in the debt being extinguished or security rights being waived or forfeited, provided the creditor received the prescribed notification of commencement and the need to submit a claim. Other laws require the creditor who has failed to submit its claim by the deadline to petition the court for admission. Where the court admits the claim, the creditor may be limited to sharing only in future dividends.

588. While creditors should be given the widest possible opportunity to submit their claim in insolvency proceedings and must therefore receive timely and appropriate notice of commencement and of the need to submit a claim, the proceedings should not be delayed by creditors who are aware of the need to submit and of the applicable deadlines, but nevertheless fail to do so in a timely manner since this has the potential to increase the costs of the proceedings and disadvantages other creditors. The consequences of failure to submit should therefore be clearly defined and creditors should be made aware of them at the time they are notified of the deadlines for submission.

(ii) *Failure to submit a claim before conclusion of the proceedings*

589. The failure of a creditor to submit a claim before the final report and accounting may lead to different results depending upon other provisions of the insolvency law. Some of those insolvency laws that provide for a discharge of the debtor upon conclusion of the insolvency proceedings also provide that claims not submitted in the insolvency proceedings are forfeited.

**3. Verification and admission of claims**

**(a) List of submitted claims**

590. Many insolvency laws require the court or the insolvency representative, depending upon requirements for submission, to prepare a list of submitted claims, either after expiry of the deadline for submission of claims or on a continuing basis in cases where there is no deadline or the deadline occurs later in the proceedings. Where the insolvency law requires preparation of a list of creditors as discussed above (see also chapter III.A), the list of claims would update that earlier list of creditors and be used as the basis of verification and admission of claims and for notification as to the receipt, admission or denial of claims, depending upon the applicable admission procedure. Many insolvency laws provide that all identified and identifiable creditors are entitled to receive notice of claims that have been made, whether personally, by publication of notices in appropriate commercial publications or by filing a list with the court. This will enable creditors, the debtor and interested parties to see what claims have been submitted and to object to the claims listed (where this is permitted under the insolvency law).

**(b) Procedures for verification and admission**

591. Verification involves not only an assessment of the underlying legitimacy and amount of the claim, but also classification of a claim for purposes of voting and distribution (e.g. secured or unsecured claims; priority claims and so on).



(i) *Deadline for verification and admission*

592. A number of insolvency laws impose time limits for verification and admission of claims, requiring that a decision be provided to creditors within a short period, for example 30 days after the expiry of the deadline for submission. Other laws make no provision for time limits. A key factor in deciding whether or not an insolvency law should impose time limits in this case is the procedure for verification and admission requires a court hearing or a meeting of creditors to be held or is conducted by the insolvency representative. In the case of the former, admission usually occurs at the hearing or meeting of creditors, subject to resolution of disputes arising from challenges to claims. For reasons of transparency and certainty, and to ensure the efficient conduct of the proceedings without undue delay, it is desirable that the decision on admission or non-admission be made in a timely manner, particularly where admission will determine participation in the proceedings and voting rights. However, as is generally the case with any consideration of the need for a time limit, the advantages of establishing a limit must be weighed against the potential disadvantages of inflexibility and the need to ensure the time limit is properly observed.

(ii) *Admission procedure*

593. Insolvency laws adopt a variety of approaches to the admission procedure, involving differing degrees of complexity and levels of involvement by the court, the insolvency representative and creditors, in some cases requiring input from all of these at various times. When coupled with rights of appeal and the difficulties associated with processing those types of claims requiring valuation, the complexity of the process has the potential to significantly interrupt the conduct of the proceedings and cause delay that will affect other steps in the proceedings. For these reasons, it is highly desirable that formalities are minimised and that decision-making is as streamlined as possible.

- *Admission by the insolvency representative*

594. As noted above, insolvency laws generally require claims to be submitted to the insolvency representative or to the court. Many insolvency laws provide that where the claim is to be submitted to the insolvency representative, it is for the insolvency representative to verify the claims and decide whether or not they should be admitted, whether in whole or in part. The creditor will be notified of the insolvency representative's decision and where the claim is denied, or admitted only in part, the insolvency representative is generally required to provide reasons for that decision (often required to be given in writing). A requirement to provide written reasons will enhance the transparency of the procedure, as well as, potentially, its predictability for creditors. Some insolvency laws also require, as already noted, the insolvency representative's decisions on admission of claims to be regularly updated on the list of claims that is filed with the court or made public in some other way in order to facilitate consideration by other creditors and the debtor. Where, following appropriate notification, the insolvency representative does not receive any objections to claims that it proposes to admit, a number of insolvency laws provide that the claim is then deemed to be admitted.

595. Under other insolvency laws the insolvency representative is required to convene a meeting of creditors to consider submitted claims on the basis of the list

it has prepared and provided to creditors. That list may be required to include recommendations as to admission, value and priority of individual claims. Where no objections to admission of claims are made at that meeting, the insolvency laws adopting this approach typically provide that the insolvency representative's recommendations are deemed under the insolvency law to be approved or the claims are deemed to be admitted.

*- Admission by the court*

596. Where claims are to be submitted to the court, the court generally will convene the meeting or hearing at which claims are examined and a decision made as to admission. A number of laws require claims to be submitted within a certain number of days before the date fixed for the meeting and the preparation of a provisional list of admissions, either by the court or by the insolvency representative to be provided to all creditors before the hearing or meeting. Where no objections to admission of the listed claims are made at that meeting, the claims are typically deemed under the insolvency law to be admitted.

*- Requirements for personal appearance of creditors*

597. One issue that may be of concern to creditors, and particularly to foreign creditors, is the requirement in some insolvency laws for them to personally attend creditor meetings called for the purpose of considering claims in order for their claims to be admitted. Such a requirement has the potential to frustrate the goal of equal treatment of similarly situated creditors and cause delay. It is therefore desirable that an insolvency law not require that in all cases creditors must appear in person for their claim to be admitted, but rather that they can be admitted on the basis of documentary evidence.

*(iii) Automatic admission of claims*

598. With a view to minimising the formalities required for verification and admission of claims, an alternative approach to those outlined above may be to provide that claims outstanding at the time of commencement do not require verification and can be admitted on an automatic basis unless the claim is challenged. This approach will require some mechanism for determining the existence, value and priority of claims. While it may not be sufficient in all cases for reasons of reliability and completeness, it may be appropriate to rely, in the first instance, upon the books and records of the debtor and the list of creditors to be prepared in the proceedings to identify all outstanding claims. Where those claims are not disputed, the claim might be admitted without the creditor having to formally submit and prove its claim. Automatic admission of claims in this manner may avoid many of the difficulties associated with the need for a precise assessment of the situation at the outset of the proceedings to enable creditors to participate in and vote at meetings held at an early stage of the proceedings.

*(iv) Provisional admission of claims*

599. Creditor claims may be of two types: liquidated claims and unliquidated claims where the amount owed by the debtor has not been determined at the time the claim is to be submitted or cannot presently be determined (for example, because it is the subject of a court action that has not been finalised at the time of

commencement and may be subject to the stay). Such claims may be either contractual or non-contractual in nature and may arise in respect of both secured and unsecured claims. Claims may also be conditional, contingent and not mature at the time of commencement (the latter would generally be subject to a deduction for the unexpired period of time before maturity).

600. Where the amount of the claim cannot be or has not been determined at the time the claim is to be submitted, many insolvency laws provide for a claim to be admitted provisionally, subject to giving it a notional value. Determining a value for such claims raises a number of issues such as the time at which the value is to be determined and whether it must be liquidated (in which case it will need to be considered by a court), or estimated (which might be undertaken by the insolvency representative, the court or some other appointed person). Where a court is required to determine the issue, an associated question relates to the court that will be appropriate (the insolvency court or some other court) and how any delay in reaching a determination can be addressed in terms of its effect on the conduct of the insolvency proceedings. The question of valuation of unliquidated claims can have a significant impact on insolvency proceedings where, for example, mass tort claims are involved. As to timing of the valuation, many insolvency laws require it to refer to the commencement of proceedings, although special rules may be required where proceedings are converted from one form of proceeding to another.

