Orderly & Effective Insolvency Procedures

Key Issues

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Foreword

Over the years, the IMF has become increasingly involved in the promotion of orderly and effective insolvency systems among its members. Experience has demonstrated that reform in this area can play a major role in strengthening a country's economic and financial system. For example, an effective insolvency system provides an important pillar of support for the domestic banking system by enabling banks to curtail the deterioration of the quality of their claims, including claims on the corporate sector, whether through a court-approved restructuring or, where necessary, through an efficient liquidation. Insolvency reform can be particularly relevant for economies in transition, where it can play a critical role in addressing the problems of insolvent state-owned enterprises. In the context of financial crises, an orderly and effective insolvency system can provide an important means of ensuring adequate private sector contribution to the resolution of such crises. Finally, although insolvency procedures are implemented through the courts, the very existence of an orderly and effective insolvency system establishes incentives for negotiations between debtors and their creditors, which may lead to out-of-court agreements being reached "in the shadow" of the law.

Drawing on the lessons of experience, this report discusses the major policy choices to be addressed by countries when designing an insolvency system. The issues discussed are relevant to all countries, irrespective of the different stages of their development. As noted in the Introduction, while the report expresses certain preferences with respect to some of the more important of these choices, it does not attempt to establish standards in this complex area. Moreover, it may need to be updated in the future to take into account developments in this area.

The report has benefited considerably from input from both the official and private sectors, and the IMF's Legal Department would like to express its thanks to those that have provided support during its preparation.

With respect to input from the *official sector*:

The report builds upon--and is consistent with--the Key Principles and Features of Effective Insolvency Regimes set forth in the report of the G-22 Working Group on International Financial Crises.

Appended to the report is a contribution from the Secretariat of UNCITRAL (the UN Commission on International Trade Law) regarding cross-border insolvency problems and the model law prepared by UNCITRAL to address these problems.

The report has benefited from comments by a number of international organizations, including the World Bank, the Organization for Economic Cooperation and Development, the European Bank for Reconstruction and Development, the Asian Development Bank, and the International Finance Corporation.

Regarding assistance from the *private sector*:

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?? Dr. Manfred Balz (Germany), one of the principal drafters of Germany's new insolvency law and former Chairman of the Group on Bankruptcy of the European Union Council; presently General Counsel, Deutsche Telekom AG;

?? Richard A. Gitlin (United States), Attorney-at-Law, Hebb & Gitlin, specializing in transnational insolvency law;

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?? Prof. Jean-Pierre Sortais (France), Professor of Law, University of Lausanne;

?? Prof. Jay Westbrook (United States), Professor of Law, University of Texas, Co-Head, U.S. Delegation, UNCITRAL Working Group on Cross-Border Insolvency; and

?? Philip Wood (United Kingdom), Solicitor, Allen & Overy, specializing in financial and insolvency law.

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Within the IMF's Legal Department, Sean Hagan drafted the report and coordinated the work of the research team, made up of Boyko Dimitrachkov, Seng

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The views expressed in the report are those of the IMF's Legal Department and should not be attributed to the Executive Directors or the Management of the IMF.

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1 Introduction

Recent experience has demonstrated the extent to which the absence of orderly and effective insolvency procedures can exacerbate economic and financial crises. Without effective procedures that are applied in a predictable manner, creditors may be unable to collect on their claims, which will adversely affect the future availability of credit. Without orderly procedures, the rights of debtors (and their employees) may not be adequately protected and different creditors may not be treated equitably. In contrast, the consistent application of orderly and effective insolvency procedures plays a critical role in fostering growth and competitiveness and may also assist in the prevention and resolution of financial crises: such procedures induce greater caution in the incurrence of liabilities by debtors and greater confidence in creditors when extending credit or rescheduling their claims.
This report identifies and discusses the key issues that arise in the design and application of orderly and effective insolvency procedures. Although it is based on a comparative study of selected insolvency laws, it is not intended to be a description of those laws. As will be seen, the approaches adopted by countries vary in a number of respects, with these differences being attributable not only to divergent legal traditions but also to different policy choices. Because of these differences, international standards do not exist in this area, and this report does not attempt to propose such standards. However, in its discussion of the key issues in this area, the report weighs the advantages and disadvantages of possible solutions, and, in that context, sets forth conclusions in which preferences are expressed.
Given the multiplicity of questions raised by insolvency proceedings and the diversity of responses in national laws, this report is necessarily selective. It focuses on the most important issues and the principal policy choices that need to be made when resolving these issues. An early caveat regarding labels is necessary: while these policy choices are often described as reflecting an underlying "pro-creditor" or "pro-debtor" attitude, these terms often have different meanings in different countries and, accordingly, they are not used extensively in this report. For instance, in some countries a pro-debtor insolvency law is understood as favoring the management of the debtor company, thereby allowing it to retain control of the company or to negotiate from a position of strength with its creditors. In other countries, insolvency law will be characterized as being pro-debtor primarily because it allows the enterprise to survive and the employees to

keep their jobs, while the managers are replaced by an administrator and, eventually, a new owner of the enterprise. Similarly, pro-creditor laws may differ regarding the way they address the respective rights of secured and unsecured creditors. While secured creditors are often the main beneficiaries of outright liquidation proceedings in which the realization of their collateral will ensure the full and prompt payment of their claims, unsecured creditors may benefit from a rehabilitation procedure that will maximize the value of the debtor's assets and, therefore, the value of the unsecured creditors' claims.

In any event, experience shows that the degree to which an insolvency law is perceived as pro-creditor or pro-debtor is, in the final analysis, less important than the extent to which these rules are effectively implemented by a strong institutional infrastructure. In particular, given the complex and urgent nature of insolvency proceedings, effective implementation requires judges and administrators that are efficient, ethical, and adequately trained in commercial and financial matters and the specific legal issues raised by insolvency proceedings. A pro-debtor law that is applied effectively and consistently will engender greater confidence in financial markets than an unpredictable pro-creditor law.

The scope of this report is limited in a number of important respects.

?? Since the IMF is principally concerned with those activities that have the greatest impact on a country's economy, the discussion will address the application of insolvency laws to enterprises rather than individuals. Indeed, while this report does not distinguish between large and small enterprises (and does not argue that an insolvency law should), it recognizes that a number of the issues discussed may only be of particular relevance to a relatively large enterprise that has a number of creditors with divergent interests.

?? This report does not discuss legal mechanisms that address the liquidity problems confronted by national or local governments. However, government ownership of an enterprise should not, in and of itself, exempt such enterprises from the disciplinary forces of insolvency laws.

?? The insolvency of financial institutions is not discussed in any detail. Because of the unique role that these institutions play in the national economic and financial system, many countries have designed specialized regimes for them. A separate study, in progress, will discuss whether such specialized regimes are merited and, if so, how they should be designed.

?? This report does not contain a comprehensive discussion of the important but complex relationship between corporate governance and insolvency. It does, however, briefly discuss the question of whether management should be personally liable for failing to commence proceedings when the financial conditions for commencement have otherwise been met.

?? Nor does this report discuss issues relating to the law on secured transactions, which is also closely related to insolvency, particularly in jurisdictions that enable a creditor to obtain a "floating charge" or general security interest over most of the debtor's assets. In a number of these jurisdictions, such secured creditors may enforce their security either by appointing a receiver under a private contract or through the courts of general jurisdiction. In these cases, the enterprise is liquidated without recourse to the general insolvency law.

?? Although this report stresses the importance of judicial implementation, it does not contain an extensive analysis of the general features of an independent and competent judiciary. However, it does discuss how the design of an insolvency law needs to take into consideration the capacity of the judiciary and also briefly reviews some of the issues that are specific to the implementation of such laws.

?? This report will not discuss in detail the features of out-of-court rehabilitation procedures, which can play a critical role in resolving financial crises. However, it will discuss them indirectly, since the way in which an insolvency law is designed and implemented plays a critical role in defining the leverage of creditors and debtors when they attempt to negotiate out-of-court settlements.

This report consists of six chapters. Chapter 2 contains a discussion of the general objectives and features of insolvency procedures and, in that context, identifies the principal features of the two main types of procedures, namely, liquidation procedures and rehabilitation procedures. These features are described in greater detail in Chapter 3 (liquidation procedures) and Chapter 4 (rehabilitation procedures). Chapter 5 briefly discusses institutional aspects of insolvency procedures and, in particular, addresses the important role of the court and the administrator. Chapter 6 briefly reviews the major issues raised by cross-border insolvencies, and the Appendix contains a study prepared by the UNCITRAL Secretariat regarding the UNCITRAL model law that is designed to address these problems.

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2 General Objectives and Features of Insolvency Procedures

General Objectives

Although the insolvency laws of countries differ in important respects, it is possible to identify two overall objectives that are generally shared by most systems. The first overall objective is *the allocation of risk among participants in a market economy in a predictable, equitable, and transparent manner*. The achievement of this objective plays a critical role in providing confidence in the credit system and fostering economic growth for the benefit of all participants. For example, in terms of the creditor-debtor relationship, the ability of a creditor to commence insolvency proceedings against a debtor as a means of enforcing its claim reduces the risk of lending and, thereby, increases the availability of credit and the making of investment more generally. An insolvency law also serves to allocate risk among different creditors, also for the benefit of borrowers. For example, if the insolvency law affords secured creditors special treatment vis-à-vis unsecured creditors, such treatment protects the value of security, which may be particularly important for those debtors that, because of their credit risk, cannot obtain (or cannot afford) unsecured credit.

?? *Predictability*. Individual countries make different policy choices as to how their insolvency laws will allocate risk among participants. Irrespective of these different choices, however, it is generally recognized that the relevant risk allocation rules should be clearly specified in the law and that they should be consistently applied by the individuals and institutions that are charged with implementing them. Experience has demonstrated that no matter what risk allocation choices countries make, participants are often able to take measures (including through price adjustment) to help manage the risk in question if the application of these rules is relatively predictable. In contrast, when the rules or their application are uncertain, such uncertainty erodes the confidence of all participants and undermines their willingness to make credit and other investment decisions.

?? *Equitable Treatment*. A common feature of all insolvency proceedings is their collective nature. Unlike other laws (e.g., foreclosure laws), an insolvency law is designed to address a situation in which a debtor is no longer able to pay its debts to its creditors generally (rather than individually) and, in that context, provides a mechanism that will provide for the equitable treatment of all creditors. As will be discussed, equitable treatment does not require equal treatment. On the contrary, to the extent that different creditors have struck fundamentally different commercial bargains with the debtor (e.g., through the granting of security), differential treatment of creditors that are not similarly situated may be necessary as a matter of equity. For the benefit of all creditors, however, an insolvency law must address the problem of fraud and favoritism that often arises in the context of financial distress. Moreover, given the importance of international credit and investment, the law must ensure that there is no discrimination against foreign creditors. Finally, the collective nature of a proceeding can give reassurance to creditors that problems will be resolved in an orderly and equitable manner. A liquidator or administrator can, for example, issue statements that can calm markets effectively.

?? *Transparency*. Closely related to the objectives of predictability and equity is that of transparency. During insolvency proceedings, interested participants must be given sufficient information for them to exercise their rights under the law. Thus, for example, creditors must receive adequate notice of meetings where creditor decisions are to be taken and must receive sufficient information from the debtor to ensure that their decisions are informed. When the institutions charged with implementing the law (the court and the court-appointed liquidator or administrator) make decisions, it

> is also important that the law provide adequate guidance as to the exercise of their discretion and, in the case of the court, require that judicial proceedings be open and that the rationale underlying the court's decision be made publicly available.

The second objective of an insolvency law is *to protect and maximize value for the benefit of all interested parties and the economy in general*. This objective is most obviously pursued during rehabilitation, where value is maximized by continuing a viable enterprise. But it is also a primary objective of procedures that liquidate enterprises that cannot be rehabilitated. The achievement of the value maximization objective is often furthered by the fulfillment of the objective of equitable risk allocation. For example, the nullification of fraudulent transactions that occurred before an insolvency proceeding ensures that creditors are treated equitably and also enhances the value of the debtor's assets. However, there can also be tension between these objectives. For example, the nullification of prior transactions also extends to nonfraudulent transactions, which can undermine the objective of predictability. Similarly, during the insolvency proceedings, many countries give the liquidator or the administrator (depending on the nature of the proceedings) the authority to interfere with the terms of a contract previously entered into between the debtor and a counterparty. While the exercise of this authority provides an important means of maximizing the value of the assets of the debtor, it also undermines the predictability of contractual relations, which is critical to making investment decisions.

Some of the key policy choices to be made when designing an insolvency law relate to how the above objectives are balanced against each other. In addition, choices need to be made on who will be the beneficiaries of the value that is maximized: while some countries view rehabilitation procedures as providing a way to enhance the value of creditors' claims through the going-concern value of the enterprise, other countries also view it as a means of providing a "second chance" to the shareholders and the management of the debtor. Still others view the continuation of the enterprise as primarily benefiting the employees. The protection of employees raises the larger issue of when reliance on the insolvency law should be avoided altogether so that certain public policy objectives can be achieved. For instance, to limit unemployment or rescue enterprises that are engaged in important national activities, the authorities may prefer to address the problems of a troubled company through various measures that will involve an extensive use of public funds and give the beneficiaries a substantial advantage over their less-favored competitors.[1]

When determining how to strike the balance between the various objectives described above, it is necessary to avoid easy stereotypes. Debtors are not always fraudulent or incompetent, and creditors are not always grasping and selfish. As borne out by recent experience, although companies may fail because of incompetence, they may also fail because of economic difficulties beyond their control.

Viewed from the perspective of the economic policymaker, and in light of the above objectives, an effective insolvency law can clearly play a critical role in a number of areas. Generally, the discipline it imposes on a debtor increases the competitiveness of the enterprise sector and facilitates the provision of credit. More specifically, to the extent that the enterprise is owned by the state, subjecting the enterprise to the application of the general insolvency law sends a clear signal regarding the limitations of public financial support. In that context, the rehabilitation provisions of an insolvency law can effectively ensure that creditors contribute to the resolution of the financial problems of state-owned enterprises, thereby limiting the public cost of rehabilitation.

With respect to the financial sector, an effective insolvency law enables financial institutions to curtail the deterioration of the value of their assets by providing them with a means of enforcing their claims. In that context, it can also facilitate the development of capital markets. For example, if an insolvency law is applied with sufficient predictability, a secondary market in debt instruments can develop that, among other things, will enable financial institutions to transfer their loans to other entities that specialize in the workout process.

Finally, in the context of a financial crisis in which the entire enterprise sector is in distress, an effective insolvency law can provide a useful means of ensuring that private creditors contribute to the resolution of the crisis. For example, a rehabilitation procedure provides a way to impose a court-approved restructuring agreement over the objections of dissenting creditors. Not only does such a mechanism reduce the public cost of the crisis and relieve external financing needs, but it also strengthens the stability of the international financial system by forcing creditors to bear the costs of the risks they incur.

General Features

When designing an insolvency law, countries will need to address a common set of issues. Moreover, countries normally resolve these issues through the implementation of *liquidation procedures* and *rehabilitation procedures*.

Common Issues

Insolvency procedures generally require two elements. The first is a legal framework that sets forth the rights and obligations of participants, both substantively and procedurally. The second is an institutional framework that will implement these rights and obligations. A key question that arises in this context is the degree of discretion that the law gives to this infrastructure when it applies the law.

Legal Framework

An insolvency law must make policy choices with respect to a number of *substantive* issues, the most important of which include the following:

- It is necessary to identify the debtors that may be subject to insolvency proceedings. Will the general insolvency law apply to all debtors or will certain debtors (e.g., state-owned enterprises) be subject to special insolvency regimes or even insulated from the application of all forms of insolvency procedures?

- The law must determine when an insolvency proceeding may be commenced (upon illiquidity? upon insolvency?), who may request commencement, and whether the nature of the commencement criterion should differ depending on who is requesting commencement (i.e., the debtor or the creditor). A related question is whether the law should give the petitioner the option of requesting the initiation of either a liquidation or a rehabilitation procedure. Finally, the law must address the issue of whether the management of the debtor has a specific duty to commence proceedings when the relevant commencement condition has been met.

?? To what extent should a debtor be displaced from the management and control of the enterprise once insolvency proceedings commence? In the case of rehabilitation procedures, some countries have opted for full debtor control (debtor-in-possession), while others have either given a court-appointed administrator full authority or have established some form of power-sharing arrangement between the debtor and the administrator.

?? Will the "stay" that applies to the enforcement of legal remedies by creditors once insolvency proceedings commence also apply to secured creditors and, if so, what type of protection will be afforded to these creditors during the insolvency proceedings?

?? To what extent will the liquidator (in the case of liquidation proceedings) or the administrator (in the case of rehabilitation) have the general authority to interfere with the terms of contracts entered into by the debtor before the proceedings? A related issue of particular importance to financial markets is the extent to which set-off or netting rights can be suspended by the commencement of the proceeding.

?? How broad will the administrator's powers be with respect to the nullification of transactions and transfers that are fraudulent or otherwise result in the interests of creditors being prejudiced?

?? In the case of rehabilitation procedures, what limitations, if any, are imposed on the contents of the plan? What conditions are required for its approval and effectiveness?

?? With respect to liquidation procedures, how should creditors be ranked for purposes of distributing the proceeds of a liquidation sale?

?? In reorganization procedures, are the interests of the current owners and management to be given weight?

Finally, in addition to these specific issues, a more general issue that must be addressed is whether an insolvency law will effectively modify other substantive laws. For example, will the insolvency law supersede labor laws that afford employees special protection? In the context of the approval of a plan that envisages debt-for-equity conversions or the sale of the enterprise as a going concern, will it supersede provisions of the company law that would otherwise require shareholder approval?

Notwithstanding the variety of substantive issues that must be resolved, insolvency laws are highly *procedural* in nature. The design of the procedural rules plays a critical role in determining how risk is to be allocated among the various participants in the proceedings. Perhaps the most critical procedural issue relates to the identification of the decision maker. For example, in the case of liquidation proceedings, in what circumstances can the creditors replace the liquidator? In the case of a rehabilitation procedure, should the determination of whether a successful rehabilitation is potentially feasible be made by the creditors, the administrator, the court, or a combination thereof? If a rehabilitation plan is approved by the creditors, can it subsequently be rejected by the court? Conversely, can the court impose a plan that has been rejected by a requisite majority of the creditors? As discussed below, to the extent that the law confers considerable responsibility upon the institutional infrastructure to make key decisions, it is critical that this infrastructure be sufficiently developed.

Institutional Framework

An insolvency law will need to provide for an institutional framework for its implementation. Since the adjudication of disputes is a judicial function, insolvency proceedings should be conducted under the authority of a court of law where judges will, at a minimum, be required to adjudicate disputes between the parties on factual issues and, on occasion, render interpretations of the law. The judiciary will only be able to fulfill this function if it is made up of independent judges with particularly high ethical and professional standards.

Moreover, the court will also need to appoint qualified professionals (liquidators and administrators) who are designated to handle key administrative matters (recording, collection and evaluation of the assets and liabilities, management of the enterprise, etc.). The availability of an experienced cadre of such professionals with adequate commercial experience is essential to a successful implementation of the law. Among other things, safeguards will need to be in place to ensure that any conflict of interest is avoided between the designated professional and those parties that have an interest in the proceedings.

To perform their tasks, the court and the designated officials will also have to rely on specialists (accountants, appraisers, and auctioneers). They will need to have access to the debtor's books and other relevant information. For a proper discharge of their functions, laws will have to require the keeping of books and the observance of accounting standards by debtors engaged in an independent business activity. Although it is not necessary for such provisions to be contained in the insolvency law itself, they are essential to its implementation.

Exercise of Discretion

How much discretion should the law give to judges and designated officials in the exercise of their duties? Mandatory rules, when precisely formulated, give legal certainty to the parties and avoid litigation; they facilitate the proceedings and reduce their cost. Moreover, specific rules and criteria provide for the predictability that is one of the overall objectives of an insolvency law. However, most laws give the court or the designated officials at least some degree of discretion when resolving disputes during the proceedings on the grounds that it is not feasible to foresee and regulate each and every possible situation.

But to what extent should the court and the designated officials have the authority to make decisions on economic and business matters, in some cases over the objections of creditors? If a court is given such authority, it is no longer responsible solely for ensuring the legality of the proceedings; it becomes an active participant, with substantive decision-making powers on the appropriateness of certain outcomes, such as the continuation of the enterprise.

The greater the discretion that the law confers upon the court and the designated officials, the greater need there is for an adequate institutional infrastructure. Countries that give their judges such a key role in the decision-making process often find it necessary to establish a specialized court system, such as a commercial court or a bankruptcy court. The members of the court may be professional judges, preferably with special training and experience, or may be elected by the business community. In cases where the judges do not have such experience, countries often prefer to rely on qualified liquidators or administrators--or the creditors themselves--to make these decisions.

Liquidation and Rehabilitation

When a debtor is unable to discharge its liabilities as they become due, there are usually a number of competing claims on its assets, whether they be unpaid loans, invoices, rents, taxes, or salaries. To satisfy those claims, a liquidation of all of the debtor's assets and a distribution of the proceeds may be necessary. In such cases, creditors may only receive a portion of the nominal value of their claims. Sometimes, however, a complete liquidation of the debtor's assets will not be the preferred course of action, either for the debtor or its creditors. Rather, a restructuring of the debtor's operations or balance sheet may allow the creditors to be fully repaid or, at least, to receive more than they would have received through liquidation.

Although the insolvency laws of countries differ in a number of respects, almost all countries address the problems described above by including both *liquidation procedures* and *rehabilitation procedures* in their insolvency laws.

Liquidation Procedures

The need for liquidation procedures can be viewed from different perspectives. From one perspective, these procedures can be seen as addressing *intercreditor* problems. Specifically, when an insolvent debtor's assets are insufficient to meet its liabilities, an individual creditor's best strategy is to rush to take the necessary legal measures to attach and seize assets before other creditors have a chance to take similar action. Applying the prisoner's dilemma paradigm, while such behavior will appear rational from the perspective of individual creditors, such a "grab race" will not, in fact, be in the collective self-interest of creditors; not only are the legal actions taken by creditors costly, but such a disorderly piecemeal dismantling of the entity will lead to a loss in value for all creditors.

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

Viewed from a broader perspective, and as discussed earlier, such liquidation procedures constitute an important disciplinary force that is an essential element of a *sustainable debtor-creditor relationship*. For example, by providing an orderly and relatively predictable mechanism by which the rights of creditors can be enforced, these procedures provide creditors with an important source of comfort when they make their lending decisions. In this way, they can be seen as promoting the interests of all participants in the economy, since they facilitate the provision of credit and the development of financial markets.

Rehabilitation Procedures

In contrast to liquidation procedures, rehabilitation procedures are designed to give an enterprise some breathing space to recover from its temporary liquidity difficulties or more permanent overindebtedness and, where necessary, provide it with an opportunity to restructure its operations and its relations with creditors. As noted above, where rehabilitation is possible, such an approach will be preferred by creditors if the value derived from the continued operation of the enterprise will enhance the value of their claims. While the benefits of rehabilitation are widely accepted, the degree to which formal rehabilitation procedures are relied upon to achieve these objectives varies considerably among countries. It is generally recognized that, in many respects, the very existence of liquidation proceedings will facilitate the restructuring of an enterprise, since it creates the necessary incentives for an out-of-court restructuring. Indeed, even in economies with sophisticated rehabilitation procedures, most rehabilitations take place "in the shadow" of insolvency proceedings. Moreover, a liquidation procedure, once activated, can also provide a basis for restructuring if it allows the enterprise to be sold as a going concern.

Notwithstanding the above considerations, there are a number of reasons why formal rehabilitation procedures can provide a mechanism for enterprise rehabilitation that serves the interests of all participants in the economy.

First, out-of-court rehabilitation requires unanimity of creditors. With the growth of capital markets and the resulting increase in the number and diversity of creditors, both the debtor and those creditors that wish to restructure may need to rely on the formal rehabilitation provisions that exist in a number of countries, which enable the debtor and the majority of its creditors to impose a plan upon a dissenting minority of creditors. Indeed, this feature of rehabilitation proceedings further facilitates out-of-court restructuring insofar as it reduces the leverage of a "hold-out" creditor during such out-of-court negotiations.

Second, in the modern economy, the degree to which an enterprise's value can be maximized through liquidation of its assets has been significantly reduced. In circumstances where the value of a company is increasingly based on technical know-how and goodwill rather than on its physical assets, preservation of the enterprise's human resources and business relations may be critical for creditors wishing to maximize the value of their claims.

Third, rehabilitation procedures may be viewed as economically beneficial in the long run, since they encourage debtors to restructure before their financial difficulties become too severe. Moreover, some countries view such procedures as serving a broader societal interest, by giving debtors a second chance and, thereby, encouraging the growth of the private sector and an entrepreneurial class.

Finally, and perhaps most important, as in the design of most other economic laws, economic efficiency is not the only consideration when designing insolvency laws. There are social and political factors that are served by the existence of formal rehabilitation provisions and, in particular, the protection of employees of a troubled enterprise. These considerations explain why the design of rehabilitation provisions varies from country to country. When countries evaluate and reform their insolvency laws, the key question will often be how to find the appropriate balance between a variety of social, political, and economic interests that will induce all actors in the economy to participate in the system.

While it is generally recognized that rehabilitation procedures are necessary, statistics show that, at least in a number of countries, up to 90 percent of insolvency proceedings end up in liquidation. Yet, statistics may be misleading. They often fail to capture the fact that larger companies (which have a greater impact on the economy) are more likely to be rehabilitated. Moreover, the failure of rehabilitation in these circumstances may often be due to the inadequate design or application of the rehabilitation procedure, and the conversion of rehabilitation into liquidation may reflect the fact that an enterprise with no chance of rehabilitation has used the rehabilitation procedure solely as a means of forestalling liquidation.

Pre-Insolvency Procedures

Some countries have adopted what can be described as "pre-insolvency" procedures that are, in effect, a hybrid of out-of-court rehabilitation and formal rehabilitation procedures. For example, in the United States, regulations have been issued that allow for the court to approve a reorganization plan under the rehabilitation chapter (Chapter 11) of the insolvency law even though the support required from creditors as a condition for court approval under this chapter was obtained through a vote that occurred before the actual commencement of the formal rehabilitation proceedings. Such "prepackaged bankruptcy" regulations are designed to minimize the cost and delay associated with formal rehabilitation procedures while providing a means by which a rehabilitation plan can be approved absent unanimous support of the creditors.

Under French law, to facilitate the conclusion of an amicable settlement with its creditors, a debtor may ask the court to appoint a "conciliator." The conciliator has no particular powers but may request the court to impose a stay of execution against all creditors if, in his or her judgment, a stay would facilitate the conclusion of a settlement agreement. During the stay, the debtor may not make any payments to discharge prior claims (except salaries) or dispose of any assets other than in the regular course of business. The procedure ends when agreement is reached either with all creditors or (subject to court approval) with the main creditors; in the latter case, the court may continue the stay against nonparticipating creditors by providing a grace period of up to two years to the debtor.

Still another method is the "London Approach." It is based on nonbinding guidelines issued by the Bank of England to commercial banks. Under this approach, banks are urged to take a supportive attitude toward their debtors that are in financial difficulties; decisions about the debtor's longer-term future should only be made on the basis of comprehensive information, which is shared among all the banks and other parties to a work-out. Interim financing is facilitated by a standstill and subordination agreement, and banks work together with other creditors to reach a collective view on whether and on what terms a company should be given a financial lifeline.

Drawing on the success of the London Approach, a number of countries that have recently experienced international financial crises have put in place nonbinding principles or guidelines that are designed to promote out-of-court restructuring of enterprises through negotiations with their domestic and foreign creditors (e.g., the Jakarta Initiative). Such guidelines establish a collective framework for negotiations and provide for the availability of interim financing to enterprises by creditors and the provision of information by these enterprises so that their restructuring proposals can be effectively evaluated by creditors. The government generally plays the important but limited role of facilitating negotiations. Although this approach is designed to minimize recourse to the insolvency law, the effective application of the law is critical to the success of these informal procedures since it provides the necessary incentives for meaningful negotiations.

Relationship Between Liquidation Procedures and Rehabilitation Procedures

Although liquidation and rehabilitation procedures are often viewed as relatively distinct from each other, there are, in fact, considerable overlap and linkages between them, both as a matter of procedure and in terms of the substantive issues they address.

Given the different objectives of these procedures, the determination of whether the enterprise is viable should, at least in theory, also determine which procedure should be used. As a matter of practice, however, when either of these procedures is initiated with respect to a debtor, it is often impossible to tell, at the time of commencement, whether the debtor should be liquidated or rehabilitated. In many countries, therefore, the party initiating the proceedings is given the choice between liquidation and rehabilitation procedures. However, when a creditor initiates a liquidation proceeding against a debtor, the law will often establish some mechanism that enables the proceedings to be converted into a rehabilitation proceeding. Conversely, in circumstances where a debtor seeks protection by commencing a rehabilitation proceeding, the law will often provide a means by which the proceedings can be converted into liquidation proceedings if it is determined that a successful rehabilitation is not likely (as discussed above, a key issue is the identity of the decision maker). As a general principle, therefore, although these are presented as "two-track" procedures, they are normally utilized sequentially; that is, a liquidation procedure will only run its course if rehabilitation efforts (whether formal or informal) have failed.

With respect to the substantive issues that these procedures must address, there is also considerable overlap. This is due (at least in part) to the fact that the distinction between a "liquidation" and a "rehabilitation" is somewhat blurred. How does one classify the sale of an enterprise as a going concern? From one perspective, it can be viewed as a rehabilitation, because the enterprise continues its activities and employment is preserved. From another perspective, it can be viewed as a liquidation of the debtor's assets because the company that owns the enterprise is liquidated and the enterprise (as an economic unit) is now under new ownership. If, as in most cases, the sale of an enterprise as a going concern is considered a possible outcome of a liquidation proceeding, the continuation of the enterprise becomes just as critical as under a rehabilitation procedure, so similar safeguards regarding the stay on creditor actions and the treatment of contracts may be required.

A number of countries reflect the above linkages in the design of their laws. For example, in some countries, liquidation procedures normally may be commenced only if all attempts to rehabilitate have failed. In effect, the law presumes that a company should be rehabilitated. The rehabilitation stage will only be skipped where there is clearly no hope for the enterprise (e.g., it is already out of business).

Following a different approach, some countries that have recently revised their bankruptcy laws have introduced "unitary" proceedings as an alternative to separate, self-contained proceedings. For example, under the revised law of Germany, all insolvencies are conducted initially under the same rules and, for an initial period of up to three months, there is no presumption as to whether the enterprise will be rehabilitated or liquidated. The proceedings only separate into liquidation proceedings and rehabilitation proceedings once a determination has been made as to whether rehabilitation is, in fact, possible. The procedural simplicity of such an approach may have advantages, particularly where the capacity of the institutional infrastructure is limited. However, this trend toward "unitary" proceedings is a recent one and is still not reflected in the structure of the insolvency laws of many countries. For this reason, the structure of this report follows the twin procedure model that still prevails, identifying the linkages and differences between these proceedings as they arise.

Contents

3 Liquidation Procedures

Objectives of an Orderly and Effective

Liquidation Procedure

Liquidation procedures are generally relied upon once there is no economically reasonable possibility of rehabilitation. Although such procedures can therefore be viewed as the second of the two components of the insolvency proceedings, they are dealt with first in this study because they are utilized most often, and are generally viewed as the "core" proceedings upon which rehabilitation procedures are constructed. While many companies successfully rehabilitate, they normally do so out of court and actually rely on the "shadow" of liquidation to facilitate rehabilitation.

Drawing on the overall objectives of an insolvency law described in the previous chapter, the most important objectives of an orderly and effective liquidation procedure may be described as follows.

(1) A primary objective is to *maximize the value of the assets of the estate*. Many of the features of the insolvency system are designed to achieve that objective. These features include the imposition of a stay on creditor enforcement of legal remedies that prevents a premature breakup; the appointment of an independent liquidator with broad powers; when the temporary continuation of the enterprise by the liquidator is considered necessary, the creation of incentives for creditors to provide financing through priority for post-petition financing; and the inclusion of "claw-back" provisions that recapture assets disposed of by the debtor to the detriment of the creditors.

(2) Another objective is to *equitably treat similarly situated creditors*. Insolvency creates a collective procedure that will only be effective if participants view it as equitable. This is achieved through the inclusion of a number of features, including claw-back provisions and the general stay on creditor enforcement of legal remedies.

(3) A final objective, albeit a much broader one, is to provide a mechanism that *facilitates the making of investment decisions*. If creditors can rely on a mechanism that enables them to enforce their rights against a debtor, this will assist them in making their investment decisions. The commencement criteria are critical for this reason. Moreover, if the distribution priorities following liquidation recognize the seniority established by contractual terms, creditors will feel confident that they are able to manage, at least to some degree, the risks that they incur when making investment decisions.

While the above objectives are normally mutually reinforcing, they can also, at times, be at odds with each other. Indeed, one of the challenges of designing an orderly and effective liquidation procedure is to strike an appropriate balance between competing objectives. For example, broad powers given to a liquidator to enable him to nullify transactions already entered into and to modify the terms of existing contracts may undermine the predictability in contractual relations that is critical to the making of investment.