601. An important reason for permitting provisional admission is to allow creditors holding those claims to participate in the proceedings, and in particular to vote on key issues, such as on approval of the reorganization plan or on other key issues requiring a decision by creditors.

602. Where an insolvency law provides for provisional admission of claims, it may be necessary to consider whether such claims will be subject, in the first instance, to the same procedure as other claims. For example, where admission involves a hearing before the court or a meeting of creditors to be called, claims that might be provisionally admitted could be subject to that procedure, or they could first be admitted by the insolvency representative, without prejudice to the right of a dissenting party to dispute that claim, and be subject to some procedure for approval at a later stage. Other issues requiring consideration include whether, when creditors with provisionally admitted claims do vote on a reorganization plan, they can as minority creditors, be bound by a plan to which they have not agreed (see chapter IV); whether creditors with provisionally admitted claims are entitled to participate in distributions occurring before the claim has been fully admitted; and, if a provisionally admitted claim is subsequently denied or admitted only in part, the effect of non-admission on decisions in which that creditor has participated. Provisional admission of a claim will generally entitle the creditor to participate in the proceedings to the same extent as other creditors, except that they may not be entitled to participate in distributions until the value of the claim is finally fixed and the claim admitted. Where, however, the claim is not ultimately fully admitted, any previous votes by the creditor in the proceedings may be discounted.

**(c) Disputed claims**

603. Where an insolvency law allows a claim submitted in the insolvency proceedings to be disputed, whether as to its value, priority, or basis, it is desirable that it also specifies the parties that are entitled to initiate such a challenge. Some laws allow claims

to be disputed only by the insolvency representative, while other laws permit other interested parties, including other creditors and the debtor, to dispute a claim. Depending upon the procedures for submission and admission of claims, the dispute may be raised with the insolvency representative, or before or at the court hearing or creditors meeting held to examine claims. Where such a meeting or hearing is held, the preparation of a provisional list of admissions, either by the court or by the insolvency representative and the provision of that list to all creditors before the hearing or meeting will facilitate the consideration of claims. Where claims are disputed in the insolvency proceedings, whether by a creditor, the insolvency representative or the debtor, a mechanism for quick resolution of the dispute is essential to ensure efficient and orderly progress of the proceedings. If disputed claims cannot be quickly and efficiently resolved, the ability to dispute a claim may be used to frustrate the proceedings and create unnecessary delay. Most insolvency laws provide for disputes to be resolved by the court to ensure finality of the decision.

604 Where claims submitted in the proceedings are the subject of a dispute outside of the insolvency proceedings, they may generally fall into one or other of the categories of claims that may be provisionally admitted in the insolvency proceedings, depending upon the nature of the claim, and pending resolution of that dispute (subject to application of the stay—see chapter II.B.3(a) and 8).

**(d) Effect of admission of a claim**

605. Admission of a creditor's claim will establish the right of that creditor to attend meetings of creditors, and the amount for which the creditor is entitled to vote at such meetings, whether on the election of an insolvency representative or approval of a reorganization plan or some other matter specified in the insolvency law. It will also fix the amount and priority of the claim that the insolvency representative must take into account in making a distribution to creditors.

**(e) Set-off of mutual claims**

606. As noted above in chapter II.G, a number of insolvency laws make provision for mutual money obligations between the debtor and creditors to be set-off in insolvency proceedings, provided certain conditions are met. These may include, for example, requirements that the claims existed and were due and payable at the time of commencement of the proceedings; that the creditor acquired the claim without fraud or was not aware of the financial situation of its debtor; that the creditor did not acquire the claim during the suspect period; that the creditor has declared its intention to seek a set-off to the insolvency representative; and that the claims were related. A very few insolvency laws provide for mandatory set-off in insolvency, while a number of other laws do not permit set-off on the basis that it violates the *pari passu* principle. Where set-off is permitted, it will usually be taken into account by the insolvency representative or the court when verifying and admitting claims.

**(f) Claims requiring special treatment**

*(i) Administrative claims*

607. Insolvency proceedings often require the assistance of professionals, such as the insolvency representative and advisors to the debtor or insolvency representative. Expenses may be incurred by creditor committees, for the purposes of operating the

business of the debtor, including many or all post-commencement debts, such as claims of employees, lease costs and similar claims, and in otherwise carrying out the proceedings.

608. Notwithstanding the importance of providing appropriate remuneration to those involved in the conduct of the insolvency proceedings, administrative expenses have the potential for a significant impact on the value of the insolvency estate. While to some extent that impact will depend upon the design of an insolvency law and its supporting infrastructure, consideration of how that impact can be minimised may be desirable. An insolvency law can provide, for example, precise but flexible criteria relating to the allowance of those expenses. These criteria may include allowing expenses on the basis of the utility of the expense to increasing the value of the estate for the general benefit of all constituents, or on the basis that they are not only reasonable and necessary, but also consistent with the key objectives of the process. Reasonableness of the expense may be assessed by reference to the amount of resources available to the proceedings and to the possible effect of the expense on the proceedings.

609. Different approaches may be taken to conducting that assessment. One approach may be to require authorization by the court prior to the cost being incurred, or authorization by the court of all costs falling outside the scope of the ordinary course of business. Another approach may be to require creditors to make the assessment, to facilitate the transparency of the proceedings, subject to recourse to the court in the event that the assessment of the creditors is disputed.

(ii) *Claims by related persons*

610. A category of creditors that may require special consideration is those persons related to the debtor, whether in a familial or business capacity (discussed above, see chapter II.F.3(e)). Special treatment of the claims of these persons is often justified on the basis that they are more likely than other creditors to have been favoured and to have had early knowledge of the financial difficulties of the debtor. While they do not properly fall within classes of excluded claims, it may be appropriate to consider whether they should be admitted and treated in the same way as other creditors or be admitted subject to special treatment. The mere fact of a special relationship with the debtor, however, may not be sufficient in all cases to justify special treatment of a creditor's claim. In some cases these claims will be entirely transparent and should be treated in the same manner as similar claims made by creditors who are not related persons; in other cases they may give rise to suspicion and will deserve special attention. An insolvency law may need to include a mechanism to identify those types of conduct or situations in which claims will deserve additional attention, such as where the debtor is severely undercapitalized (e.g. where the principal of the debtor has advanced funds to the company in the form of a loan when the company is undercapitalized and continues to trade without sufficient funds to pay creditors) or where there is evidence of self-dealing (i.e. that the related persons have taken advantage of their position to obtain a benefit e.g. where 6 months before liquidation the principal agrees to a compensation package which the company cannot pay, and files a claim for it in the liquidation). In those cases, the claim may be restricted in the amount that can be admitted or subordinated to the claims of other classes of creditors (see chapter V.B), or the voting rights of the related creditor can be restricted with respect to certain issues

(such as in selection of the insolvency representative, where the insolvency law allows creditors that choice).

(iii) *Claims for interest*

611. Different approaches are taken to the accrual and payment of interest on claims. Some insolvency laws provide that interest on claims ceases to accrue on all unsecured debts once liquidation proceedings have commenced, but that payment in reorganization will depend upon what is agreed in the plan. Other insolvency laws provide that interest may accrue, but payment will be given a low priority, such as after the payment of all unsecured creditors.

**4. Claims not admitted**

612. Many insolvency laws provide that where a claim is denied, the creditor concerned will have a right to seek review of the decision not to admit, whether that decision was made by the court or the insolvency representative, within a specified period of time. Examples include periods from 10 to 45 days (see chapter II.D).