Commencement Requirements

Qualification of the Debtor

The determination of which entities are eligible to be subjected as debtors to a country's general insolvency law is an important threshold issue and has important implications for a country's economy. For example, if the law excludes certain entities, these entities will be neither subject to the discipline imposed by an effective insolvency regime nor able to take advantage of the protection it affords. At the same time, important policy considerations may lead countries to establish special insolvency procedures for natural persons or for certain regulated entities. However, the exclusion of an enterprise from any form of insolvency regime should be avoided.

Natural/Legal Persons

An insolvency law should generally define which entities are subject to its provisions. It may decide to treat legal entities separately from natural persons, either through different statutes or through different chapters within the same statute. This separate treatment may arise for a number of reasons, including public policy concerns regarding consumer protection. Since this report is primarily concerned with the insolvency law's treatment of those actors that have the greatest impact on the country's economy, it does not express a preference as to whether natural persons should be subject to a special regime or the design of such a regime.

Government-Related Entities

It is universally recognized that sovereign nations are not subject to any insolvency law, international or national. Local government entities, such as municipalities, may be excluded from the scope of the insolvency law altogether or the law may establish a special regime for them.[2] While the treatment of government-owned entities may also vary, there appears to be no reason why such an enterprise operating in the market place as a distinct entity should be excluded from the coverage of the general insolvency law unless the government has extended an explicit guarantee with respect to all its liabilities. As discussed in Chapter 2, the inclusion of a government-owned enterprise within the scope of the insolvency law has the advantage of both subjecting the enterprise to the discipline of the market place and sending a clear signal that government financial support will not be unlimited.

Financial Institutions and Other Regulated Entities

An insolvency law may exclude banks and insurance companies from the purview of general insolvency law on the grounds that the unique role played by these institutions in the economy and, in particular, the payments system merits a special regime. Whether financial institutions should be subject to a special insolvency regime and, if so, what the design of that regime should be is of critical importance to the IMF given its work in this area. For this reason, and as noted in Chapter 1, this issue will be the subject of a separate study. Countries may also wish to establish special regimes for other highly regulated entities, such as utility companies or, alternatively, may give the relevant regulatory agency a special role under the general insolvency law.

Foreign Debtors

Whether or not a debtor is owned by foreigners should not be a criterion for determining jurisdiction over insolvency proceedings. However, international insolvencies raise a number of complex jurisdictional issues, for the resolution of which international cooperation is necessary. On this cooperation, see the Appendix, which describes UNCITRAL's model law on cross-border insolvency.

Principal Conclusions

> While the exclusion of an enterprise from any form of insolvency regime should be avoided, countries may wish to establish special regimes outside the scope of the general insolvency law for individuals or highly regulated entities, such as financial institutions. However, government ownership of an enterprise should not, in and of itself, provide a basis for excluding an enterprise from the coverage of the general insolvency law.

Conditions for Commencement

Although insolvency laws generally provide for liquidation proceedings to be initiated by either a creditor or the debtor, they differ on the specific criteria that must be satisfied before the proceedings can commence. Moreover, a number of laws set forth alternative criteria. Nevertheless, a criterion that is relied upon extensively--and which is consistent with the overall objectives of insolvency--is one that allows for commencement when the debtor has ceased to meet its liabilities generally as they become due. The way in which this criterion is used by countries varies. In some countries, it provides the basis for the initiation of either a liquidation or a rehabilitation procedure and, where liquidation is chosen, the procedure can later be converted into a rehabilitation. In other countries, only a rehabilitation procedure may be initiated on the basis of this criterion and the procedure may only be converted into a liquidation once it has been determined that the enterprise cannot be rehabilitated. Under a third approach, this criterion is relied upon to commence a unitary procedure, and the choice between liquidation and rehabilitation is only made later.[3]

Given that the objectives of liquidation and rehabilitation proceedings are different, reliance on the same criterion for both proceedings by a number of countries requires some explanation. For example, while one could envisage such a criterion--which effectively provides evidence of illiquidity--as being appropriate for the commencement of rehabilitation proceedings, it may seem more logical to condition the opening of liquidation proceedings upon a demonstration of even greater financial distress, such as insolvency. If an insolvency test were relied upon exclusively and applied in the strict sense, liquidation proceedings would, at least in most cases, normally only be opened at a later stage, that is, when the balance sheet of the enterprise showed that the value of the company's liabilities exceeded its assets.[4]

One of the principal reasons why countries often allow liquidation proceedings to be opened on the basis of a determination of a "general cessation of payments" can best be explained in terms of the objectives of these proceedings. To the extent that liquidation proceedings are designed to avoid a "grab race" by individual creditors that causes the dismemberment of the debtor to the detriment of the collective interests of creditors, waiting until the debtor is insolvent will often only interrupt the grab race that is well under way. Moreover, proving balance sheet insolvency is often difficult for creditors since they lack inside information.

Reliance on a "general cessation of payments test," on the other hand, is designed to activate the proceedings sufficiently early in the debtor's financial distress that this race will be preempted. The obvious problem of this "preemptive" approach--the fact that liquidation proceedings will commence with respect to a financially troubled, but still viable, enterprise--may be resolved by providing the debtor the opportunity to transform the liquidation proceedings into a rehabilitation proceeding. As noted above, an alternative way to resolve this problem is to only allow the creditor to initiate a rehabilitation or "unitary" procedure on the basis of the general cessation of payments test, with the possibility of a subsequent conversion to liquidation.

Although the "general cessation of payments" criterion is, in theory, often applied to both creditor- and debtor-initiated proceedings, the issues that arise in its application in these two different cases will vary. Each is discussed now in turn, as well as the initiation of liquidation proceedings by the government.

Creditor Petitions

When a creditor files a petition to commence a liquidation proceeding, how does it demonstrate that the debtor has generally ceased to make payments? As noted earlier, insolvency laws are designed to be utilized when a debtor is unable to make its payments *generally.* Recourse to other laws (e.g., the laws on foreclosure) is normally relied upon when only a small amount of the debtor's outstanding obligations are unpaid. However, while the creditor will be in a position to demonstrate the debtor's nonpayment on its own claim, it will generally not have evidence that the cessation of payments is, in fact, of a general nature. It is therefore important that the law avoid placing an unreasonably heavy evidentiary burden on the creditors. Laws differ in the way they address this problem. In some cases, they may require the petition to be filed by a number of creditors. In other cases, upon the filing of a petition by a single creditor, the debtor is required by the court to furnish information that will enable it to determine whether the nonpayment is the result of the dispute with the creditor or part of a more general pattern of nonpayment due to a lack of liquid assets. Whichever approach is followed, most countries presume that an enterprise is unable to pay its debts generally if it has, in fact, generally ceased making payments as they become due.

The imposition of other hurdles upon creditors wishing to initiate liquidation proceedings should normally be discouraged. In particular, the law should not preclude or otherwise limit *foreign creditors* (i.e., nonresident creditors or nonresident-controlled creditors) from initiating liquidation proceedings. Given the important role that insolvency systems play in the development of commercial and financial relations, such a limitation would severely undermine a country's ability to attract foreign investment and access international capital markets.

Debtor Petitions

As a technical matter, the commencement criterion that is applied to creditor petitions will often be applicable to debtor petitions. In practice, however, since a debtor normally only initiates liquidation proceedings as a last resort, when it does so the insolvency law normally presumes that the debtor has reached a stage where it is unable to pay its debts. Thus, although the laws of most countries may, in theory, apply a similar criterion for both debtor- and creditor-initiated liquidation proceedings, in practice the application of the criterion will not be scrutinized in the case of debtor-initiated petitions. In some cases, the criterion is dispensed with altogether.

The more difficult question that arises in the context of debtor-initiated petitions is whether the insolvency law should actually impose a duty upon a debtor to initiate proceedings at a certain stage of its financial difficulties. One approach to this problem is to include specific rules in the law that impose liability upon officers and directors for "trading while insolvent." The advantage of this approach is that it forces debtors to initiate either liquidation or rehabilitation proceedings at an early stage. Such early filings increase the chances for rehabilitation or, at a minimum, protect creditor interests by preventing the further dissipation of the enterprise's assets. However, the disadvantage of including such rules is that they may discourage management to attempt an out-of-court restructuring agreement, out of a fear that any delay in commencing formal proceedings may result in personal liability. If a country chooses not to rely on penalties as a means of *forcing* debtors to commence proceedings early, it may find it necessary to *encourage* debtors to do so through the creation of commencement incentives. As will be discussed in the next chapter, such incentives can be effectively incorporated into the rehabilitation procedure.

Initiation by a Governmental Authority

As noted in the previous section, regulated industries such as financial institutions may be subject to special insolvency regimes and, in these cases, the law may give the relevant regulatory agency of the government the exclusive authority to initiate insolvency proceedings against the debtor. In addition, the general insolvency law may give a governmental agency (normally the public prosecutor's office or the equivalent) the nonexclusive authority to initiate liquidation proceedings against *any* enterprise if it ceases its payments or, more broadly in other countries, if it is considered in "the public interest." In the latter cases, a demonstration of illiquidity may not be necessary, thus enabling the government to terminate the operations of otherwise healthy enterprises that have been engaged in activities--for example--of a fraudulent or criminal nature. While the exercise of such a police power may be appropriate in certain circumstances, efforts should normally be made to ensure that such powers are not abused and are exercised in accordance with clear guidelines.

Court Decision

It is normally for the court of competent jurisdiction to determine if the relevant conditions for commencement have been met. The decision should be published or made publicly available in the court's registry. Because speed is critical in the context of insolvency proceedings, consideration can be given to requiring that the court render a decision within a specified period following the filing of a petition. Such a limit may be particularly important when the capacity of the judiciary is limited.

Principal Conclusions

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

Consequences of Commencement: Establishing and Protecting the Estate

Once liquidation proceedings have commenced, an insolvency law will normally provide that control over the assets of the debtor is transferred to an independent official and the assets are protected from the actions of both the debtor and its creditors. Although this section will describe those assets that are subject to this protection as the "estate," differences in legal traditions of countries require an important, albeit technical, qualification regarding the use of this term. Specifically, the concept of an "estate" is only familiar in those countries that recognize divided ownership and trusts. In such countries, legal title over the assets is transferred to the designated official ("trustee"), and beneficial ownership in the "estate" vests with those that are eligible to receive the proceeds of the assets of the estate following liquidation, namely, the creditors. However, in those countries that do not recognize divided ownership, legal title continues to be retained by the debtor. Irrespective of the legal tradition of the country, the insolvency law of any country will normally need to address two issues. First, what property of the debtor will become subject to the control of the liquidator and be available for liquidation, that is, what are the assets of the "estate" (as a functional rather than legal concept)? Second, what measures will be taken to protect these assets from actions taken by the debtor and its creditors?

Assets of the Estate

As a general rule, the assets of the estate should include the property of the debtor as of the date the insolvency proceedings begin plus the assets acquired by the liquidator after that date. The liquidator should normally have the authority to abandon property of the debtor that it views as burdensome (e.g., useless equipment).

Property of the Debtor

The property of the debtor should normally include all assets in which the debtor has an ownership interest, whether or not these assets are in the debtor's possession at the time of the commencement of the proceedings. This would include all tangible assets that would be readily found on the debtor's balance sheet (e.g., cash, equipment, inventory, and real estate). It would also include intangible assets, which, depending on the stage of development in the country's property law, will differ. Although it may be necessary to exempt some assets in the case of individuals, such an exemption is less justified--and not common--in the case of enterprises.

Assets excluded from the estate will normally include assets of a third party that are in the possession of the debtor when the proceedings commence, for example, trust assets and bailments. The treatment of assets being used by the debtor pursuant to a lease agreement where the lessor retains legal title (title retention agreements) merits special attention. In countries where the provision of such title financing is of considerable importance, it may be appropriate to respect the creditor's legal title in the asset and allow it to be separated from the estate. Other countries may choose to scrutinize such financing arrangements to determine whether such leases are, in fact, disguised secured lending arrangements, in which case the lessor would be subject to the same restrictions as the secured lender.

Whether the debtor's property located outside of the country where the proceedings are taking place will become part of the estate raises important cross-border issues and is addressed in the contribution of the UNCITRAL Secretariat, set forth in the Appendix.

Post-Commencement Assets

The estate should normally include all assets acquired by the liquidator after the commencement of the liquidation proceedings. Perhaps the most important among these assets are those acquired by the liquidator by exercising avoidance powers, which are discussed in a subsequent section. Moreover, to the extent that the liquidator continues to operate the debtor's business prior to liquidation, assets acquired during this period would normally be included in the estate.

Protecting the Estate

An essential objective of an effective insolvency system is the establishment of a protective mechanism to ensure that the value of the estate's assets is not diminished by the actions of various parties in interest. The parties from whom the estate needs the greatest protection are the debtor and its creditors. In the former case, the debtor must be displaced from any position of influence or control over the operation of the business since, upon the opening of the liquidation proceedings, beneficial ownership in the assets of the estate effectively shifts from the debtor to its creditors. Protective measures are therefore also needed to ensure that the debtor does not remove assets from the estate immediately before or after the liquidation proceedings commence.

While creditors are the future beneficiaries of the estate, one of the fundamental principles of insolvency law is that measures are also needed to protect the creditors' collective and common interest from individual actions of one of them. The "stay" on creditor actions against the estate that is normally established once the liquidation proceedings commence enhances the collective interests of creditors by imposing limitations on the exercise of individual creditor interests. However, as will be discussed in subsequent sections, the nature and scope of this stay varies considerably among countries, this variation reflecting differing legal traditions and policy choices.

Interim Protective Measures

Between the time when the debtor or creditor petitions the court to open liquidation proceedings and the time this petition is granted, the debtor's assets are in danger of being dissipated even before the estate has been created. Upon the filing of the petition, the debtor may be tempted to transfer assets out of the business. Moreover, upon learning that a petition has been filed, other creditors may take remedial legal actions against the debtor to preempt the effect of any stay that will be imposed when the court makes a positive determination. An insolvency law should therefore consider providing for the imposition of interim protective measures to preserve the estate before the opening of an insolvency proceeding. Generally, the court will impose such measures at its discretion or upon a creditor's request. Interim protective measures may include appointing a preliminary liquidator, prohibiting the debtor from disposing of assets, sequestering some or all of the debtor's assets, and suspending enforcement of security interests against the debtor (the treatment of secured creditors is discussed extensively below). In some countries, if the debtor enters into transactions during this period, those transactions are void. Since these are provisional protective measures that are provided before a judicial determination is made that the commencement criteria have been met, the court may request a petitioning creditor to provide evidence that the measure is necessary and, in some cases, may require a bond from the petitioning creditor.

Protection Against the Debtor

Once the liquidation proceedings are opened, the conservation of the estate requires the imposition of comprehensive measures to protect the estate from the debtor. For this reason, the debtor is normally divested of all rights to manage and operate the business and a liquidator is appointed to assume all responsibilities divested by the debtor, including the right to initiate and defend legal actions on behalf of the estate and the right to receive all payments directed to the debtor. Initially, the liquidator inventories the estate's assets and may freeze (or "seal") them. Upon the commencement of the proceedings, any actions that are taken by the debtor that are detrimental to the estate are normally void.

Upon the commencement of the proceedings, the debtor should be required to disclose all of its assets and liabilities and any questionable transactions. Violations of this rule should give rise to penalties.

There may be circumstances in which a liquidator or the court determines that the most effective means of liquidating the estate is to sell it as a going concern. In such situations, even though the law may give him complete control over the estate, the liquidator may decide to permit the debtor to retain some control over the operation of the business until it is sold. In these cases, the liquidator would be liable for the wrongful acts of the debtor during this period and would normally only take such a step after consultation with the creditors.

Protection Against Creditors

One of the principal purposes of an insolvency law is to provide for the imposition of a "stay" on the ability of creditors to enforce their rights through legal remedies during the period of the liquidation proceedings. Such a stay is necessary not only to provide the liquidator with adequate time to avoid making a forced "fire sale" that fails to maximize the value of the assets being liquidated, but also to provide the liquidator with an opportunity to sell the enterprise as a going concern. Notwithstanding the above, the scope of the rights that are affected varies considerably among countries. There is little debate regarding the need to impose a stay on the ability of unsecured creditors to attach assets as a means of enforcing their contractual claims and precluding all creditors from initiating legal proceedings to recover debts that accrued before the proceedings were initiated. Although the stay may need to apply to secured creditors for a limited period, the coverage of secured creditors raises a number of difficult issues, which are discussed in the next section. Regarding the ability of creditors to exercise other contractual rights, countries vary as to whether they give the liquidator the power to interfere with set-off rights and contractual provisions that provide for termination upon bankruptcy or those that preclude assignment. These subjects are also discussed later. One of the key issues in the design of an effective insolvency law is how to balance the immediate benefits that accrue to the estate by having a broad stay with comprehensive powers given to the liquidator, on the one hand, and the longer-term benefits that are derived from limiting the degree to which this stay interferes with contractual relations with creditors, on the other hand.

Protection Against the Liquidator

Given the broad powers that are conferred upon the liquidator, the estate must be protected against abuse or incompetence by the liquidator. As will be discussed later, such measures should normally include court supervision, creditor or court approval, and personal liability.

Principal Conclusions

Upon commencement of the liquidation proceedings, all assets in which the debtor has an ownership interest as of that date should be transferred to an independent, court-appointed liquidator. The debtor should be required to disclose all assets and questionable transactions.

During the proceedings, all assets over which the liquidator

> exercises control should be protected by a "stay" on the ability of unsecured creditors to enforce legal remedies against the assets of the estate. Although the scope of the stay may vary among countries, it should, at a minimum, preclude unsecured creditors from (i) attaching, selling, or taking possession of assets as a means of enforcing their claims, or (ii) initiating legal proceedings to recover debts incurred before the liquidation proceedings were commenced. While the stay should apply to secured creditors for a limited period, important limitations need to be imposed with respect to the coverage of these creditors (see next section).
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> Once a petition for commencement has been filed, it is advisable to give the court the authority to impose interim measures to protect the debtor's assets pending a determination of commencement by the court. The range of measures should normally include full or partial divestiture of the debtor's control over the assets, the appointment of an interim administrator, and the imposition of a stay on the ability of creditors to attach assets.

Proceedings: Specific Issues

Treatment of Encumbered Assets and Secured Creditors

Creditors generally seek security for the purpose of protecting their interests if the debtor fails to repay. If security is to achieve this objective, it can be argued that, upon the commencement of insolvency proceedings, the secured creditor should not in any way be delayed or prevented from immediately foreclosing upon its collateral. Whether or not this argument is accepted, the introduction of any measures that erode the value of security interests requires careful consideration. Such an erosion will ultimately undermine the availability of affordable credit: as the protection provided by security interests declines, the price of credit will invariably need to increase to offset the greater risk. Indeed, under certain market conditions, creditors may be unwilling to provide even secured credit at any price.

Notwithstanding this imperative, it is increasingly recognized that permitting secured creditors to freely separate their collateral from the other assets in the estate can frustrate the basic objectives of insolvency proceedings. As will be discussed in Chapter 4, this is particularly obvious in the case of rehabilitation. Where estate assets essential to the operation of the debtor's business are encumbered by the security interests, the fact that secured creditors can immediately enforce their claims at the commencement of the rehabilitation proceedings may make it impossible for the debtor to keep its business in operation while it formulates a rehabilitation plan. However, this is also true--but to a lesser extent--under liquidation proceedings: the exclusion of secured creditors from the general stay on creditor actions may frustrate the liquidator's ability to maximize the value of the estate prior to distribution. In particular, if important assets serve as collateral, the liquidator will be unable to sell the debtor's business--or any business division--as a going concern. Moreover, even if the debtor's assets cannot be sold as a going concern, a temporary stay will give the liquidator time to arrange a sale that will give the highest return for the benefit of all unsecured creditors.

To balance the above considerations, any stay on secured creditors must be accompanied by measures that protect the interests of secured creditors during the liquidation proceedings. Two measures are of particular importance. First, the stay should be in place only when it protects the value of the estate. Thus, upon commencement of a liquidation proceeding, it is reasonable that the stay automatically apply to secured creditors for a brief period (e.g., 30 or 60 days), to give the liquidator the opportunity to assume its duties and take stock of the assets and liabilities of the estate. While the court would have the authority to extend such a "cool down" period, it should normally only be granted upon a demonstration by the liquidator that such an extension provides a necessary means of maximizing the value of the estate because, for example, there is a reasonable possibility that the enterprise, or units of the enterprise, can be sold as a going concern. To provide additional protection, the law should impose a limit on how long the stay can be extended. Such a limit may be particularly important in cases where the capacity of the institutional infrastructure is limited.

The second set of measures that are necessary to protect the interests of secured creditors are those that maintain the economic value of the secured claims during the period of the stay. Various approaches can be taken to achieve this protection.

Protecting Collateral

One means of protecting the value of the secured claim is to protect the value of the collateral itself, on the understanding that, upon liquidation, the proceeds of the sale of the collateral will be distributed directly to the creditor to the extent of the value of the secured portion of its claim. If this approach is followed, the following steps need to be taken to protect the collateral.

Compensation for Depreciation. During the period of the stay, it is possible that the value of the creditor's collateral will depreciate. Since, at the time of the eventual distribution, the extent to which the secured creditor will receive priority will be limited by the value of the collateral, such a depreciation will prejudice the secured creditor's interests. Accordingly, as is specifically provided by a number of laws, the liquidator should be required to compensate the secured creditor for the amount of this depreciation, either by providing substitute collateral or by making periodic cash payments that correspond to the amount of depreciation.

Payment of Interest. Some countries that protect the interests of the secured creditor by preserving the value of the collateral also allow for payments of interest during the period of the stay, but only to the extent that the creditor is oversecured, that is, to the extent that the value of the collateral exceeds the value of the secured claim. By permitting the payment of interest only in these circumstances, the law provides a strong incentive for a creditor to seek collateral that exceeds the value of its claim.

Protection and Compensation for Use. In some cases, the liquidator may find it necessary to use or sell encumbered assets prior to liquidation. For example, to the extent that the liquidator is of the view that the value of the estate can best be maximized if the business continues to operate for a temporary period, the liquidator may wish to sell inventory that is partially encumbered. Thus, in cases where secured creditors are protected by preserving the value of the collateral, it would seem appropriate for the law to give the liquidator the choice of providing the creditor with substitute equivalent collateral or paying the full amount of the secured claim.

Lifting the Stay. In cases where the insolvency laws require that the value of the collateral be protected during the period of the stay, a mechanism needs to be in place to ensure that the stay will be lifted when necessary to protect the secured creditor's interests. At least two circumstances can be envisaged. Under the first, the secured creditor requests the lifting of the stay on the grounds that it is not receiving adequate protection. Alternatively, the liquidator, on its own initiative, may release the collateral on the grounds that the provision of adequate protection may not be feasible or would be overly burdensome to the estate. In addition, the law may create exceptions to the stay to exclude assets that are generally not needed to sell the business as a going concern, such as cash collateral.

Protecting the Value of the Secured Claim

As an alternative to a system that preserves the value of the asset used as security, some countries protect the interests of secured creditors by protecting the value of the secured portion of the claim. Specifically, immediately upon the commencement of the proceedings, the encumbered asset is valued and, based on that valuation, the value of the secured portion of the creditor's claim is determined. This value remains fixed throughout the proceedings and, upon distribution following liquidation, the secured creditor receives a first-priority claim to the extent of that value. Moreover, during the proceedings, the secured creditor receives the contractual rate of interest on the secured portion of the claim to compensate him for the delay that is imposed by the proceedings.

Principal Conclusions

As a general principle, an insolvency law should strike a balance between, on the one hand, preventing secured creditors from undermining the objective of maximizing the value of the assets of the estate and, on the other hand, protecting the interests of such creditors so that the value of their security--and, as a consequence, the availability of credit--is not eroded. To implement this principle, the liquidation procedure should normally provide for the following.

(1) For a brief--and specified--period following the commencement of the liquidation proceedings (e.g., 30 or 60 days), the general stay on creditor enforcement should also apply to secured creditors, thereby precluding them from enforcing their contractual rights upon the collateral during the proceedings, subject to the qualifications described below. The stay should normally be extended beyond this period by the court only upon a demonstration by the liquidator that such an extension provides a necessary means of maximizing the value of the assets of the estate for the benefit of creditors generally (e.g., because of the possibility of selling the enterprise or units of the enterprise as a going concern). It may be advisable for the law to impose a limit on the period of extension.

> (2) Exceptions to this stay may be appropriate with respect to those assets that are generally not necessary for a sale of the business as a going concern (e.g., cash collateral).
>
> (3) During the period of the stay, a mechanism should exist that ensures that the interests of the secured creditor are adequately protected. Where this protection is provided by preserving the value of the creditor's collateral, these measures should include, for example, compensation for the depreciation of the collateral and, if the collateral is to be used or sold by the liquidator, the provision of replacement collateral. Countries may, as an alternative, protect the interests of the secured creditor by fixing the value of the collateral at the commencement of the proceedings and giving the secured creditor a first-priority claim based on that value, plus a priority claim for regular payments of contractual default interest.
>
> (4) Where the liquidator is unable to provide a secured creditor with the type of protection described above, the stay against the secured creditor should be lifted.

Avoidance of Pre-Commencement Transactions and Transfers

A debtor may enter or be placed into insolvency proceedings days, weeks, months, or sometimes years after recognizing that this outcome is inevitable. In anticipation of the formal commencement of insolvency proceedings, therefore, debtors may deviate from their ordinary business practices by attempting to hide assets from their creditors, incurring artificial liabilities, favoring certain creditors over others, or making donations to relatives or friends. Even though some of these activities might be perfectly permissible outside an insolvency context, the detrimental effects of such actions for the general unsecured creditors--that is, those who were not parties to the said actions and who are not fully secured--become unacceptable once a procedure has been opened, since this undermines the objective of equitable treatment among creditors.

For this reason, insolvency laws should set forth a mechanism that recaptures assets whose transfer prior to the commencement of the proceedings has such a detrimental effect. The design of the avoidance provision requires the resolution of a number of technical issues that will, in turn, reflect important policy choices. On the one hand, the stronger such avoidance rules, the greater the increase in the value of the estate for the advantage of the common creditors. In addition, strong avoidance rules may, in some cases, assist the debtor in its out-of-court negotiations since it creates a disincentive for a single creditor to take legal action to obtain an advantage, thereby facilitating collective creditor action. On the other hand, it should be borne in mind that very broad avoidance powers may undermine the predictability of contractual relations. This is particularly the case where the transactions and transfers are perfectly normal, but are voidable simply because they occurred in the proximity of the commencement of the proceedings.

Designing the Mechanism

In many respects, designing an avoidance provision involves making choices regarding evidentiary rules. One approach emphasizes the reliance on generalized, objective criteria for determining whether transactions or transfers are avoidable. Did the transaction or transfer take place within the period prior to commencement that is specified in the law? Does the transaction or transfer contain any of the general characteristics specified in the law (e.g., inadequate consideration)? Another approach emphasizes case-specific, subjective criteria. Is there evidence of an intent to hide assets from creditors? Was the debtor insolvent when the transaction or transfer was made and did the counterparty know of this insolvency? As is always the case in insolvency, there are advantages and disadvantages to both approaches. Generalized, objective criteria provide for simplicity in application. However, if relied upon exclusively, they can also result in arbitrariness. For example, while perfectly legitimate and useful transactions that fall within the specified period may be voided, fraudulent or preferential transactions and transfers that happen to fall outside the period may be protected. To prevent such arbitrariness, consideration should be given to designing an avoidance provision that attempts to reach an appropriate balance between both approaches. Whatever approach is adopted, it is generally accepted that stricter rules should be applied to transactions and transfers made to insiders (i.e., persons who have a close corporate or family relation to the debtor or its creditors). A stricter regime for such transactions is generally justified on the grounds that insiders are more likely to be favored and tend to have the earliest knowledge of when the debtor is, in fact, insolvent.

Set forth below are the categories of transactions and transfers that are most commonly covered under avoidance provisions.

(1) *Transactions and transfers made where there is evidence of the debtor's actual intent to defraud creditors by placing assets beyond their reach and where the counterparty knew of such an intent.* Such transactions and transfers constitute actual fraud in that there is evidence that both the debtor and the counterparty had the subjective intent to defraud creditors. Many insolvency laws do not limit the period during which such transactions and transfers can be avoided.

(2) *Transactions and transfers with a third party for inadequate consideration.* This category is often described as giving rise to constructive fraud: an intent to defraud is presumed whenever the transaction is unbalanced and does not appear to be made at "arm's length." Gifts (which can include, for example, debt forgiveness) are also included in this category. While most laws specify a maximum retroactive period (calculated from the date of commencement) during which such transactions and transfers can be voided, some laws also require a finding that the debtor was insolvent or was about to become insolvent when the transaction or transfer took place.

(3) *Transactions and transfers to creditors that are "voluntary."* Unlike (1) and (2) above, these transactions and transfers are limited to those with creditors and address the problem of preferential treatment of certain creditors over others. Many laws provide that, where the debtor gives a benefit to an individual creditor who is not legally entitled to that benefit, such a transaction or transfer is evidence of a preference and is avoidable. Such transactions and transfers include, for

example, early payments on a debt or the provision of a security interest on an existing debt. As in the case with (2) above, a maximum retrospective period is normally established in the law, with many countries also requiring evidence of insolvency (or near insolvency) when the transaction took place.

(4) *Ordinary transactions and transfers with creditors*. A number of countries allow for the nullification of transactions with and transfers to creditors, even when they do not include any "voluntary" features; for example, payments made to a creditor on or after the due date. The rationale for including such transactions and transfers is that, in cases where such transactions and transfers occur very close to the commencement of insolvency, there should be a presumption that insolvency actually existed when the payment was made and that, therefore, the creditor in question received preferential treatment. Since these transactions and transfers are normal in every other sense, the retroactive period is very brief (3090 days). Moreover, some countries will only allow for nullification if the creditor knew (or should have known) that the debtor was insolvent. Other countries make exceptions for transactions and transfers made in the ordinary course of business. Thus, for example, while payment made upon the receipt of goods that are regularly delivered (and paid for) could not be nullified, payment on a long overdue debt could be.

Implementation

If a transaction or transfer falls into the above categories, the law will either render it automatically void or make it voidable. If the latter approach is followed, the exercise of discretion will be required, which is normally left to the liquidator, as to whether the avoidance of the transaction or transfer will be beneficial to the estate, taking into account the delays involved in recovering the transfer (which may be of relevance when liquidation is imminent) or the possible costs of litigation. The scope of the liquidator's discretion is, of course, limited by its own obligation to maximize the value of the estate, and it may be responsible for its failure to do so, depending on the scope of its liability (which is discussed in a subsequent section). In that context, the law may permit a creditor or the creditors' committee to act on behalf of the estate and to void these transactions and transfers. A creditor could be allowed by the law to obtain a court injunction requiring the liquidator to initiate an avoidance action that appears to be beneficial to the estate.

Principal Conclusions

The liquidation procedure should set forth a mechanism that enables the liquidator to recapture assets that the debtor transferred prior to commencement, where such transfers prejudice creditors generally. The avoidance provision should specify the type of transactions and transfers that should be covered and the maximum "suspect period" prior to commencement during which these transactions and transfers will be subject to avoidance. Stricter rules should normally apply to transactions and transfers with insiders. At a minimum, it is advisable for the following types of transactions and transfers to be included.

(1) Transactions and transfers made where there is evidence of the debtor's actual intent to defraud creditors by placing assets beyond their reach and where the counterparty knew of such an intent. No maximum period need be specified in the insolvency law.

(2) Transactions and transfers for inadequate consideration, including gifts, that took place when the debtor was insolvent or about to become insolvent, with a maximum period specified.

(3) "Voluntary" transactions and transfers to creditors, where, for example, the debtor makes early payments on a debt or provides a security interest on an existing debt. A demonstration of actual or imminent insolvency may be necessary, with a maximum period specified.

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

Treatment of Contracts

It is inevitable that, at the commencement of a liquidation proceeding, the debtor will be party to a contract that has not yet been fully performed. Insolvency laws will, to varying degrees, give the liquidator the authority to interfere with the terms of contracts that, ordinarily, have not been fully performed by both the debtor and the counterparty. While this interference serves to further one of the broad objectives of liquidation proceedings, that of value maximization, it often needs to be weighed against competing social and political interests, particularly with respect to labor and lease contracts. Moreover, as in the case of avoidance provisions, the right of liquidators to interfere with the terms of unperformed contracts will undermine the predictability of commercial and financial relations. As will be seen, defining the scope of a liquidator's powers in this area requires a balancing of these considerations.

Termination

As a general matter, it is important that a liquidator or the court be given the authority to terminate a contract in which both parties have not yet fully performed their obligations. For example, before commencement of the proceedings, the debtor may have reached an agreement with a supplier to deliver goods for a specified price. When the liquidation proceedings commence, only some of the goods may have been delivered and payment may still be due. In these circumstances, the liquidator should normally be given the right to terminate the contract, in which case the counterparty would be excused from performing the rest of the contract and would become an unsecured creditor with a claim equal to the amount of damages caused by the termination.

Continuation

In some cases, continuation of a contract will be more valuable to the estate than its termination. For example, the debtor may be the lessee under a lease agreement where the rental is below market value, and a substantial term still remains under the lease. In these cases, the liquidator may wish to continue the lease in order to sell the debtor's business as a going concern with the lease intact. To give some assurance to the counterparty, it is generally recognized that the liquidator should indicate whether it will continue or terminate the contract within a specified period following the initiation of liquidation proceedings. Moreover, in the event of continuation, the law should protect the counterparty by ensuring that the cost of performance and any damages arising from a breach by the liquidator be an administrative (i.e., priority) expense. Since the granting of such a priority will constitute a risk for other creditors (who will be paid after the priority creditor), a liquidator will normally seek to continue only those contracts that it expects to be profitable.