**Recommendations**

**Purpose of legislative provisions**

The purpose of provisions on creditor claims is to:

- (a) define the claims that can or are required to be submitted and the treatment to be accorded to those claims;
- (b) enable persons who have a claim against a debtor to submit claims against the estate;
- (c) establish a mechanism for verification and admission of claims;
- (d) provide for review of disputed claims;
- (e) ensure that similarly ranked creditors are treated equally.

**Contents of legislative provisions**

*Requirement to submit*

(154) The law should require creditors to submit their claims,<sup>100</sup> including the basis and amount of the claim. The law should also minimize the formalities associated with submission of claims.

*Claims that may be submitted*

(155) The law should specify that claims that may be submitted include all rights to payment which arise from acts or omissions of the debtor<sup>101</sup> prior to

<sup>100</sup> The insolvency law should address claims that may require special treatment, for example claims of foreign creditors, conditional or non-conditional monetary claims, claims for interest, and claims in respect of unmature liabilities.

<sup>101</sup> This would include claims by third parties or a guarantor for payment arising from acts or omission of the debtor.

commencement of the insolvency proceedings, whether mature or not, whether liquidated or unliquidated, whether fixed or contingent.<sup>102</sup> The law should identify claims that will not be affected by the insolvency proceedings.<sup>103</sup>

*Secured claims*

(156) The law should specify whether secured creditors are required to submit claims.<sup>104</sup>

*Equal treatment of similarly ranked creditors*

(157) The law should specify that all similarly ranked creditors, regardless of whether they are domestic or foreign creditors, are to be treated equally with respect to the submission and processing of their claims.

*Timing of submission of claims*

(158) The law should specify the time period after commencement in which claims may be submitted, which time period should be adequate to allow creditors to submit their claims.

*Consequences of failure to submit a claim*

(159) The law should specify the consequences of failure to submit a claim within the time limit.

*Foreign currency claims*

(160) Where claims are denoted in foreign currency, the law should specify the circumstances in which those claims must be converted and the reasons for conversion. Where conversion is required, the law should specify that the claim will be converted into local currency by reference to a specified date, such as the date of commencement of insolvency proceedings, [subject to special measures that may apply in situations of high currency instability].

*Evidence of claims*

(161) The law may permit claims that are undisputed to be admitted by reference to the list of creditors and claims prepared by the debtor in cooperation with the insolvency representative<sup>105</sup> or the court or the insolvency representative may require a creditor to give to provide evidence of its claim. , The law should not require that in all cases a creditor must appear in person to prove its claim.

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<sup>102</sup> See chapter II.E for recommendations in respect of claims arising from rejection of contracts.

<sup>103</sup> Some insolvency laws provide, for example, that claims such as [government] fines and penalties and taxes will not be affected by the insolvency proceedings. Where a claim was to be unaffected by the insolvency proceedings it would continue to exist and would not be included in any discharge.

<sup>104</sup> See UNCITRAL Model Law on Cross-Border Insolvency, art. 14 (3) and para. 111 of the Guide to Enactment, which notes that under some laws a secured creditor who files a claim is deemed to have waived the security or some of the privileges attached to the credit, while under other laws failure to submit a claim has that result.

<sup>105</sup> See recommendations on duties and functions of the debtor and insolvency representative.

*Admission or denial of claims*

(162) The law should permit the insolvency representative to admit or deny any claim, in full or in part.<sup>106</sup> Where the claim is to be denied, whether in full or in part, notice of the reasons for the decision to deny should be given to the creditor.

(163) The law should permit creditors whose claims have been denied, whether in full or in part, to request [within a specified period of time after notification of the decision to deny the claim], the court to review their claim.

*Disputing a claim*

(164) The law should permit an interested party to dispute any submitted claim, either before or after admission, and request review of that claim by the court.

*Provisional admission*

(165) The law should specify that, claims disputed in the insolvency proceedings can be admitted provisionally by the insolvency representative pending resolution of the dispute by the court.

[(166) The law should permit unliquidated claims to be admitted provisionally, pending determination of the amount of the claim by the insolvency representative.]

[(167) The law should provide that the insolvency representative may determine the portion of a secured creditor's claim that is secured and the portion unsecured by valuing the encumbered asset.]

*Effects of admission*

(168) The law should specify the effects of admission, including provisional admission, of a claim. These effects may include:

- (a) Entitling the creditor to participate in the proceedings and to be heard;
- (b) Permitting the creditor to vote at a meeting of creditors, including on approval of a plan;
- (c) Determining the priority to which the creditor's claim is entitled;
- (d) Determining the amount for which the creditor is entitled to vote;
- (e) Except in the case of provisional admission of a claim, permitting the creditor to participate in a distribution.<sup>107</sup>

<sup>106</sup> In some jurisdictions, the court may be required to ratify the decision of the insolvency representative.

<sup>107</sup> However, when making a distribution, the insolvency representative may be required to take account of claims which have been provisionally admitted, or submitted but not yet admitted: see chapter V.B



*Claims by related parties*

(169) The law should specify that claims by related parties should be subject to scrutiny and, where justified:<sup>108</sup>

- (a) The voting rights of the related party may be restricted;
- (b) The amount of the claim of the related party may be restricted; or
- (c) The claim may be subordinated.<sup>109</sup>

**B. Priorities and distribution [of proceeds of liquidation]**

**1. Priorities**

**(a) Introduction**

613. There are many diverse and competing interests in an insolvency proceeding. For the most part, creditors are creditors by virtue of having entered into a legal and contractual relationship with the debtor prior to the insolvency. There are creditors, however, who have not entered into such an arrangement with the debtor, such as taxing authorities (who will often be involved in insolvency proceedings) and tort claimants (whose participation will generally be less common). Accordingly, the rights of creditors will be governed by a number of different laws.

614. While many creditors may be similarly situated with respect to the kinds of claims they hold based on similar legal or contractual rights, others may have superior claims or hold superior rights. For these reasons, insolvency laws generally rank creditors for the purposes of distribution of the proceeds of the estate in liquidation by reference to their claims, an approach not inconsistent with the objective of equitable treatment. To the extent that different creditors have struck different commercial bargains with the debtor, the ranking of creditors may be justified by the desirability of the insolvency system recognizing and respecting the different bargains, preserving legitimate commercial expectations, fostering predictability in commercial relationships and promoting the equal treatment of similarly situated creditors. Establishing a clear and predictable ranking system for distribution can help to ensure that creditors are certain of their rights at the time of entering into commercial arrangements with the debtor and, in the case of secured credit, facilitate its provision.

615. There is, however, a limit on the extent to which these goals can be achieved, given the balance that is desirable in an insolvency law between these competing objectives and other public policy considerations. To the extent that these broader public interests compete with private interests, they may lead to a distortion of normal commercial incentives. In addition to relying upon rankings based upon commercial and legal relationships between the debtor and its creditors, distribution policies also very often reflect choices that recognize important public interests (such as the protection of employment), the desirability of ensuring the orderly and effective conduct of the insolvency proceedings (providing priority for the remuneration of insolvency professionals and the expenses of the insolvency

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<sup>108</sup> Sufficient justification may involve situations where the debtor is undercapitalized or there has been self-dealing, as noted above, see 3 (f) (ii).

<sup>109</sup> On subordination, see chapter V.B

administration), and promoting the continuation of the business and its reorganization (by providing a priority for post-commencement finance). Where public interests are given priority, and equality of treatment based upon the ranking of claims is not observed, it is desirable that the policy reasons for establishing that priority be clearly stated in the insolvency law. In the absence of equality of treatment, this approach will at least provide an element of transparency and predictability in the area of claims (see chapter V.A), distribution (see chapter V.C) and the establishment of creditor classes under a reorganization plan (chapter IV.A).

616. Insolvency laws adopt a wide variety of different approaches to the ranking of creditors, both in terms of priorities between different ranks and in terms of the treatment of creditors within a particular rank, for example those creditors broadly defined as unsecured, where different sub-ranks may be employed.

**(b) Subordination of claims**

617. When an individual or organization owes debts to more than one creditor, the priority scheme established in the applicable law or by agreement between the parties will determine the order in which those debts should be paid. Even where a priority scheme is in place, however, a creditor with a higher priority may be paid after one with a lower priority because of subordination.

618. Subordination refers to a rearranging of the creditors' priorities and does not relate to the validity or legality of a claim. A subordinated claim may be valid and enforceable but because of an agreement or a court decision, it will be paid later in the distribution scheme than it would otherwise be paid. These two types of subordination are discussed below.

*(i) Contractual subordination*

619. Contractual subordination occurs when two or more creditors of a single debtor enter into an agreement (referred to as "subordination" or "distribution agreements") which provides that one creditor agrees to receive payment on its claim against the debtor after the payment of another creditor. These agreements may be between secured creditors or between unsecured creditors. If between secured creditors, the agreement usually provides that one creditor receives priority over the holder of an otherwise senior security interest. Agreements between unsecured creditors typically provide that one creditor will receive payment in full on its claim before the subordinated creditor receives any distribution.

620. Subordination agreements can arise in different contexts. For example, debenture holders typically agree to subordinate their claims to the debtor's working capital lender. Also, when a business is in financial distress, certain creditors may agree to subordinate their claims in order to aid the business's reorganization efforts. Some creditors may agree to subordinate themselves to a lender injecting new money into the business in the hope that the new money will help the business recover and, thus, improve the prospects of the subordinated creditors being paid in full.

621. The laws that determine contract validity and enforceability also apply to subordination agreements, as do the normal contract defences such as lack of consideration, fraud, and unconscionability.

(ii) *Subordination by the court (referred to as equitable subordination)*

622. This type of subordination occurs where a court has the power to change the priority of payment of claims to prevent, for example, a claimant who has committed fraud or some other illegal activity or acted inappropriately to gain an advantage over other creditors, from benefiting from that act. The doctrine originally arose to prevent related persons from using legal mechanisms to obtain advantages in priority.

623. For this type of subordination to apply, the conduct under consideration must actually result in some harm to other creditors such as altering the normal distribution scheme and giving a creditor an unfair priority position. The court could then use subordination to restore the priority scheme so that a fair distribution occurs. If the conduct occurs but does not result in an unfair advantage, subordination generally cannot be used.

(c) **Ranking of claims**

(i) *Secured creditors*

624. Many insolvency laws recognize the rights of secured creditors to have a first priority for satisfaction of their claims, either from the proceeds of sale of the specific assets secured or from general funds. The method of distribution to secured creditors depends on the method used to protect the secured creditor during the proceedings. If the security interest was protected by preserving the value of the encumbered asset, the secured creditor generally will have a priority claim on the proceeds of the sale of that asset to the extent of the value of its secured claim. Alternatively, if the security interest was protected by fixing the value of the secured portion of the claim at the time of the commencement of the proceedings, the creditor generally will have a priority claim to the general proceeds of the estate with respect to that value. Where the secured creditor's claim is in excess of the value of the encumbered asset, or the value of the secured claim as determined at commencement (where that approach is followed), the unsecured portion of the claim will generally be treated as an ordinary unsecured claim for purposes of distribution.

625. Some insolvency laws do not afford secured creditors a first priority. Payment of secured creditors may be ranked after costs of administration and other claims which are afforded the protection of priority, such as unpaid wage claims, tax claims, environmental claims and personal injury claims. Another approach is reflected in those laws which provide that the amount that can be recovered (in priority) by secured creditors from the assets securing their claim is limited to a certain percentage of that claim. In some of the laws which adopt that approach, a distinction is made between security interests over essentially all of the assets of a business (sometimes referred to as an enterprise mortgage or floating charge) and other types of security interest. The carved-out portion of the claim is generally used to serve the claims of other creditors, whether lower ranking priority creditors or ordinary unsecured creditors, or to pay the remuneration and expenses of the insolvency representative and costs in connection with the preservation and administration of the estate where the value of assets of the estate is insufficient to meet these costs. One of the rationales of this approach is that the secured creditor should share, in some equitable manner, some of the losses of other creditors in

liquidation and, in reorganization, some of the costs. Unless some portion of the debtor's assets are reserved for payment of those other claims, it is unlikely that they will share in a distribution. The adoption of these types of exceptions to the rule of first priority of secured creditors has the potential to create uncertainty with respect to the recovery of secured credit, thus discouraging the provision of secured credit and raising the associated costs. It is highly desirable that the use of such exceptions in an insolvency law is limited.

626. Where the secured claim is satisfied directly from the net realization proceeds of the asset concerned, the secured creditor, unlike unsecured creditors, generally will not contribute (either directly or indirectly) to the general costs of the insolvency proceeding, unless there are provisions such as noted above. However, the secured creditor still may be required in those cases to contribute to other costs directly related to its interests, such as the administrative expenses related to the maintenance of the encumbered asset. If the insolvency representative has expended resources in maintaining the value of the secured asset, it may be reasonable to recover those expenses as administrative expenses from the amount that would otherwise be paid in priority to the secured creditor from the proceeds of the sale of the asset. A further exception to the first priority rule may also relate to priorities provided in respect of post-commencement finance, where the effect on the interests of secured creditors of any priority granted should be clear at the time the finance is obtained, particularly since it may have been approved by the secured creditors (see chapter VI.B).

(ii) *Administrative costs and expenses*

627. The administrative expenses of the insolvency proceeding often have priority over unsecured claims, and generally are accorded that priority to ensure proper payment for the parties acting on behalf of the insolvency estate. These expenses would generally include remuneration of the insolvency representative and any professionals employed by the insolvency representative or in some cases the debtor; debts arising from the proper exercise of the insolvency representative's (or in some cases the debtor's) functions and powers (see chapter IV.A and B); costs arising from continuing contract obligations (e.g. labour and lease agreements); costs of the proceedings (e.g. court fees) and, under some insolvency laws, the remuneration of any professionals employed by a committee of creditors.

(iii) *Priority or privileged claims*

628. Insolvency laws often attribute priority rights to certain (mainly unsecured) claims which in consequence will be paid in priority to other, unsecured and non-privileged (or less privileged) claims. These priority rights, which are often based upon social, and sometimes political, considerations, militate against the principle of *pari passu* distribution and generally operate to the detriment of ordinary unsecured creditors by reducing the value of the assets available for distribution to them. The provision of priority rights has the potential to foster unproductive debate on the assessment of which creditors should be afforded priority and the justifications for doing so. The provision of these rights in an insolvency law also has an impact on the cost and availability of credit, which will increase as the amount of funds available for distribution to other creditors decreases.

629. Some priorities are based on social concerns that may more readily be addressed by other law, such as social welfare legislation, than by designing an insolvency law to achieve social objectives which are only indirectly related to questions of debt and insolvency. Providing a priority in the insolvency law may at best afford an incomplete and inadequate remedy for the social problem, while at the same time rendering the insolvency process less effective. Where priorities are to be included in an insolvency law or where priorities that exist in other laws will be recognized and have effect in insolvency proceedings, it is desirable that these priorities be clearly stated or referred to in the insolvency law (and if necessary ranked with other claims). This will ensure that the insolvency regime is at least transparent and predictable as to its impact on creditors and will enable lenders to more accurately assess the risks associated with lending.