As long as the terms of the contract in question do not preclude the liquidator from continuing the contract, the liquidator's assumption is unobjectionable. Indeed, subject to the principle of "quid pro quo," it is appropriate that the liquidator have this option. However, one of the key issues raised under an insolvency law is whether a liquidator may elect to continue a contract even if such continuation is inconsistent with the terms of the contract. Many commercial and financial contracts provide that initiation of an insolvency proceeding will automatically constitute an event of default under the agreement by the debtor, giving the counterparty the unconditional right to terminate the contract (sometimes referred to as "ipso facto" clauses). Under one approach, such termination clauses will be honored, in which case the liquidator will be able to continue the contract only if the counterparty elects not to terminate the contract. In such cases, the counterparty may be induced to consent to continuation because it is usually afforded priority of payment for services rendered after the commencement of bankruptcy proceedings. In contrast to this "consensual" continuation approach, another approach actually allows the liquidator to continue the contract over the objection of the counterparty; that is, any termination clause will be nullified by operation of the bankruptcy law.

Assignment

The ability of a liquidator or administrator to continue the contract over the objection of the counterparty provides the debtor with a particularly important tool to effect a rehabilitation (as is discussed later). In the context of liquidation, this ability will also be of considerable benefit when, following a decision to continue the contract, the liquidator can assign the agreement to a willing third party for value. Applying the example, described above, of the lease agreement that provides for rental payments that are below market value, the liquidator may wish to enhance the value of the lessee's estate by assigning the lease to a third party for a price. However, many agreements preclude a party from assigning the lease without the consent of the counterparty and, in many countries (particularly of the civil law tradition), assignment will not be permitted--even in insolvency--without the consent of all parties, unless it is part of the sale of a business as a going concern. Nevertheless, consistent with the broad assumption powers provided to a liquidator discussed above, some countries provide in the insolvency law that the effectiveness of these nonassignment clauses are null and void, thus enabling the liquidator to effect the assignment for the benefit of the estate. While this option is considered of critical importance in the liquidation proceedings of some countries, it is entirely foreign to many others and is precluded.

The ability of the liquidator to elect to continue and assign contracts in violation of the terms of the contract can have significant benefits to the estate and, therefore, the beneficiaries of the proceeds of distribution following liquidation. However, this ability clearly undermines the contractual rights of the counterparty to the contract. Moreover, assignment raises issues of prejudice to the nondebtor party to the agreement, especially where it has little or nothing to say in the selection of the substitute to the debtor. Therefore, in circumstances where such continuation and assignment are allowed, it would be appropriate to require the liquidator to demonstrate to the counterparty that the assignee can adequately perform under the contract. Moreover, as noted above, any claims arising from the performance of the contract after the commencement of insolvency proceedings should be treated as an administrative expense and, therefore, be given priority in distribution.

Special Contracts

Irrespective of the breadth of the termination or continuation powers given to a liquidator, exceptions may need to be made for certain contracts. Perhaps the most notable example of a liquidator's rejection powers being limited is in the administration of labor contracts. Although the protection of labor contracts will be particularly relevant in rehabilitation proceedings, it may also be relevant in liquidation proceedings. Specifically, in circumstances where the liquidator is attempting to sell the enterprise as a going concern, a higher price may be obtained if the liquidator is able to terminate onerous employment contracts. Countries may specifically limit this capability out of concern that this type of liquidation may be used expressly to eliminate the protection afforded to employees by such contracts. An additional issue relates to lease agreements: if the debtor is a lessor, limitations may be imposed on the ability of the liquidator to terminate lease agreements.

Exceptions to the power of the liquidator to continue contracts can generally be placed in two categories. First, if the liquidator is given the power to nullify termination provisions, specific exceptions may be made to this power for specific types of contracts. Perhaps the most important exceptions in this category are short-term financial contracts, such as swap and futures agreements, which are discussed later. The second category relates to those contracts where, irrespective of whether the law provides for the nullification of a termination provision, the contract cannot be continued because it provides for performance by the debtor of personal services.

Principal Conclusions

Liquidation procedures should give the liquidator the authority to terminate or continue contracts that have not been fully performed by both parties. Designing the scope of this power requires making important policy choices: while broader termination or continuation powers maximize the value of the assets of the estate, they also cause greater interference with contractual relations. Moreover, these powers may need to be limited with respect to certain types of contracts.

(1) *Termination*. The liquidator should have the authority to terminate unperformed contracts. Upon termination, the counterparty will become an unsecured creditor with a claim equal to the amount of damages caused by the termination. Countries may choose to limit this power with respect to special contracts, such as labor contracts or lease agreements (where the debtor is the lessor)--a limitation that will be relevant in liquidation proceedings where there is an intent to sell the enterprise (or a business unit of the enterprise) as a going concern.

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

Set-Off

An important issue that arises in the design of an insolvency law is the treatment of a creditor who, at the time of the initiation of the liquidation proceedings, also happens to be a debtor to the estate. If the fundamental principle of equality of treatment of similarly situated creditors were applied, the outcome would be relatively straightforward: the liquidator should be able to receive the full amount owed by the creditor and the creditor's claim would be satisfied to the extent to which all other unsecured creditors get satisfied upon the liquidation of the estate. However, an alternative approach permits the creditor, in these circumstances, to exercise set-off rights against the estate after liquidation is initiated, with the effect that, depending on the size of the estate's claim on the creditor, the creditor's claim may be satisfied in full.

There are several reasons why it may be appropriate to include the right of set-off in an insolvency law. The first is that of fairness: notwithstanding the importance of equality of treatment among creditors, it is considered unfair for a debtor to refuse to make payment to a creditor but, at the same time, to insist upon payment from that creditor. In addition, since many counterparties are banks, the right of set-off is particularly beneficial to the banking system and, because of the important credit creation role of banks, is therefore considered to be of general benefit to the economy. By virtue of their core functions (lending and deposit taking), banks that have lent to an entity that has gone bankrupt will often find that they have financial obligations to the debtor in the form of deposits. A post-commencement right of set-off would allow the banks to offset their unpaid claims with the debtor's deposits even though these reciprocal claims are not yet due and payable.

Even among countries that do not provide for a general right of set-off in the context of insolvency, set-off will still normally be permitted in two circumstances: if both claims are mature at the time insolvency takes place, or if the mutual claims arise from the same transactions.

The right of set-off interacts with other provisions of insolvency in a number of important respects. For example, the right of a creditor to set-off following the initiation of insolvency proceedings will be subject to the avoidance provisions if the claim held by the debtor was received by the creditor during the suspect period. In addition, to the extent that an insolvency law generally nullifies termination ("ipso facto") clauses and, thereby, allows the liquidator to assume unperformed contracts, a creditor will only be able to exercise set-off rights regarding mutual monetary claims if the right of the liquidator to nullify such clauses is expressly limited to allow for a creditor to terminate the contract and set off these claims. This is particularly applicable in the context of short-term financial transactions, which is discussed in detail in the next section.

Principal Conclusions

A pre-commencement right of set-off existing under general law should be protected during liquidation proceedings and generally should be exercisable by both the creditors and the estate. Moreover, the law should also permit post-commencement set-off if the mutual claims arise under the same transaction. In addition, countries may also wish to consider allowing for post-commencement set-off in other circumstances, particularly with respect to mutual financial obligations.

Financial Contracts and Netting

Depending on how an insolvency law addresses issues relating to the treatment of contracts and set-off rights, it may or may not need to include specific provisions regarding certain types of short-term financial contracts, including derivative agreements (e.g., currency or interest rate swaps). The terms of the master agreements governing these individual transactions, which have become increasingly standardized, normally contain provisions that enable one party, upon the commencement of the insolvency of the other party, to net the total of all its gains and losses and all unpaid amounts on separate transactions. Such "close-out netting" provisions, which aggregate all independent payment obligations, are normally effective only upon the insolvency of one of the parties if the insolvency law contains two features. First, it must allow for the termination (or "close-out") of all outstanding transactions under the agreement upon the insolvency of a party, and second, it must allow for the noninsolvent party to set off its claims against its obligations to the insolvent party.

As was discussed earlier, a number of countries have insolvency laws that do not contain both these features. With respect to termination, some countries allow a liquidator to elect to continue the contract in contravention of the termination provisions of the contract. With respect to set-off, a number of countries do not allow for the set-off of independent financial claims that are not mature at the time of commencement.

Many countries that do not possess general rules that provide for both termination and set-off have carved out exceptions to these general rules for the specific purpose of allowing "close-out netting" for financial contracts. They have done so because such transactions have become an increasingly important component of the global financial market and, in the absence of certainty regarding netting upon the insolvency of one party, access to such transactions would be severely restricted. Notwithstanding these important advantages, it is recognized, however, that such a "carve-out" will complicate the law and will result in preferential treatment for certain types of creditors.

Principal Conclusions

> In countries where post-commencement set-off is not permitted for mutual financial obligations or where the liquidator is able to interfere with contract termination provisions, it may be necessary to make an exception to these rules so that "close-out netting" provisions contained in financial contracts between the debtor and another party can be applied with certainty.

Liquidation and Distribution

Liquidation Procedure

An effective insolvency system must also provide for procedures that ensure the assets of the estate are sold and distributed in a timely, predictable, and equitable manner. Moreover, the liquidator should try to ensure that the sales price is maximized but that the cost of the sale and the distribution is limited. This subsection deals with procedural aspects of the liquidation process, while the next subsection provides a comparative analysis of the substantive priority rules for distribution.

In many respects, the first step in the liquidation procedure is the identification and collection of the estate's assets. Once the assets have been identified, the liquidator must identify and verify the liabilities of the estate. It then must sell the assets in accordance with a transparent procedure that will maximize the value of the assets being sold. Finally, it must distribute the proceeds in accordance with the priority rules set forth in the law. The verification of claims procedure, the treatment of claims of foreign creditors, and the procedure applicable to the sale of the assets are all important related issues.

Verification of Claims

Most laws provide for the liquidator to verify the claims of the creditors of the debtor. This involves not only an assessment of the underlying legitimacy and amount of the claim, but also a determination of the category within which this claim fits for distribution purposes (e.g., secured versus unsecured, pre-petition versus post-petition). Most laws place the burden upon the creditors to produce evidence of their claims to the liquidator for its review. If the liquidator challenges any aspect of a creditor's claim, this dispute will need to be adjudicated by the relevant court. Some countries also permit other interested parties, including creditors, to challenge a claim. In that context, review of a final list of creditors' claims might be advisable, at one or more creditor assemblies following preparation of such a list by either the court or the liquidator. As a means of ensuring transparency, it is critical that adequate and timely notice be provided. If it is, liquidation can be expedited by establishing deadlines by when creditors must file their proof of claims. As a sanction for delay, it may be provided that latecomer creditors will either be excluded from distributions altogether or participate ratably only in the distribution of any assets remaining after the verification of claims.

Foreign Creditor Claims

As noted elsewhere, foreign creditors should normally be afforded nondiscriminatory treatment during the insolvency proceedings.[5] The valuation of foreign exchange claims is of particular relevance to foreign creditors. For verification and distribution purposes, such claims are normally converted into the domestic currency at the exchange rate prevailing on the day when the proceedings are opened. Accordingly, to the extent the domestic currency depreciates or appreciates during the period prior to distribution, the amount of foreign exchange actually received by the creditor will be affected. To address this problem, consideration could be given to revising this approach so that the exchange rate prevailing at the time of distribution is utilized, at least in circumstances where the depreciation or appreciation exceeds a specified percentage.[6]

Methods for Disposition of Assets

The sale of assets as part of a going concern or as part of business units often produces greater value for creditors at distribution than does a sale of individual assets. Although an insolvency law may reflect this preference in the law itself, this may not be necessary since it is assumed that the liquidator will follow whichever course will maximize the proceeds for distribution.

One area, however, where the law will normally need to provide some guidance is the sales procedure that may be utilized by the liquidator. To ensure that the liquidator sells the assets in question in a manner that will maximize the sales price, some limits may need to be imposed on the discretion of the liquidator's ability to choose the method of sale. In cases where the liquidator chooses to conduct the sale privately rather than through a public auction, the law may need to ensure that the sale is adequately supervised by the court or that it is approved by the creditors. To avoid collusion, the law may need to specifically preclude the sale from being made to insiders, that is, to the debtor, the creditors, or related parties. As long as the sale is adequately supervised, however, an absolute prohibition on sales to insiders may not be necessary. Whichever method is utilized, it is critical that creditors receive adequate notice of the sale.

Principal Conclusions

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

Priority of Distribution

All insolvency laws need to incorporate the principle that, for purposes of determining the priority of distribution of the proceeds of the estate, creditors should be ranked by categories. Such a ranking is not, in and of itself, inconsistent with the principle of equitable treatment. On the contrary, to the extent that different creditors have struck fundamentally different commercial bargains with the debtor, the ranking of creditors may actually be required as a matter of equity. Indeed, the priority system can provide an important instrument for facilitating the provision of credit. Most important, if a secured creditor is given the equivalent of a first priority at the time of distribution (or receives directly the proceeds of the sale of collateral), it facilitates the provision of secured credit.

Another acceptable basis for providing priority relates to the conduct of the insolvency proceedings themselves. Specifically, to create incentives for professionals, particularly the liquidator, to perform the necessary services to ensure the insolvency proceedings are orderly and effective, the insolvency law must normally provide that these professionals receive compensation from the proceeds of liquidation on a priority basis. Applying the same principle, to attract financing once the insolvency proceedings have commenced, priority will also need to be given to "post-petition" creditors. While the provision of this assurance is generally viewed as essential in the context of rehabilitation proceedings, it can also be important in the context of liquidation proceedings, particularly where the liquidator considers that the value of the estate can be maximized by the temporary continued operation of the estate (which may occur, for example, if it is attempting to sell the enterprise as a going concern).

While a ranking based on either contractual terms or the provision of services or financing during the insolvency proceedings, as described above, may provide an important means of meeting the objectives of liquidation proceedings, the relevance of "privileges" based on social and political consideration may be less obvious, but these are still very prevalent.

Secured Claims

The method of distribution to secured creditors depends on the method used to protect the secured creditor during the proceedings. If these interests were protected by preserving the value of the collateral, the secured creditor has a first-priority claim on the proceeds of its collateral to the extent of the value of the secured claim. Alternatively, if the interests of the secured creditor were protected by fixing the value of the secured portion of the claim at the time of the commencement of the proceedings, the creditor has a first-priority claim to the general proceeds with respect to that value. Of course, if the secured creditor's claim is in excess of the value of the collateral or (if the alternative approach is followed) the value of the secured claim as determined at commencement, the unsecured portion of its claim will be treated as an unsecured claim for distribution purposes.

Exceptions to this first-priority rule should be limited. One such exception relates to administrative expenses associated with the maintenance of the collateral. Specifically, if the liquidator has expended resources in maintaining the value of the collateral, it may be reasonable for these expenses to be deducted as administrative expenses.

Administrative Expenses

Subject to the above exceptions, the first priority for distribution among unsecured claims will normally be payment of administrative expenses. Administrative claims usually include court costs and fees of the liquidator, payments relating to contracts that were entered into--or continued--by the liquidator after the commencement of the proceedings, and all other expenses relating to the collection, management, appraisal, and distribution of the assets of the estate. As noted above, priority for such expenses is justified by the fact that, absent such preferential treatment, the liquidation process would not be able to attract the resources, both human and financial, necessary to make it succeed. Some countries give the same rank as administrative claims to claims for employee compensation that have accrued prior to the commencement of the proceedings. As with other privileges described below, this ranking reflects a policy choice to ensure that the rights of employees are safeguarded in the context of insolvency proceedings.

Privileged Creditors

Once secured claims and administrative expenses have been satisfied, the means by which the remaining resources are distributed vary considerably among countries. Insolvency laws often identify a number of different types of privileged prebankruptcy creditors that will receive distribution before the unsecured creditors. In those countries that have eliminated most of these statutory privileges, any balance after distribution will flow directly to unsecured creditors. Although political pressure may require granting such privileges, they undermine the efficiency and overall effectiveness of the proceedings for a number of reasons. From the perspective of the general unsecured creditors, such privileges are inequitable since they effectively revalue the claims of a privileged class of unsecured creditors. As a result, unsecured trade creditors and banks may become disinterested in the proceedings, which will adversely affect the conduct of these proceedings. Moreover, they may complicate the negotiations of a rehabilitation plan to the extent that they require the creation of separate creditor classes to reflect the priority in question.