630. In some recent insolvency laws there has been a significant reduction in the number of these types of priority rights, reflecting a change in the public acceptability of such treatment. A few countries, for example, have recently removed the priority traditionally provided to tax claims. In other countries, however, there is a tendency to increase the categories of debt that enjoy priority. Maintaining a number of different priority positions for many types of claims has the potential to complicate the basic goals of insolvency and to make efficient and effective proceedings difficult to achieve. It may create inequities and, in reorganization, complicates preparation of the plan. In addition, it should be remembered that adjusting the order of distribution to create these priorities does not increase the total amount of funds available for creditors. Rather, it will only result in a benefit to one group of creditors at the expense of another group. The larger the number of categories of priority creditors, the greater the scope for other groups to claim that they also deserve priority treatment. The greater the number of creditors receiving priority treatment, the less beneficial that treatment becomes.

631. Some of the factors that may be relevant in determining whether compelling reasons exist to grant privileged status to any particular type of debt may include the need to give effect to international obligations; the need to strike a balance between private rights and public interests and the alternative means available to address those public interests; the desirability of creating incentives for creditors to manage credit efficiently and to fix the price of credit as low as possible; the impact of creating certain preferences on transaction and compliance costs; and the desirability of drawing fine distinctions between creditors that result in one class of creditor having to bear a greater burden of unpaid debt.

632. Many different approaches are taken to the types of claims that will be afforded priority and what that priority will be. The types of priorities afforded by countries vary, but two categories are particularly prevalent. The first is a priority for employee salaries and benefits (social security and pension claims), and a second is for tax claims. Consideration of the priority of tax claims may be of particular concern in transnational cases. One approach might be to disallow priority for all foreign tax claims. An alternative might be to recognize some type of priority for such tax claims, perhaps limited in scope, either where there is reciprocity with respect to the recognition of such claims or where insolvency proceedings in respect of a single debtor are being jointly administered in more than one state. Article 13 of the UNCITRAL Model Law on Cross-Border Insolvency recognizes the importance of the non-discrimination principle with respect to the ranking of

foreign claims, but also provides that countries which do not recognize foreign tax and social security claims can continue to discriminate against them.<sup>110</sup>

- *Employee claims*

633. In a majority of countries, workers' claims (including claims for wages, leave or holiday pay, allowances for other paid absence, and severance pay) constitute a class of priority claims, which in a number of cases ranks above tax and social security claims. This approach is generally consistent with the special protection that is afforded to employees in other areas of insolvency law (see chapter III.D.6), as well as with the approach of some international conventions.<sup>111</sup> In some insolvency laws, the importance of maintaining continuity of employment in priority to other objectives of the insolvency process, such as maximization of value of the estate for the benefit of all creditors, is evidenced by a focus on sale of the business as a going concern (with the transfer of existing employment obligations), as opposed to liquidation or reorganization where these obligations may be altered or terminated.

634. In some countries, employee claims are afforded priority but will rank equally with taxes and social security claims in a single class of priority claims and may be satisfied proportionately in the event of insufficient funds. In other countries, no priority is provided for employee claims and they are ranked as ordinary unsecured claims, although in some cases payment of certain obligations accrued over specified periods of time (for example, for wages and remuneration arising within three months before commencement of insolvency proceedings) may be guaranteed by the State through a wage guarantee fund. The fund guaranteeing the payment of such claims may itself have a claim against the estate and may or may not have the same priority vis-à-vis the insolvency estate as the employee claims, depending upon policy considerations such as the use of public monies (as opposed to the assets of the insolvent debtor) for funding the provision of wage compensation. Usual practice would be for the fund to enjoy the same rights as the employee, at least in respect of a certain specified amount which may be denoted in terms of an amount of wages or a number of weeks of pay.

- *Tax claims*

635. Priority is often accorded to government tax claims on the basis of protecting public revenue. According a priority to such claims has been justified on a number of other grounds. These grounds include that it can be beneficial to the reorganization process because tax authorities will be encouraged to delay the collection of taxes from a troubled business on the basis that eventually they will be afforded a priority for payment under insolvency, and that because the government is a non-commercial and unwilling creditor, it may be precluded from some commercial debt recovery options. Providing a priority to such claims, however, can be counterproductive because failure to collect taxes can compromise the uniform enforcement of tax laws and may constitute a form of state subsidy which

<sup>110</sup> UNCITRAL Model Law on Cross-Border Insolvency, article 13(2) and footnote 2.

<sup>111</sup> For example, the ILO Protection of Workers' Claims (Employer's Insolvency) Convention, 1992 (No. 173). Article 8(1) provides that "national laws or regulations shall give workers' claims a higher rank of privilege than most other privileged claims, and in particular those of the State and social security system". The Convention entered into force in 1995.

undermines the discipline that an effective insolvency regime is designed to support. It may encourage tax authorities to be complacent about monitoring debtors and collecting debts in a commercial manner that would assist to prevent insolvency and the depletion of assets.

(iv) *Ordinary unsecured creditors*

636. Once all secured and priority creditors have had their claims satisfied the balance of the insolvency estate generally would be distributed pro rata to ordinary unsecured creditors. There may be subdivisions within the class, with some claims being treated as subordinate or with a priority as noted above. Some claims that generally are subordinated are discussed below.

(v) *Owners and equity holders*

637. Owners and equity holders may have claims arising from loans extended to the debtor and claims arising from their equity or ownership interest in the debtor. Many insolvency laws distinguish between these different claims. With respect to claims arising from equity interests, many insolvency laws adopt the general rule that the owners and equity holders of the business are not entitled to a distribution of the proceeds of assets until all other claims which are senior in priority have been fully repaid (including claims of interest accruing after commencement). As such, these parties will rarely receive any distribution in respect of their equity interest in the debtor. Where a distribution is made, it would generally be made in accordance with the ranking of shares specified in the company law and the corporate charter. Debt claims, such as those relating to loans, however, are not always subordinated.

(vi) *Related persons*

638. A category of creditors that may require special consideration is those persons related to the debtor, whether in a familial or business capacity (discussed above, see chapter II.E.3(e) and chapter V.A). Under some insolvency laws, these claims are always subordinated, and under other laws they are subordinated only on the basis of inequitable conduct or fraudulent or quasi-fraudulent conduct. Where they are subordinated, the claims may rank after ordinary unsecured claims. Other approaches for treatment of these claims do not relate to ranking, but to restrictions on voting rights or to the amount of the claim that will be admitted in the proceedings.

(vii) *Fines, penalties and post-commencement interest*

639. Some countries treat claims such as gratuities, fines and penalties (whether administrative, criminal or some other type) as ordinary unsecured claims, and subordinate them to other unsecured claims. In some insolvency laws these types of claims are treated as excluded claims.

640. Different approaches are taken to the accrual and payment of interest on claims. Some insolvency laws provide that interest on claims ceases to accrue on all unsecured debts once liquidation proceedings have commenced, but that payment in reorganization will depend upon what is agreed in the plan. In other cases where provision is made for interest to accrue after commencement of proceedings, payment may be subordinated and it will be paid only after all other unsecured claims have been paid.

**2. Distribution****(a) Liquidation**

641. Where there are a number of different categories of claims with different priorities, each level of priority generally will be paid in full before the next level is paid. Once a level of priority is reached where there are insufficient funds to pay all the creditors in full, the creditors of that priority share pro rata. In some laws that do not establish different levels of priority, all the creditors share pro rata if there are insufficient funds to pay them in full.

**(b) Reorganization**

642. A plan of reorganization may propose distribution priorities that are different to those provided by the insolvency law in a liquidation, provided that creditors voting on the plan approve such a modification. It may be desirable to provide in reorganization proceedings that priority claims must be paid in full as a predicate to confirmation of a plan unless the affected priority creditors agree otherwise (see chapter IV).

**Recommendations****Purpose of legislative provisions**

The purpose of provisions on priority and distribution is to:

- (a) establish the order in which claims should be satisfied from the estate ;
- (b) ensure that similarly ranked creditors are satisfied proportionately out of the assets of the estate;
- (c) specify limited circumstances in which priority in distribution is permitted.

**Contents of legislative provisions***Classes and treatment of creditors affected by commencement of insolvency proceedings*

(170) The law should specify the classes of creditors that will be affected by the commencement of insolvency proceedings and the treatment of those classes in terms of priority and distribution.

*Establishing an order for satisfaction of claims*

(171) The law should establish the order in which claims are to be satisfied from the estate.

*Priority claims*

(172) The law should minimize the priorities accorded to unsecured claims. The law should set out clearly the claims that will be entitled to be satisfied in priority in insolvency proceedings.



*Secured claims*

(173) The law should specify that secured claims should be satisfied from the security in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the law. To the extent that the value of the security is insufficient to satisfy the secured creditor's claim, the secured creditor may participate as an ordinary unsecured creditor.

*Ranking of claims*

(174) The law should specify that claims other than secured claims, are ranked in the following order:

- (a) Administrative costs and expenses;
- (b) Claims with priority;
- (c) Ordinary unsecured claims;
- (d) Deferred or subordinated claims.<sup>112</sup>

(175) The law should specify that in the event that there is a surplus after all claims have been satisfied in full, the surplus is returned to the debtor.

*Distribution in liquidation*

(176) The law should provide, as a general principle, that similarly ranked claims are paid *pari passu*. All similarly ranked claims in a particular class should be paid in full before the next rank is paid.

(177) The law should specify that in making a distribution the insolvency representative is required to make provision for submitted claims that are not yet finally admitted.

(178) The law should specify that, in liquidation proceedings, distributions be made promptly and that interim distributions may be made.

## **C. Treatment of corporate groups in insolvency**

### **1. Introduction**

643. It is common practice for commercial ventures to operate through groups of companies and for each company in the group to have a separate legal personality. Where a company in a group structure becomes insolvent, treatment of that company as a separate legal personality raises a number of issues which are generally complex and may often be difficult to address. In certain situations, such as where the business activity of a company has been directed or controlled by a related company, the treatment of the group companies as separate legal personalities may operate unfairly. That treatment, for example, may prevent access to the funds of one company for the payment of the debts or liabilities of a related

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<sup>112</sup>The law may provide for further ranking of claims within each of the ranks set forth in paras. (a), (b) and (d). Where all creditors within a rank cannot be paid in full, the order of payment should reflect any further ranking specified in the law for claims of the same rank.

debtor company (except where the debtor company is a shareholder or creditor of the related company), notwithstanding the close relationship between the companies and the fact that the related company may have taken part in the management of the debtor or acted like a director of the debtor and caused it to incur debts and liabilities. Furthermore, where the debtor company belongs to a group of companies, it may be difficult to untangle the specific circumstances of any particular case to determine which group company particular creditors dealt with or to establish the financial dealings between group companies.

644. Two issues of specific concern in insolvency proceedings involving one of a group of companies are:

(a) Whether any other company in the group will be responsible for the external debts of the insolvent company (being all debts owed by the insolvent company except for those owed to related group companies, i.e. “intra -group debts”); and

(b) Treatment of intra-group debts (claims against the debtor company by related group companies).

645. Insolvency laws provide different responses to these issues. Some laws adopt a prescriptive approach which strictly limits the circumstances in which group companies can be treated as other than separate legal personalities, in other words, the circumstances in which a related company can be responsible for the debts of an insolvent group member. Other laws adopt a more expansive approach and give courts broad discretion to evaluate the circumstances of a particular case on the basis of specific guidelines. The range of possible results in the latter case is broader than under those laws adopting a prescriptive approach. In either case, however, it is common for insolvency laws to address these issues of intra -group liability based upon the relationship between the insolvent and related group companies in terms of both shareholding and management control. One possible advantage of addressing these issues in an insolvency law is to provide an incentive for corporate groups to continuously monitor the activities of companies within the group, and take early action in the case of financial distress of a member of that group. Treating companies as other than separate legal entities however, may undermine the capacity of business, investors and creditors to quarantine, and make choices about, risk (which may be particularly important where the group includes a company with special requirements for risk management, such as a financial institution); it may introduce significant uncertainty that affects the cost of credit, particularly when the decision about responsibility for group debts is made by a court after the event of insolvency; and it may involve accounting complexities concerning the manner in which liabilities are treated within the group.

## **2. Group responsibility for external debts**

646. Insolvency regimes look to a number of different circumstances or factors in the assessment of whether a related or group company should bear responsibility for the external debts of an insolvent member of the group.

647. It is common to many jurisdictions for the related company to bear responsibility for the debt where it has given a guarantee in respect of its subsidiaries. Similarly, many regimes infer responsibility to compensate for any loss or damage in cases of fraud in intra-group transactions. Further solutions may be

prescribed by other areas of law. In some circumstances, for example, the law may treat the insolvent company as an agent of the related company, which would permit third parties to enforce their rights directly against the related company as a principal.

648. Where the insolvency law grants the courts a wide discretion to determine the liability of one or more group companies for the debts of other group companies, subject to certain guidelines, those guidelines may include the following considerations: the extent to which management, the business and the finances of the companies are intermingled; the conduct of the related company towards the creditors of the insolvent company; the expectation of those creditors that they were dealing with one economic entity rather than two or more group companies; and, the extent to which the insolvency is attributable to the actions of the related group company. Based on these considerations, a court may decide on the degree to which a corporate group has operated as a single enterprise and, in some jurisdictions, may order that the assets and liabilities of the companies be consolidated or pooled,<sup>113</sup> particularly where that order would assist in a reorganization of the corporate group, or that a related company contribute financially to the insolvent estate, provided that contribution would not affect the solvency of the contributing company. Contribution payments would generally be made to the insolvency representative administering the insolvent estate for the benefit of the estate as a whole.

649. One further and important consideration in insolvency laws that allow such measures is the effect of those measures on creditors. These regimes, in seeking to ensure fairness to creditors as a whole, must reconcile the interests of two (or more) sets of creditors who have dealt with two (or more) separate corporate entities. These collective interests will conflict if the total assets of the combined companies are insufficient to meet all claims. In such a case, creditors of a group company with a significant asset base would have their assets diminished by the claims of creditors of another group company with a low asset base. One approach to this issue is to consider whether the savings to creditors collectively would outweigh the incidental detriment to individual creditors. In the situation where both companies are insolvent, some laws take into account whether the withholding of a consolidation decision, ensuring separate insolvency proceedings, would increase the cost and length of proceedings and deplete funds which would otherwise be available for creditors, as well as allowing the shareholders of some corporate group companies to receive a return at the expense of creditors in other group companies.<sup>114</sup>

650. The common principle of all regimes with laws of this type is that, for a consolidation order to be granted, the court must be satisfied that creditors would suffer a greater prejudice in the absence of consolidation than the insolvent companies and objecting creditors would from its imposition. In the interests of fairness, some jurisdictions allow for partial consolidation by exempting the claims of specific creditors and satisfying these claims from particular assets (excluded from the consolidation order) of one of the insolvent companies. The difficulties

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<sup>113</sup> A decision that a corporate group has operated as one economic entity will give rise to application of other provisions of the insolvency law, for example, the duty of directors to prevent insolvent trading. Some laws also allow, in limited circumstances, companies to voluntarily pool assets and liabilities.

<sup>114</sup> Some laws require creditors, as well as assets and liabilities, of each relevant group company to be separately identified before any distribution can be made.

imposed by this reconciliation exercise have resulted in such orders being infrequently made in those countries where they are available.