The types of privileges provided by countries vary and, in some cases, seem to reflect the leverage of particular interest groups in the political process of the country in question. Two categories of privileges, however, are particularly prevalent. The first provides priority for employee salaries and benefits (social security claims and pension claims). Such privileges are generally consistent with the special protection that is afforded to employees in other areas of insolvency law. The second category relates to tax claims of the government. This latter privilege has been justified on the grounds that giving the government priority with respect to tax claims can be beneficial to the rehabilitation process in that it gives the tax authorities an incentive to delay the collection of taxes from a troubled company. However, the creation of such incentives can in fact be counterproductive. Not only does failure to collect taxes compromise the uniform enforcement of the tax laws, but it also constitutes a form of state subsidy and, thereby, undermines the disciplinary forces that an effective insolvency law is designed to support.

Unsecured Creditors

Once all privileged creditors have had their claims satisfied, the balance, if any, of the proceeds will be distributed on a pro rata basis to unsecured creditors. There may be subdivisions within the class. For example, if a creditor has agreed to subordinate its claims, this should be respected. Certain claims, such as gratuities, fines and penalties, shareholder loans, and post-petition interest on general unsecured claims are treated as subordinate claims by some countries while they are treated as nonallowable (excluded) claims by others.

Owners

In the unlikely event that there is any balance to distribute to shareholders, it will be distributed in accordance with the ranking of shares specified in the company law and corporate charter.

Principal Conclusions

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

Discharge

Following distribution, it is likely that a number of creditors will not have been paid in full. This raises the question of whether such creditors will still have an outstanding claim against the debtor or, alternatively, the debtor will be released or "discharged" from these residual claims.

When the enterprise is a limited liability company, the question of discharge following liquidation does not arise: either the law provides for the disappearance of the juridical entity or, alternatively, the entity merely continues to exist as a shell with no assets. In any event, the shareholders are not liable for the residual claims and the issue of their discharge does not arise. However, if the enterprise is an individual (sole proprietorship), a group of individuals (partnership), or an entity whose owners have unlimited liability, the question arises whether these individuals will still be personally liable for the unsatisfied claims following liquidation.

Insolvency laws vary significantly with respect to the question of discharge. In some, the debtor is still liable for unsatisfied claims, subject to the statute of limitations. Such a rule emphasizes the value of a debtor-creditor relationship: the continued responsibility of the debtor following liquidation serves to both moderate a debtor's financial behavior and encourage the creditor to provide financing. On the other hand, some countries provide for a complete discharge of an honest, nonfraudulent 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. Other laws attempt to strike a compromise: discharge is granted after a period following distribution, during which time the debtor is expected to make a good faith effort to satisfy its obligations.

On the question of discharge, it is not feasible to have rules on the business debts of individuals differ from the rules that apply to the consumer debts of that individual. As discussed earlier, the treatment of consumers is generally outside the scope of this report.

Principal Conclusions

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

Contents

4 Rehabilitation Procedures

Objectives of Rehabilitation

The overall economic objective of rehabilitation procedures is to enable a financially distressed enterprise to become a competitive and productive participant in the economy, thereby benefiting not only the stakeholders of the enterprise (owners, creditors, and employees) but also the economy more generally. For a rehabilitation procedure to achieve this objective, it must create incentives for all stakeholders to participate in the proceedings, or--when necessary--prevent some stakeholders from undermining it. Thus, for example, the features of the procedures must be sufficiently attractive to encourage debtors to commence proceedings sufficiently early on in their financial difficulties, thereby increasing the chance of rehabilitation. On the other hand, the rehabilitation procedure must provide sufficient protection to creditors to gain their confidence that it will not be used merely as a device by a nonviable enterprise to delay liquidation, during which time the value of their claims will deteriorate. To ensure that the rehabilitation achieved under the procedure will provide for long-term competitiveness rather than merely a temporary respite, the insolvency law (and other relevant laws) must avoid placing undue constraints on the type of restructuring that can take place. Thus, for example, a rehabilitation plan should be able to provide for debt-for-equity conversions, as well as for the restructuring or forgiveness of debt.

A closely related objective of a rehabilitation procedures is to provide a means by which the value of creditors' claims can be enhanced or, at least in the case of secured creditors, maintained. To achieve this objective, it is important that the law provide creditors an adequate opportunity to vote on the plan or, in the case of secured creditors, provide for measures that will ensure that their claims and/or property rights are not impaired. Moreover, creditors should also be given the opportunity to initiate a plan for rehabilitation, either directly or through the administrator.

For some countries, an additional and somewhat specific objective of rehabilitation procedures is to provide enterprise owners a "second chance." By doing so, an effective rehabilitation procedure encourages the development of an entrepreneurial class. To achieve this objective, a rehabilitation procedure should give the debtor the opportunity to prepare and propose a rehabilitation plan, either directly or through an administrator.

From the perspective of the economic policymaker, another objective of a rehabilitation procedure is to ensure participation of private creditors during a financial crisis, thereby limiting the public cost of crisis resolution. Such participation also forces creditors to bear the costs of the risks they incur, which, in the long term, will generate more stability in the financial system.

Commencement Requirements

As was discussed in the chapter on liquidation, the ability of either the debtor or a creditor to initiate liquidation proceedings on the basis of a general cessation of payments serves a number of important objectives of the liquidation procedure. To what extent do the specific objectives of rehabilitation merit deviation from this condition for purposes of the commencement of rehabilitation proceedings?

Who May File

While it is undisputed that rehabilitation proceedings may be initiated by a debtor, there is less consensus as to whether such proceedings can also be commenced by a creditor. Given that one of the objectives is to provide an opportunity for creditors to enhance the value of their claims through the rehabilitation of the enterprise, it is preferable that the debtor not be given the exclusive authority to initiate such a rehabilitation. As is discussed in greater detail below, the ability of creditors to take the initiative in rehabilitation is also central to the question of whether the creditors can propose a rehabilitation plan, with a number of countries taking the position that the creditors should have an opportunity in this regard since, in many cases, they will be the primary beneficiaries of a successful rehabilitation. If creditors are given such a right, it would seem reasonable--and consistent--to also provide them with the opportunity to commence rehabilitation proceedings; indeed, countries that allow creditors to propose plans normally allow them to commence rehabilitation proceedings.

Commencement Criterion

As noted above, one of the objectives of rehabilitation proceedings is to establish a framework that will encourage debtors to address their financial difficulties at an early stage, thereby increasing the chances of an effective rehabilitation. For instance, the way in which the debtor is treated during the proceedings (e.g., the degree of protection it is given and the amount of control it is able to retain) will have a major impact on whether a debtor will be encouraged to take advantage of these procedures. Providing such incentives may be particularly important where an alternative means of encouraging the early utilization of insolvency proceedings--that of penalties imposed on management--is not adopted.

Consistent with this objective, it would seem appropriate to design a commencement criterion that would not require the debtor to wait until it has ceased to make its payments generally (i.e., wait until it is illiquid) before commencing rehabilitation proceedings. Many countries have recognized the merit of this approach, albeit in different ways. In some cases, the rehabilitation procedure does not actually involve the application of a substantive criterion: the debtor may open the proceedings whenever it wishes. In other cases, the law will specify that the debtor may open the proceedings if it envisages that, in the future, it will not be in a position to pay its debts when they come due. Even among countries that have adopted unitary proceedings, such a prospective illiquidity criterion has been introduced for petitions filed by debtors, with the intention that this would encourage debtors to rehabilitate at an earlier stage in their financial difficulties.

It may be argued that such a relaxation of the commencement criterion could invite debtors to abuse the procedure. For example, a debtor that is not in financial difficulty may attempt to commence proceedings, submitting a rehabilitation plan that would enable it to shed a number of onerous obligations (e.g., labor contracts). However, whether such abuse would arise depends primarily on the design of the other elements of the rehabilitation procedure, such as the degree of control over the enterprise that the law permits the debtor to retain once the proceedings commence.

Applying a lower standard for petitions filed by creditors will, however, be more difficult to justify. For example, if the law allows a debtor to initiate a rehabilitation proceeding on the basis of prospective financial difficulties, it is difficult to envisage how creditors would have adequate information to assess whether the debtor has, in fact, met this standard. As a general matter, it would seem unreasonable for any form of insolvency proceeding (whether it be liquidation or rehabilitation) to be initiated against a debtor's will unless the creditors can demonstrate that their rights have been impaired.

For the above reasons, it would seem more appropriate that the principal commencement criterion that is applied to creditors with respect to the commencement of a liquidation procedure (general cessation of payments) also be applied in the context of rehabilitation. Indeed, in those cases where a country adopts a two-track approach (i.e., separate liquidation and rehabilitation procedures), it appears that any differences in the commencement criterion would be less attributable to the procedure being utilized, and more attributable to whether the petitioner is the creditor or the debtor. In the case of creditor petitions, the principal criterion one would expect is that of a general cessation of payments, irrespective of which procedure is used. In the case of debtor filings, a more relaxed standard could--at least in practice--be available under both of these procedures. For countries that utilize a unitary proceeding, such a creditor-debtor petition distinction would also be relevant for formulating the commencement criterion. The exception to this approach would be those countries that, for public policy reasons, preclude either a debtor or a creditor from initiating liquidation procedures until a determination is made that rehabilitation is impossible. In those cases, the commencement criterion for a liquidation procedure is not a general cessation of payments but, in effect, a determination that rehabilitation cannot succeed.

Conversion From Liquidation to Rehabilitation

As noted in Chapter 3, in those cases where separate liquidation and rehabilitation procedures are utilized, the right of a creditor to commence liquidation proceedings upon a determination of a general cessation of payments requires the establishment of additional safeguards to ensure that viable companies are still given the opportunity to be rehabilitated. It is therefore important that the insolvency law allow for conversion from liquidation to rehabilitation, to be initiated by the debtor, the administrator, the court, or even the creditors. Some countries permit the debtor to initiate such a conversion as a matter of right--that is, there is no need to demonstrate that there is a likelihood of rehabilitation. However, such laws generally provide for a conversion back to liquidation if, in fact, rehabilitation is not considered feasible. In cases where a conversion to rehabilitation is initiated by the debtor, a shareholders' resolution may be necessary to forestall abusive filings by management.

Principal Conclusions

The law should allow for rehabilitation proceedings to be initiated by the debtor or by a creditor. To encourage a debtor to commence a rehabilitation proceeding early, thereby increasing

> the chances of a successful rehabilitation, the commencement criterion should not require a demonstration of a general cessation of payments. However, such a demonstration should normally be relied upon in the case of a petition filed by a creditor. The law should also provide for commencement of rehabilitation proceedings through a conversion from liquidation proceedings.

Consequences of Commencement

Once liquidation proceedings have commenced, control over the debtor's assets is normally transferred to an independent liquidator and such assets are protected from the actions of creditors. Given the objective of the rehabilitation procedure, to what extent should such an approach be followed in these proceedings?

The Stay

In a liquidation procedure, one of the reasons for a stay on the ability of creditors to enforce their legal remedies is to avoid a premature dismemberment of the enterprise, thereby providing an opportunity for the liquidator to maximize the value of the assets of the estate. It should be of no surprise, therefore, that the existence of a stay in the context of a rehabilitation procedure is critical. An enterprise cannot be rehabilitated if it is being dismembered through the attachment of its assets by creditors.

In addition, since the design of a rehabilitation procedure needs to take into consideration the objective of encouraging debtors to attempt to rehabilitate as early as possible, the imposition of a stay on the ability of creditors to enforce legal remedies provides an important incentive for debtors to initiate rehabilitation proceedings. Moreover, since rehabilitation proceedings are also designed to maximize the value of creditor claims through the rehabilitation of the enterprise, such a stay will not, in and of itself, be inconsistent with the interests of creditors. Most countries provide for such a stay during rehabilitation proceedings and, as will be discussed below, it is important that the stay also apply to secured creditors.

Debtor Control

Upon the commencement of liquidation proceedings, the debtor is normally removed from the operation of the business and comprehensive measures are put in place to protect the assets of the enterprise from actions of the debtor. Indeed, legal title to the assets or control over the assets is transferred from the debtor to the liquidator, who is responsible for the management of the estate for the benefit of the creditors. There is considerable debate about the extent to which rehabilitation proceedings should also result in the displacement of the debtor from the management of the enterprise once rehabilitation proceedings commence, and there is no uniformity regarding the way countries address this issue. If rehabilitation proceedings mirrored liquidation proceedings in terms of the degree of control that the debtor is given over the enterprise, such an approach would clearly undermine any incentive for the debtor to voluntarily make use of rehabilitation proceedings. Moreover, the removal of the debtor's incumbent management in all cases could undermine the possibility of rehabilitation, since management will, in some cases, have the best understanding of the business's operation.

In light of these considerations, one approach is to enable the debtor to retain full control over the operation of the business, with the consequence that the court does not appoint an independent administrator once the proceedings begin. This approach has been followed by the United States, which relies on the concept of "debtor in possession" during the rehabilitation proceedings. Notwithstanding the advantages of this approach, a number of policy considerations need to be borne in mind when contemplating the possibility of allowing the debtor to retain full control during the proceedings.

The first consideration relates to the type of incentives such an approach may create. As noted earlier, if a debtor perceives that it has everything to gain (the stay on creditors) but nothing to lose (no loss in control in the business), it may be tempted to utilize the rehabilitation procedures when rehabilitation is clearly not possible. Specifically, a debtor that is no longer viable may attempt to use rehabilitation proceedings solely to delay the inevitable, with the consequence that the assets of the debtor continue to be dissipated. Accordingly, instead of promoting rehabilitation, such a system may merely encourage debtors to delay liquidation to the prejudice of creditors.

A second disadvantage with a system that enables the debtor to retain full control is that, even when the enterprise can be rehabilitated, there is the possibility that the debtor's management may act irresponsibly and, in some cases, even fraudulently during this period. Not only will this undermine the possibility of rehabilitation, but it will also prejudice interests of creditors in the event of liquidation.

In some respects, the above problems can be mitigated by providing for a mechanism that allows the court (either on its own motion or at the request of the creditors) to convert the proceedings to liquidation proceedings when there is no reasonable likelihood of rehabilitation or when there is evidence that the debtor is not acting responsibly and in good faith. The shortcoming of this approach is that it places considerable emphasis on the exercise of discretion by the judiciary. Such reliance may not prove to be effective, particularly if the capacity of the judiciary is limited.

In light of the above considerations, an alternative approach is for the procedure to mandate the establishment of a "power-sharing" arrangement between the debtor and the administrator. Under this approach, which is followed by a number of countries, although the debtor continues to operate the business of the company on a day-to-day basis and is given an opportunity to prepare a rehabilitation plan (discussed below), its activities are supervised by a court-appointed administrator, who is also responsible for approving all (or the most significant) transactions conducted by the debtor. Not only does such an approach attempt to establish a better balance of incentives for the debtor that will reduce the chance of abuse (loss of control but retention of an opportunity to rehabilitate), it also safeguards the interests of the creditors during the proceedings, since it enables an independent party to obtain sufficient information to form an assessment of viability and also limits the ability of the debtor to dissipate its assets. While the law can allow the judiciary to determine the scope of the administrator's powers in individual cases, the grant of too broad a discretion will create its own risks and could undermine the effectiveness of such a power-sharing arrangement. Moreover, without relatively precise rules regarding the division of authority, all parties in interest will be uncertain as to how the rehabilitation proceedings will operate. However, if the debtor demonstrates gross mismanagement or has squandered or misappropriated the assets, the court should have the authority, on its own motion or on that of the administrator or the creditors, to displace the debtor completely.

Principal Conclusions

> It is important that the rehabilitation procedure provide for a stay on the ability of creditors to enforce legal remedies against the assets of the debtor once rehabilitation procedures are commenced. The scope of the stay should be at least as comprehensive as the minimum requirements outlined under Liquidation Procedures, discussed above. As is discussed below, the stay should also apply to secured creditors.
>
> Total displacement of the debtor from the management of the enterprise will eliminate the incentive for debtors to avail themselves of rehabilitation procedures at an early stage and may undermine the chances of successful rehabilitation. On the other hand, allowing the debtor to retain full control over the enterprise creates a number of risks, including that the assets of the debtor will be dissipated to the detriment of creditors. It is therefore preferable for the law to provide for an arrangement whereby the debtor continues to operate the enterprise on a day-to-day basis, but under the close supervision of an independent, court-appointed administrator. However, the court should have the authority to displace the debtor's management entirely when there is evidence of gross mismanagement or misappropriation of assets.

Transition to Liquidation

There are risks that rehabilitation proceedings may be abused by the debtor and, in these circumstances, it is important that the law provide for a mechanism to convert the rehabilitation proceedings into liquidation. In designing the conversion mechanism, the administrator must be given a central role to play in this process. Other than the debtor's management itself, it is usually the administrator who 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. Accordingly, it would seem reasonable to give the administrator the power to recommend to the court that the proceedings be converted if it determines either that there is no reasonable likelihood of viability or that the debtor is not cooperating with the administrator (withholding information, etc.) or is otherwise acting in bad faith (e.g., fraudulent transfers). In addition, it is reasonable for the creditors, perhaps through the creditors' committee, to have standing to request the court to convert the proceedings on similar grounds. Finally, this power can also be given to the court, which would be able to convert the proceedings on its own motion.