651. It should be noted that insolvency laws providing for consolidation do not affect the rights of secured creditors, other than possibly the holders of intra-group securities (where the secured creditor is a group company).

### 3. Intra-group debts

652. Intra-group debts may be dealt with in a number of ways. As discussed above (see chapter II.E), intra-group transactions may be subject to avoidance actions. Under some insolvency laws that provide for consolidation, intra-group obligations are terminated by the consolidation order. Other approaches involve classifying intra-group transactions differently from similar transactions conducted between unrelated parties (e.g. a debt may be treated as an equity contribution rather than as an intra-group loan) with the consequence that the intra-group obligation will rank lower in priority than the same obligation between unrelated parties.

## D. Applicable law governing in insolvency proceedings

(Note: The section on applicable is currently being developed and a final draft will be available for consideration by the Working Group at its 30th session in 2004. The revised recommendations set forth below reflect the discussion at the 29th session of the Working Group in September 2003.)

### Recommendations

#### Purpose of legislative provisions

The purpose of provisions on the applicable law governing insolvency proceedings is to:

- (a) facilitate commerce by providing a clear and transparent basis for predicting the law that will apply in the context of insolvency proceedings;
- (b) provide courts with clear and predictable rules for determining the law applicable in the context of insolvency proceedings [including enforcement of contractual choice of law provisions].

#### Contents of legislative provisions

##### *Law of the insolvency proceedings*

(179) The insolvency law should provide of the place where insolvency proceedings are commenced should apply to all aspects of the conduct, administration and conclusion of those insolvency proceedings, including:

- (a) eligibility and commencement criteria;
- (b) creation and scope of the insolvency estate;
- (c) treatment of property of the estate, including the scope of, exceptions to, and relief from application of a stay;

- (d) costs and expenses;
- (e) proposal, approval, confirmation and implementation of a plan of reorganization;
- (f) the voidness, voidability or unenforceability of legal acts detrimental to creditors;
- (g) effect of the commencement of the proceedings upon contracts under which both the debtor and its counterparty have not yet fully performed their respective obligations, including the enforceability of automatic termination and anti-assignment provisions in those contracts;
- (h) conditions under which setoff can occur after commencement of insolvency proceedings;
- (i) rights and obligations of the debtor, insolvency representative, creditors and creditors' committee;
- (j) claims and their treatment;
- (k) priorities for ranking of claims;
- (l) distribution of proceeds of liquidation; and
- (m) resolution and conclusion of the proceedings.

*Exception to application of law of the insolvency proceedings*

(180) As an exception to recommendation (1)(f) and (h), the insolvency law may provide that the law of another State applies to set-off or to the avoidability of a transaction that occurred before the application for commencement or the commencement of insolvency proceedings.<sup>115</sup>

*Validity of contractual choice of law provisions*

(181) The insolvency law should recognize contractual provisions in which the debtor and its counterparty expressly agree that the law applicable to their legal relationship under the contract will be the law of a specified jurisdiction without regard to the nexus between the transaction or the parties at issue and the chosen applicable law, except where such a provision is viewed as manifestly contrary to public policy [of the jurisdiction whose law would apply in the absence of such a provision].

*Determining the applicable law*

(182) The insolvency law should clearly indicate when the insolvency law would allow the application of the laws of another jurisdiction.

(183) As to the application of law other than insolvency law, the insolvency court will need to apply a conflict of laws rule to determine which State's law should apply. The conflict of laws rules should be clear and predictable and should follow

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<sup>115</sup> The use of the word "transaction" in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, a security, a guarantee, a loan or a release [or an action making a security interest effective against third parties] and may include a composite series of transactions.

modern conflict of laws rules embodied in international treaties and legislative guides sponsored by international bodies.

## VI. Conclusion of proceedings

### A. Discharge

#### 1. Discharge of the debtor in liquidation<sup>116</sup>

653. Following distribution in the liquidation of the estate of a natural person debtor, it is likely that a number of creditors will not have been paid in full. An insolvency law will need to consider whether these creditors will still have an outstanding claim against that individual debtor or, alternatively, whether the debtor will be released or “discharged” from those residual claims.

654. When the debtor is a limited liability company, the question of discharge following liquidation does not arise; either the law provides for the disappearance of the legal entity or, alternatively, that it will continue to exist as a shell with no assets. The shareholders will not be liable for the residual claims and the issue of their discharge does not arise. If the debtor’s business takes a different form, such as a sole proprietorship, a group of individuals (a partnership), or an entity whose owners have unlimited liability, the question arises as to whether these individuals will still be personally liable for unsatisfied claims following liquidation.

655. There is an increasing awareness in some circles of the need to recognize business failure as a natural feature of the economy and to accept that both weak and good businesses can fail, albeit for different reasons, without necessarily involving irresponsible, reckless or dishonest behaviour on the part of the management of the business. A person who has failed in one business may have learned from that experience and some studies suggest that they are often very successful in later business ventures. For these reasons, a number of countries have taken the view that their insolvency regime needs to focus not only on addressing the administration of failure, but also upon facilitating a fresh start for insolvent debtors by clearing their financial situation and taking other steps to reduce the stigma associated with business failure, rather than upon punishment of the debtor. In addition to adapting the insolvency law to remove unnecessary conditions and restrictions on discharge, there is a need to encourage banks and the wider community to take a different view of business failure, and to provide assistance and support to those involved. At the same time, the insolvency regime needs to protect the public and the commercial community from those debtors whose conduct of their financial affairs has been irresponsible, reckless or dishonest.

656. Insolvency laws adopt different approaches to the question of discharge. In some, the debtor remains liable for unsatisfied claims, subject to any applicable limitation periods (which in some cases might be quite long, for example, 10 years) and may also be subject to a number of conditions and restrictions relating to professional, commercial and personal activities. This type of rule emphasizes the value of a debtor-creditor relationship: the continued responsibility of the debtor following liquidation is intended to both moderate a debtor’s financial behaviour

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<sup>116</sup> These paragraphs relate to discharge of a debtor who is a natural person.

and encourage a creditor to provide financing. At the same time, it may work to inhibit opportunity, innovation and entrepreneurial activity because the sanctions for failure are severe.

657. Other insolvency laws provide for a complete discharge of an honest, non-fraudulent debtor immediately following liquidation. This approach emphasizes the benefit of the "fresh start" that discharge brings and is often designed to encourage the development of an entrepreneurial class. It is also a recognition that over-indebtedness is a current economic reality and should be addressed in an insolvency law. A third approach attempts to strike a compromise: discharge is granted after a period following distribution, during which the debtor is expected to make a good faith effort to satisfy its outstanding obligations.

658. Some insolvency laws adopt the approach that in some circumstances, it may be appropriate to limit the availability of discharge. These circumstances vary from law to law but may include where the debtor has acted fraudulently; engaged in criminal activity; violated employment or environmental laws; failed to keep appropriate records; failed to participate in the insolvency proceedings in good faith or to cooperate with the insolvency representative; failed to provide or actively withheld or concealed information; continued trading at a time when it knew it was insolvent; incurred debts with no reasonable expectation of being able to pay them; and concealed or destroyed assets or records after the application for commencement.

659. Different approaches are taken to the conditions that will apply to discharge in these types of circumstances. In some countries, the period before a discharge is given may be quite long or conditions and restrictions will apply to the discharge, or a combination of both. Certain types of debts may be excluded from the discharge, such as tort claims; claims arising from maintenance agreements (payments to a divorced spouse or to support children of the debtor); fraud; debts based on penalties where the alternative is a gaol sentence and taxes.

660. Conditions may also be imposed upon the debtor, both during the proceedings or as a condition for a discharge, either by way of recommendation by the insolvency representative or by the court. These conditions may include restrictions on the ability of the debtor to obtain new credit, to leave the country, to carry on business for a certain period of time or a ban, where relevant, on practising its profession for a period of time. They may also include a discharge that is provided on the condition that the debtor does not subsequently acquire a substantial new fortune from which previous debts could be paid. The length of the application of these provisions varies, depending upon the situation of the debtor. Other limitations adopted by insolvency laws relate to the number of times a debtor can be discharged. In some jurisdictions, a discharge is a once in a lifetime opportunity; in others there is a minimum waiting period, for example, 10 years, before a debtor will qualify for a new discharge, or even be able to enter insolvency proceedings which may lead to a new discharge. A further approach restricts discharge where, for example, the debtor has been given a discharge within a certain period of time before commencement of the current proceedings and where the payments made in those proceedings were less than a fixed percentage.

661. The choice between these different alternatives involves weighing the underlying rationale of the insolvency proceedings and the provision of a discharge

against the need to sanction certain behaviour. A distinction might be drawn between behaviour that is inappropriate and perhaps negligent, and behaviour that would amount to criminal misconduct. If the underlying purpose of the insolvency law is to resolve the financial difficulties of the debtor and provide for a fresh start to encourage entrepreneurial activity and risk taking, an honest and cooperative debtor that has performed its obligations under the insolvency law can be discharged after liquidation with minimal restrictions. An approach that imposes severe restrictions upon such debtors and provides for discharge only after long periods of time and the fulfilment of many conditions suggests an underlying purpose of punishing, rather than rehabilitating the debtor. Imposing conditions and restrictions might be more appropriate in cases where the debtor has not been honest, has not cooperated with the insolvency representative or performed its obligations under the insolvency law or in more extreme cases, has been guilty of criminal misconduct.

662. An additional consideration is the connection between the conditions imposed and the basic rationale of discharge. The imposition of certain broad conditions, such as prohibiting the debtor from engaging in business activities, may be inconsistent with the basic notion of providing a discharge. Depending upon the circumstances, more limited conditions such as limiting the debtor's ability to serve on a board of directors might be more appropriate. Where an insolvency law adopts the approach of imposing conditions and exempting certain debts from discharge, it is desirable that those conditions and exemptions be kept to a minimum. To the extent possible, types of debt to be exempted should be set forth in the insolvency law to ensure transparency and predictability.

663. Some insolvency laws also provide that where a discharge is given at an early stage of the proceedings it can be suspended where, for example, the debtor fails to comply with an obligation, or revoked, where for example, the discharge was obtained by fraud, the debtor fraudulently withheld information concerning property that should be part of the estate, or failed to comply with orders of the court.

664. One issue that may need to be taken into account in considering discharge of individuals engaged in a business undertaking is the intersection of business indebtedness with consumer indebtedness. Recognizing that different approaches are taken to the insolvency of natural persons (in some countries a natural person cannot be declared bankrupt at all, in others there is a requirement for the person to have acted in the capacity of a "merchant") and that many countries do not have a developed consumer insolvency system, a number of countries do have insolvency laws that seek to distinguish between those who are simply consumer debtors and those whose liabilities arise from small businesses. Since consumer credit often is used to finance small business either as start-up capital or for operating funds, it may not always be possible to separate the debts into clear categories. For that reason, where a legal system recognizes both consumer and business debt, it may not be feasible to have rules on the business debts of natural persons that differ from the rules applicable to consumer debts.

## **2. Discharge of debts and claims in reorganization**

665. To ensure that the reorganized debtor has the best chance of succeeding, an insolvency law can provide for a discharge or alteration of debts and claims that have been discharged or otherwise altered under the plan. This approach supports



the goal of commercial certainty by giving binding effect to the forgiveness, cancellation or alteration of debts in accordance with the approved plan. The principle is particularly important to ensure that the plan provisions will be complied with by creditors that rejected the plan and by creditors that did not participate in the process. It also gives certainty to other lenders and investors that they will not be involved in unanticipated liquidation or have to compete with hidden or undisclosed claims. Thus the discharge establishes unequivocally that the plan fully addresses the legal rights of creditors.

666. Discharge in reorganization might be effective from the time the plan becomes effective under the insolvency law or from the time it is fully implemented. In the event that the plan is not fully implemented or implementation fails, an insolvency law many insolvency laws provide that the discharge can be set aside.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on discharge is to:

- (a) enable an a natural person debtor to be finally discharged from liabilities for pre-commencement debts, thus providing the debtor with a fresh start;
- (b) establish the circumstances under which discharge will be granted and the terms of that discharge.

### **Contents of legislative provisions**

#### *Discharge in liquidation*

(184) Where natural persons are eligible as debtors under the insolvency law, the issue of discharge of the debtor from liability for pre-commencement debts should be addressed. The insolvency law may specify that the discharge may not apply until after the expiration of a specified period of time following commencement, during which period the debtor is expected to cooperate with the insolvency representative. Upon the expiration of such time period, the debtor may be discharged where the debtor has not acted fraudulently and has cooperated with the insolvency representative in performing its obligations under the insolvency law. The law may specify that the discharge be revoked where it was obtained fraudulently.

(185) Where the insolvency law provides that certain debts are excluded from the discharge such debts should be kept to a minimum to facilitate the debtor's fresh start and should be set forth in the insolvency law. Where the insolvency law provides that the discharge may be subject to conditions, those conditions should be kept to a minimum to facilitate the debtor's fresh start.

## **B. Conclusion of proceedings**

667. Insolvency laws adopt different approaches to the manner in which a proceeding is to be concluded or closed, the pre-requisites for closure and the procedures to be followed.

## 1. Liquidation

668. A number of insolvency laws adopt an approach that generally requires, following realisation of assets and distribution, that the insolvency representative call a meeting of creditors and present a final accounting. Provided that creditors agree to the accounting, all that is then required under some laws (where the debtor is a corporate entity) is that the final accounts and a report of the final meeting be filed with the administrative body responsible for registration of corporate entities and the debtor entity will be dissolved, while other laws require a formal application to the court for an order for dissolution. Some variations on this general approach include slightly different procedures for proceedings commenced on debtor and creditor applications.

## 2. Reorganization

669. In general, insolvency laws adopt one of two or three approaches to the conclusion of reorganization proceedings. Reorganization proceedings may be treated as concluded when the reorganization plan is approved (and confirmed where this is required)(see chapter IV.A.6); where the liabilities have been discharged in accordance with the plan and the plan has otherwise been fully implemented (with or without the need for a formal court order, although some laws make provision for the insolvency representative to be discharged from its duties by a formal order of the court); and where the court orders the proceedings to be dismissed because they constituted an improper use of the insolvency law or the debtor did not meet the commencement criteria at the time of commencement. Proceedings may also be concluded in accordance with the terms of the plan or some other contractual agreement with creditors. Where the reorganization plan is not fully implemented, the insolvency law may provide for the court to convert the proceedings to liquidation, in order to avoid the debtor being left in an insolvent state with its financial situation unresolved. Whether this may constitute a formal conclusion of the reorganization proceedings and commencement of liquidation proceedings depends upon the approach of the jurisdiction in question. Where the reorganization proceedings conclude once the plan has been approved (and confirmed, where this is required) rights and obligations included in the plan will be enforced under non-insolvency law.

## Recommendations

### Purpose of legislative provisions

The purpose of provisions on conclusion of proceedings is to determine a procedure for concluding the proceedings once the goal of those proceedings has been achieved.

### Contents of legislative provisions

#### *Liquidation*

(186) The law should specify that liquidation proceedings should be closed following final distribution or a determination that no distribution can be made.

*Reorganization*

(187) The law should specify that reorganization proceedings should be closed when the reorganization plan is fully implemented or at an earlier date determined by the court.