The effective implementation of the above safeguard will ultimately depend on the quality of the judiciary and, in some countries, this may prove problematic. One alternative approach would be to supplement the above safeguard through a provision that enables creditors to actually convert the proceedings on the basis of their own vote at any time (or after a specified initial period), thereby eliminating the role of the court in this process. The difficulty with this approach is that, unless a very high majority requirement is relied upon, it may actually give too much power to creditors, who may merely use this authority to convert the proceedings even before the debtor has had an opportunity to prepare a plan.

Another alternative is to supplement the ability of the court to convert the proceedings (on the recommendation of either the administrator or the creditors) with time limits that are actually prescribed in the law itself. Following this approach, a rehabilitation proceeding would not be able to continue beyond a prescribed period (e.g., 120 days from the date of commencement) and the court would not be given the authority to extend this period. While such an approach runs the risk of imposing constraints that may prove unwarranted in certain cases, it has the advantage of providing all participants with a "bright line" that acts as a catalyst for the preparation and approval of the plan. A variation of this approach that would give greater leverage to the creditors (and would avoid the outside deadline being perceived as a target) is the establishment of an initial time period (perhaps 60 or 90 days) that could be extended only by a vote of the creditors (perhaps on the basis of a report by the administrator regarding the feasibility of rehabilitation), but which, in any event, could not exceed an outside time period (perhaps 120 days).

Principal Conclusions

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

Proceedings: The Plan

Identifying the Preparer

For a rehabilitation procedure to achieve the objectives set forth at the beginning of this chapter, the debtor must be given some opportunity to prepare the rehabilitation plan. If the debtor is denied this opportunity, it will have less of an incentive to utilize the rehabilitation procedure. Moreover, given that--at least for some countries--one of the objectives of a rehabilitation procedure is to foster an entrepreneurial class, denying the debtor the opportunity to prepare a plan (which will presumably involve the debtor retaining some equity and/or some management role) would undermine this objective because it would effectively deny the debtor the possibility of having a "second chance." Finally, and perhaps most important, since the debtor may be in the best position to determine what steps are necessary to make the enterprise viable again, enabling it to prepare the plan may enhance the chances of successful rehabilitation.

A subsequent issue is whether the debtor should be given the exclusive opportunity to prepare the plan and, if not, who else should have that opportunity, and when. Since a plan will be successful only if it is approved by the requisite majority of creditors, there is always a risk that rehabilitation will fail, not because the enterprise is no longer viable but because 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 (or even all equity interest) in the enterprise and/or may also deprive the incumbent management of any responsibilities. If the debtor is given the exclusive opportunity to prepare the plan and refuses to consider such an arrangement, the rehabilitation will fail, to the detriment of the creditors, the employees of the enterprise, and the economy in general.

Accordingly, to increase the possibility that an enterprise will be rehabilitated, it may be necessary not to give the debtor the exclusive opportunity to propose a plan. One approach that attempts to maintain some incentive for the debtor to utilize the rehabilitation procedure is to provide the debtor with an initial period in which it has the exclusive privilege to propose a plan and, at the expiration of this period, the creditors may also propose a plan. This can be achieved through reliance on a creditors' committee, the features of which are discussed in Chapter 5. If such an approach is followed, limiting the court's ability to extend this exclusivity period may be worth consideration. As with the discussion regarding the conversion from rehabilitation to liquidation, while the use of firm time limits in the law might sometimes lead to arbitrary results, it will increase confidence in the procedure in countries where the capacity of the judiciary is limited. In practice, the mere possibility of a creditor plan will encourage the debtor to quickly propose a plan that has a reasonable chance of garnering creditor support. As with many other aspects of the rehabilitation procedure, the option of a creditor plan provides the necessary leverage to one participant that will persuade the other participant to compromise.

Once a debtor has exhausted its opportunity to propose a plan, it may be reasonable to give the administrator a chance to do so, either as an alternative or as a supplement to a creditor-proposed plan. Given that it will have had the opportunity to become knowledgeable about the enterprise, it will be well placed to determine what measures are necessary for viability. If the administrator is to be given this authority, however, it is important that it have the expertise to engage in this exercise, which requires highly specialized skills.

Whether the administrator or the creditors, or both, are given the authority to propose a plan may, in fact, be of less significance in circumstances where approval by the requisite majority of creditors is a necessary condition for the effectiveness of the plan: when designing the plan, the administrator will clearly need to ensure that whatever is proposed will be acceptable to creditors. However, in circumstances where creditor approval is not necessary or can be overruled by the court, the ability of the administrator to propose a plan may have important implications as to its content.

In addition, a few countries provide for the court's consideration of opinions on the plan from third parties (such as governmental agencies and labor unions). Such a procedure has the potential to lengthen the duration of the proceedings and will need to be carefully monitored by the court, perhaps through the imposition of time limits.

While the law may give a number of parties in interest the opportunity to propose a plan, it is generally recommended to avoid having a number of plans proposed simultaneously. Such a multiplicity of plans (including a multiplicity of creditor plans) will only complicate the negotiating process and undermine the efficiency of the rehabilitation proceedings.

Principal Conclusions

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

Content

Virtually all countries have laws requiring, to a greater or lesser extent, that the rehabilitation plan adequately and clearly disclose to all parties information regarding both the financial condition of the company and the transformation of legal rights being proposed by the proponent of the plan. (A few countries also impose substantive limits on the terms of a reorganization plan.) Beyond this, however, the question of what should or should not be included in a rehabilitation plan is difficult to discuss in isolation of issues relating to the approval of the plan and effect of approval. As a general rule, to the extent that a plan can be approved and enforced upon dissenting creditors, the law will need to ensure that the content of the plan provides adequate protection for such dissenting creditors. Whether or not other limits should exist regarding the nature of the plan also requires an assessment of the appropriateness of other laws. For example, to the extent that the company 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 rehabilitation, it will be necessary to eliminate this prohibition at least in the context of a rehabilitation proceeding: if features of the plan are limited to debt forgiveness or the lengthening of maturities, the plan may not receive adequate support from the creditors and, perhaps even more importantly, may not result in effective rehabilitation.[7]

The policy considerations arising from the application of other laws, however, may be more complicated. While authorizing debt-for-equity conversions may not be controversial, the removal of limits on foreign investment, particularly foreign direct investment, may well be. Such a restriction may limit the possibility of effective rehabilitation in circumstances where many of the creditors are nonresidents. On the other hand, in financial crises where the entire corporate sector is in stress, the authorities may be concerned that the rehabilitation procedure will become a device by which foreign creditors may acquire a controlling interest in nationally important industries. Similarly, the flexibility that a plan proponent will have with respect to the treatment of employees under the relevant labor law may be limited, unless these rules are explicitly derogated from in the insolvency law. While it is generally accepted that the terms of an employment agreement approved under a plan should not deviate from the standards established under the labor law, a more difficult question is whether, for example, a plan can effectively modify an existing collective bargaining agreement.

Principal Conclusions

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

Approval and Effect

Designing the rules regarding the approval and effect of the plan requires balancing a number of competing considerations. On the one hand, it is important that these rules provide a way to impose a rehabilitation plan upon a minority of creditors. Such a mechanism will not only increase the chances of success of rehabilitation, but will also provide a means by which creditors can be "bailed into" the resolution of financial crises. On the other hand, to the extent that the approval procedure results in a significant impairment of creditors' claims without their consent, such a procedure runs the risk of undermining the willingness of creditors to provide credit in the future, which would be to the detriment of the economy in general. Any discussion of issues relating to the approval and effect of the plan is inextricably linked to issues of the plan's content and, in circumstances where a plan can be imposed on dissenting creditors, the law may need to ensure that the interests of these creditors are adequately protected.

Secured and Priority Claims

In many cases, secured claims will represent a significant portion of the value of the debt owed by the debtor. To the extent that the law ensures--as is the case with traditional "composition" plans--that an approved plan will in no way preclude secured creditors from exercising their rights, there is generally no need to give secured creditors the right to vote, since their interests will not be impaired by the plan. Priority creditors are treated similarly under such a composition plan. These creditors (including, for example, post-petition creditors and--depending on the law--employees) do not vote on the plan but, upon the plan's approval, they are entitled to receive full payment on their claims; the plan cannot impair the value of their claims.

The limitation of the above "composition" approach is that it effectively reduces the chances for a successful rehabilitation. For example, in the case of a secured creditor, the assets securing the claim may be vital to the success of the rehabilitation plan. Accordingly, unless the secured creditor is bound by the plan or the plan provides for full satisfaction of the secured creditor's claims, the exercise of the creditor's rights may render the plan's implementation infeasible. Similarly, in certain circumstances, the only way in which a rehabilitation plan may succeed is if priority creditors receive less than the full value of their claims immediately upon the plan's approval.

One approach that has been adopted by some countries to address this problem is to allow for secured creditors and priority creditors to vote as separate classes on a plan that would otherwise impair the value of their claims. The creation of separate classes is considered necessary since the nature of their rights under liquidation differ from those of unsecured creditors, and they accordingly also have different interests. To the extent that majority support is obtained from each of these classes, all secured creditors and priority creditors would be bound to the terms of the plan. In these circumstances, the law requires that any dissenting creditors be entitled to receive at least as much as they would have received under liquidation. A majority of secured creditors may be willing to accept an impairment in the value of their claims in circumstances where they have a long-term interest in the continuation of the enterprise (e.g., financial institutions), and such continuation requires the adoption of a plan that provides them with less than immediate cash payment on their collateral. Similarly, employees that are priority creditors may very well be willing to receive less than full payment on back wages if this is necessary to ensure the survival of the enterprise.

General Unsecured Creditors

Even if the law does not provide for voting by secured or priority creditors, it must provide an effective means by which general unsecured creditors can vote on a plan. A number of mechanisms may be used to increase the chance that a rehabilitation plan will be approved by these creditors.

Majorities. Irrespective of whether the law provides for voting of classes of creditors, all insolvency laws must set forth rules that identify the minimum threshold of support of general unsecured creditors required to bind such creditors, and the voting procedures that are to be used to determine this support. Various majorities can be envisaged (two-thirds or three-fourths of the total value of unsecured claims), with the chances of approval increasing as the minimum percentage of required support goes down. One issue that needs to be addressed in this regard is whether calculation of votes should be based exclusively on the percentage of the value of the debt that supports the plan or whether it should also take into consideration the number of creditors that are supportive. For example, the law may require that the plan must be supported by both (i) two-thirds of the value of the debt, and (ii) one-half of the creditors in number. While such a two-tiered voting requirement will effectively raise the hurdle for approval, it may be justified on the basis of the principle that the insolvency law is designed to be a collective proceeding: if a single creditor holds a majority of the value of the debt, this rule prevents that creditor from imposing its support of the plan against the will of all the other creditors.

Regarding voting procedure, many countries have found it preferable to calculate the percentage of support on the basis of the percentage of those creditors that actually participate in the voting. Absentees are considered to have little interest in the proceedings, normally because their claims are small. To the extent such an approach is relied upon, it is critical that there be adequate notice provisions and that these notice requirements be effectively implemented. This is of particular importance when many of the creditors are nonresidents.

Classes. Some countries that have established classes for secured creditors and priority creditors also provide for the division of unsecured creditors into different classes.[8] The creation of such classes is designed to enhance the prospects of rehabilitation in at least two respects. First, as in the case of secured and priority creditors, such classes are a useful way to identify the varying economic interests of unsecured creditors and, therefore, provide an appropriate framework for structuring the terms of the plan. Experience demonstrates that, as with secured and priority creditors, some unsecured creditors have different interests in terms of what they feel they need to receive under the plan. For example, while certain unsecured creditors may only be interested in immediate cash payments (e.g., discontinued vendors), other creditors that have a long-term interest in maintaining a relationship with the enterprise (e.g., ongoing trade creditors) may be willing to accept deferred payment or equity. The creation of classes on the basis of these interests and the structuring of the plan to accommodate them provide a greater chance that a rehabilitation plan will receive adequate support. The second way in which the creation of classes of unsecured creditors enhances the chances of rehabilitation is that it provides 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. This is discussed more generally below.

"Cram-down" Authority. A few countries that provide for voting 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 class to make the plan binding on other classes (including classes of secured creditors and priority creditors) without their consent. Such a mechanism, which is designed to further enhance the chances of rehabilitation, is often referred to as a "cram-down" provision. If such a mechanism is relied upon (the merits are discussed below), it is important that protection be provided to the dissenting class to ensure that the priority rules that are established in liquidation procedures are respected. In particular, in addition to providing for the minimum level of protection for each dissenting creditor (which ensures that a creditor receives at least as much as it would have received under liquidation), discussed earlier, laws that seek to protect

the relative rights of "crammed-down" classes of creditors also apply what is known as the "absolute priority rule." Under this rule, a dissenting class of creditors may not be forced to receive less than the full value of its claims if creditors of a junior class receive any value.[9]

The creation of classes and the application of "cram-down" rules complicate both the law and its application by the court and the administrator. Where the institutional infrastructure is relatively well developed, such complexity may be merited, especially given the limitations of the traditional "composition" model, which can severely limit the opportunities for rehabilitation. However, where the capacity of the institutional infrastructure is limited, the inclusion of such rules will require careful consideration given that, among other things, their application may require the exercise of considerable discretion on economic issues. For example, the creation of separate classes of unsecured creditors will often require a categorization of such creditors by the court on the basis of their economic interests. Where creditors do not have confidence in the ability of the institutional infrastructure to exercise this discretion in an informed, independent, and predictable manner, such rules may actually undermine creditor confidence.

Shareholders. Some laws provide for the approval of plans by shareholders of the debtor enterprise, at least where the corporate form, the capital structure or the membership will be affected by the plan. In addition, when the debtor's management proposes a plan, the terms of the plan may already have been approved by the shareholders. Depending on the type of enterprise in question (publicly traded or privately held), this may be required under the terms of the constitutive instrument of the enterprise. This is particularly the case when the plan involves debt-for-equity conversions, either through the transfer of existing shares or through the issuance of new shares. However, in circumstances where the law permits creditors or an administrator to propose a plan, and such a plan contemplates a debt-for-equity conversion, some countries allow this plan to be approved over the objection of the shareholders, irrespective of the terms of the constitutive instrument of the enterprise. As a result, such plans can result in existing shareholders being entirely displaced in the new enterprise without their consent.

Court Approval. As has been discussed above, many countries enable the courts to play an active role in "binding in" creditors by making the plan enforceable upon a class of creditors in circumstances where they have not approved the plan. Conversely, in cases where the plan has been approved by the requisite majority of creditors, the court will normally have the authority to reject the plan on the grounds that the interests of dissenting creditors have not been adequately protected (because, for example, they have not received as much as they would have received in liquidation) or if there is evidence of fraud in the approval process. In addition, some laws may give the court the authority to reject a plan on the grounds that it is not feasible. This may be justified, for example, where secured creditors are not bound by the plan but the plan does not provide for full satisfaction of the secured claims of these creditors. In these cases, the court may reject the plan if it considers that secured creditors will exercise their rights against the collateral and that such an event will render the plan nonviable. The risk of this occurring is quite limited, however, if a qualified and independent administrator has been involved in the plan's preparation and approval. In such circumstances, the court would normally be expected to approve a plan that has been approved by the requisite majority of creditors.

After the approval of the plan by the court, several countries permit the court to authorize continued supervision of the affairs of the debtor, to varying degrees, by a supervisor or administrator after the confirmation of the plan.

Principal Conclusions

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

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

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

Proceedings: Other Issues

Chapter 3 identified a number of issues that need to be addressed when considering the design of effective liquidation procedures. These issues are all also relevant in rehabilitation procedures. If they are resolved in a manner that enables an administrator to maximize the value of the assets of the estate prior to liquidation, this will increase the chances of an effective rehabilitation. This section summarizes those issues that merit special attention in the context of rehabilitation. It also discusses issues relating to the treatment of post-commencement financing, which is critical to an effective rehabilitation proceeding, and briefly discusses the benefits of pre-negotiated and prepackaged bankruptcy procedures.

Treatment of Encumbered Assets and Secured Creditors

A rehabilitation procedure will not be effective unless it provides for a stay on the ability of secured creditors to exercise their rights with respect to the encumbered assets. Such a stay ensures that continuation of the enterprise is not prevented by the ability of a secured creditor to dismember the enterprise. While a stay under the rehabilitation procedure is of considerable importance and, unlike in the case of liquidation, should be in place throughout the proceedings, this does not diminish the need to ensure that the interests of secured creditors are adequately protected during the period of the stay. Although a liquidation proceeding will often normally run its course relatively quickly, a rehabilitation proceeding may be protracted. During this period, the value of the secured creditor's collateral could depreciate significantly and the ability of the administrator to provide adequate protection may become more limited. In these circumstances, it is imperative that the secured creditor be given an opportunity to request relief from the stay. The imposition of time limits with respect to the duration of the rehabilitation proceedings may also be of assistance in this regard.

Principal Conclusions

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

Avoidance of Pre-Commencement Transfers and Transactions

Avoidance powers will be of considerable benefit to an enterprise that is utilizing the rehabilitation procedure. However, the considerations identified in Chapter 3 regarding the drawbacks of avoidance powers are also of relevance when considering the costs and benefits of these powers in rehabilitation procedures. One issue peculiar to rehabilitation arises when the debtor retains total control over the operation of the enterprise during the rehabilitation proceedings and an administrator is not appointed. In these circumstances, creditors may need to be given the power to request the court to avoid pre-commencement transactions since the debtor may be reluctant to avoid a transaction where it has a conflict of interest--because, for example, the transfer is made to an insider. This may not be satisfactory, however, and argues further for the appointment of an administrator in the context of rehabilitation, particularly if there has been considerable lending among related entities and allegations of fraud taking place prior to the commencement of the insolvency procedure.

Principal Conclusions

> The existence of avoidance provisions is a critical component of rehabilitation proceedings. The application of such proceedings

> may be more effective in circumstances where an independent administrator has been appointed.

Treatment of Contracts

As noted in Chapter 3, a number of particularly difficult policy choices need to be made when assessing the treatment of contracts under a liquidation procedure, particularly in the area of continuation. In some respects, these choices become even more stark in the context of rehabilitation. Specifically, if a country does not provide for the nullification of contract termination clauses upon the commencement of rehabilitation, it will be more difficult for the enterprise to rehabilitate if the contracts in question are critical, such as lease agreements. With respect to the powers to discontinue contracts, the treatment of labor contracts will take on particular importance. In liquidation, the rejection of labor contracts is not particularly relevant, unless the enterprise is being sold as a going concern. In rehabilitation, however, the ability of the debtor to terminate such contracts may, in and of itself, provide a motive for commencing rehabilitation proceedings, and countries may find it necessary to impose limits in this respect.

Principal Conclusions

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

Post-Commencement Financing

In liquidation proceedings, it may be necessary to continue to operate the business for a temporary period and, for that purpose, the liquidator may need to obtain credit, which would be treated as an administrative expense. The continued operation of the business is critical for rehabilitation and it is therefore important that the law contain provisions that empower the administrator to obtain credit for that purpose. The central issue is the breadth of that power or, more specifically, the range of inducements that the administrator can offer a potential creditor as a means of obtaining credit.

It is generally accepted that the administrator can obtain unsecured credit without creditor or court approval, and that such credit will be treated as an administrative expense. In cases where the credit is not made in the ordinary course of business, some countries will require approval by the court or the creditors. Many countries also allow the administrator to obtain credit by giving a security interest on unencumbered property or a second-priority security interest on encumbered property. In addition, if these inducements are not sufficient (or are not available) to facilitate the provision of credit, some countries allow the administrator to give a creditor a "super" administrative priority; that is, a priority over other administrative creditors. An extreme approach is one that allows an administrator, when it is unable to otherwise obtain credit, to grant a post-petition creditor a "super" priority security interest, namely, a priority that is senior to existing liens. However, such an approach risks hampering the extension of secured credit and, therefore, is not recommended.

Principal Conclusions

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

Prepackaged and Pre-Negotiated Rehabilitation Plans

As a means of enhancing the efficiency of the rehabilitation process, some countries permit the approval of "prepackaged" rehabilitation plans. In these cases, both the negotiation and voting for the plan take place prior to commencement of the rehabilitation procedure and court approval is sought immediately upon commencement. As a variation to this approach, the plan can be negotiated prior to commencement but formal voting takes place once the proceedings have commenced. While the former approach will normally require the adoption of specific rules (either in the legislation or in the regulations), the latter will not.

The advantages of prepackaged and pre-negotiated plans are important. In effect, this technique draws upon the most significant advantage of a court-approved rehabilitation--the ability to impose a plan on dissenting creditors--but, at the same time, seeks to benefit from the efficiency of the informal process. From a debtor's perspective, it provides certainty with respect to its retention of control of the enterprise and, overall, minimizes the disruption of the business. In circumstances where the capacity of the institutional infrastructure is limited, shortening the amount of time spent in formal proceedings is particularly important. Of course, the most significant limitation of this technique is that it does not provide the debtor with any protection (i.e., the stay) while it conducts negotiations with its creditors.

Principal Conclusions

> To enhance the efficiency of the rehabilitation process, the law should allow for the approval by the court of rehabilitation plans that have been voted upon (or, at a minimum, negotiated) before commencement of the rehabilitation proceedings.

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5 Institutions and Participants

Creditors

Given that creditors are key beneficiaries of the insolvency process, the law should be designed and implemented in a manner that enables them to play an active role in this process. They should normally be the decision makers in a number of key areas. For example, during liquidation proceedings, it is advisable that creditors be given the authority to dismiss the liquidator (discussed below), approve the temporary continuation of the business by the liquidator, and approve a private sale. In rehabilitation proceedings, they should normally have the authority to dismiss the administrator and propose and approve a rehabilitation plan. In addition, the law should give them a role in requesting or recommending action from the court, including, for example, a recommendation that the rehabilitation proceedings be converted to liquidation. Giving creditors an active role in the process is particularly important when the institutional framework is relatively underdeveloped. Creditors will lose confidence in the process if all of the key decisions are made by individuals that are perceived as having limited expertise or independence.

Whatever role is provided for creditors under the law, they will only be able to fulfill this role in an effective manner if the proceedings are actually conducted in a transparent manner. It is therefore imperative that they receive adequate notice of important meetings and decisions and that they receive sufficient information to make fully informed decisions. Given the increasing number of insolvency proceedings involving nonlocal creditors, it is advisable for the law to allow for voting to take place by mail or proxy.

In cases where there are a large number of creditors, the creation of a creditors' committee that will act on behalf of creditors provides for coherence and efficiency in the process. The law should normally allow for the creation of such committees and provide that their costs will be borne by the estate. For the benefit of all participants, it is advisable for the court to have the authority to limit excessive costs incurred by the committee so as to preclude any abuse by or proliferation of professional advisors.

Although a creditors' committee plays only an advisory role in the decision-making process (they normally are not given the legal authority to take major decisions on behalf of all creditors), such a role can, as a matter of practice, be very important. The creditors' committee will normally make recommendations to creditors on how to make key decisions (e.g., approval of a plan) and will also make recommendations to the court as to how it should decide on important matters. Although the court should listen to all creditors before making its decision, considerable weight will normally be given to the committee's views.

In addition to facilitating the decision-making process, an effective creditors' committee can play an important role in the negotiation of a rehabilitation plan. Experience demonstrates that, in circumstances where there are a large number of creditors with divergent interests, one of the critical stumbling blocks is the resolution of inter-creditor issues. The creation of a creditors' committee with a single financial advisor can greatly facilitate the resolution of those issues. One of the financial advisor's principal roles will be to forge creditor agreement on the features of the plan. A committee can also assist in increasing the flow of information. Debtors may be much more willing to provide particularly confidential information to a small committee rather than the full body of creditors, particularly where the committee members have signed confidentiality agreements.

For a creditors' committee to play the above role, it is important to avoid creating a multiplicity of committees. At the same time, it will be difficult to create a small and manageable committee if there are many creditors with divergent interests. Although the value of a creditor's claim should be taken into consideration for the purpose of determining who should serve on the committee, that should not be the exclusive consideration. The chances of a successful rehabilitation increase to the extent that a plan attempts to capitalize on the different economic interests of creditors. For this reason, it is important that the makeup of the committee reflect these interests. Thus, for example, it may be useful to include in the committee creditors such as bond holders, employees, financial institutions, and trade creditors.[10]

Principal Conclusions

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

The Liquidator and the Administrator

The liquidator and the administrator play a central role in the effective implementation of the law. Although their respective roles differ substantially, they are similar in one important respect. As court-appointed officials, they have an obligation to ensure that the law is applied effectively and impartially. Moreover, since they normally have the most information regarding the circumstances of the debtor, they are in the best position to make informed decisions. That does not mean, however, that they are a substitute for the court: due process requires that a dispute between the liquidator and an interested party be adjudicated by a court of competent jurisdiction. Even in countries where there are serious problems with the capacity of the judiciary, there is a limit to the amount of authority that the law can confer upon these officers.

Qualifications and Appointment

To what extent should the liquidator and the administrator be required to have different qualifications? On one level, their roles would appear different: a liquidator manages, collects, and distributes assets, which may require an accounting background, while an administrator supervises the operation of a business, making recommendations on viability and, perhaps, preparing a plan, which may require a management/business background. In fact, however, the qualifications are essentially the same: a knowledge of the law, impartiality, and adequate experience in commercial and financial matters. If specialized knowledge is needed in the management of a particular business, the administrator can always hire experts. To ensure expertise and integrity, consideration can be given to establishing qualifications on the basis of a self-regulatory licensing system. Both the liquidator and the administrator should be appointed by the court. It is generally recommended that this appointment be derived from a list of eligible candidates, which can be provided by the self-regulatory organization if one exists. To avoid collusion, appointment should be precluded when there is any evidence of a conflict of interest arising from a preexisting relationship with the debtor, a creditor, or a member of the court.

Dismissal

The law should permit the liquidator or administrator to be dismissed on the basis of either a decision taken by a majority of unsecured creditors or a decision of the court, acting on its own motion or at the request of any party in interest. In the latter case, the court's decision should normally be based upon a determination that the liquidator has violated its legal duties. In contrast, dismissal by the creditors should not normally require any justification, although the law may specify that such removal without cause be made within a specified period after commencement.

Remuneration

A variety of approaches can be used when calculating fees--for example, on an hourly basis or as a percentage of the distribution to unsecured creditors (in liquidation) or assets of the enterprise (in rehabilitation). Whichever approach is followed, it is critical that it be transparent and that creditors be made aware of the method of calculation from the beginning of the proceedings. Leaving the determination of fees to the exclusive discretion of the court should be avoided.

Liability

As a court-appointed official, the liquidator and the administrator owe a duty of care to all parties in interest and therefore can be liable to all these parties for a violation of this duty. What standard of care is owed to these parties? As a general matter, the standard should not be stricter than that of negligence, a standard that will take into consideration the difficult circumstances in which a liquidator or administrator finds itself when it is fulfilling its duties. A stricter standard would make it difficult to attract qualified professionals. It should be noted that a liquidator or administrator's liability can be effectively reduced by obtaining advance approval of creditors before the making of any key decisions (e.g., the continuation of the business during liquidation).

Principal Conclusions

Given the central role that a liquidator and an administrator play in insolvency proceedings, it is important that they have an adequate knowledge of the law and sufficient experience in commercial and financial matters. To ensure that these officials have adequate integrity and expertise, countries may wish to consider establishing some form of self-regulatory licensing system.

The court should have the authority to appoint the liquidator or administrator. The law should determine the conditions under

> which these officials can be dismissed by either the court or a majority of unsecured creditors.
>
> While a variety of methods can be used to determine the remuneration of a liquidator or administrator, it is important that the method chosen be transparent and that creditors be made aware of this method from the beginning of the proceedings.
>
> As court-appointed officials, liquidators and administrators have an obligation to ensure that the law is applied effectively and impartially. Accordingly, they owe a duty of care to all parties in interest and should be personally liable to all these parties for a violation of this duty. As a general matter, the duty of care should be considered violated only in cases of negligence.

The Court

Throughout this report, it has been noted that an insolvency law will be effective only if the judiciary has sufficient capacity to implement it. Although discussion of the means by which this capacity can be enhanced is beyond the scope of this study, set forth below are several issues that are of general relevance when considering the relationship between the capacity of the judiciary and the design of an insolvency law.

Exercise of Discretion

Irrespective of the quality of the judiciary, all insolvency laws should provide adequate guidance as to how a court should exercise its discretion when making a determination on matters that involve economic or commercial issues. This is essential if the law is to be predictable. When the capacity of the judiciary is limited, consideration may also need to be given to actually eliminating the role of the judge entirely when determinations are made regarding the viability of the enterprise. For example, any authority of the court to overrule the creditors' views on such matters should be treated very cautiously. Moreover, consideration can also be given to allowing the specified period of the rehabilitation proceedings to be extended only upon a vote of the creditors.

Because an insolvency proceeding is a judicial proceeding, there are, however, important limits to how much the court's role can be diminished. A party in interest cannot be denied an opportunity to appear before the court if it feels that its rights are not being adequately protected. Moreover, there are certain key decisions (e.g., the decision to commence proceedings) that can only be made by the court. Accordingly, if the capacity of the court system is constrained, efforts will need to be made to improve it; one cannot design an insolvency law in a manner that circumvents the judiciary.

Efficiency

An insolvency proceeding is a dynamic process. Unlike many other adjudicative proceedings, which involve an inquiry into historical events, an insolvency proceeding takes place in "real time": delays in a court's adjudication can have an adverse effect on the value of the assets or the viability of the enterprise. It is therefore critical that procedures be put in place to ensure that hearings can be held quickly and that decisions are rendered soon thereafter. Similarly, it is critical that an accelerated appeal process be available. In any event, during the period of appeal, the lower court's decision should normally continue to be binding.

Specialization

In light of the need to ensure efficiency and the proper exercise of discretion, a number of countries have established specialized courts, in the form of either bankruptcy courts or commercial courts. The judges appointed to these courts often have received special training and, in some cases, these judges are actually selected from the business world. If such an approach is followed, it is important that the relevant law give the court exclusive subject matter jurisdiction over all or most of the matters that may have an impact on the estate, for example, the liquidator's pursuit of a contractual claim of the debtor against a third party. If there are exceptions to this general rule they should be limited and specified--for example, disputes over ownership of real property and tort claims.

Principal Conclusions

To ensure that an insolvency law is applied with predictability, the law should provide adequate guidance on how the court should exercise its discretion, particularly when the court's decision involves an assessment of economic and commercial issues.

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

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

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6 Cross-Border Insolvency Issues

The differences in national insolvency laws have important consequences in the case of enterprises with assets and liabilities in different countries. If a branch of an enterprise located in one country becomes insolvent, should creditors in that country be allowed to initiate insolvency proceedings while the enterprise as a whole is still solvent? If the enterprise as a whole is insolvent, should there be separate proceedings in the various countries where its branches are located? This approach is referred to as the "territorialist principle." Alternatively, should there be a single procedure, based in the country where the head office or place of incorporation is situated? This approach is referred to as the "universalist principle." Should there be a single liquidator or administrator, or one for each country where the enterprise has a place of business or assets? Should the liquidator or administrator appointed in one country be able to recapture assets fraudulently transferred by the debtor to another country? A review of national laws finds that countries take divergent positions on these issues.

From a practical standpoint, this diversity of approaches creates considerable uncertainty and undermines the effective application of national insolvency laws in an environment where cross-border activities are becoming a major component of the business of large enterprises. For this reason, a number of initiatives have been undertaken to improve recognition of foreign proceedings and cooperation in this area. For example, in November 1995 the text of the European Union Convention on Insolvency Procedures was adopted. This Convention sets forth rules for the treatment of insolvencies where the debtor has an establishment or assets in more than one state, including rules on choice of law, cooperation between courts, and the recognition of foreign judicial decisions and orders. The Convention has not been ratified by all members and its prospects for entry into force are still uncertain. In addition, the International Bar Association's Insolvency and Creditor's Rights Committee (known as Committee J) has developed the Cross-Border Insolvency Concordat, which is also designed to provide a framework for cooperation in multijurisdictional insolvencies.

A particularly important development in this area is the 1997 Model Law on Cross-Border Insolvency by the UN Commission on International Trade Law (UNCITRAL), negotiated among more than 40 countries representing a broad spectrum of differing legal systems. One of the distinguishing features of this model law is that it attempts to achieve limited but effective cooperation, compatible with all legal systems and, therefore, acceptable to all countries. Its goals are to ensure cooperation in cross-border insolvency cases through recognition of foreign decisions and access of foreign liquidators or administrators to local court proceedings. A Note on the Model Law, provided by the UNCITRAL Secretariat, comprises the Appendix to this report.

Principal Conclusions

> In light of the growing importance of cross-border insolvencies, measures should be introduced to facilitate the recognition of foreign proceedings and the cooperation and coordination among courts and administrators of different countries. The adoption by countries of the Model Law on Cross-Border Insolvency prepared by UNCITRAL would provide an effective means of achieving these objectives.

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[1]Such measures can include, for example, direct subsidies, concessional loans, procurement contracts, tax rebates and deferrals, early retirement schemes, and equity participation.

[2]As local governments are usually vested with powers (e.g., taxation) that provide a source of income but that cannot be transferred to their creditors, a special regime normally provides for a restructuring of their liabilities, but not a liquidation of such entities.

[3]As will be discussed in the subsection of chapter 4 entitled "The Commencement Criterion," countries that rely on unitary proceedings may also allow a debtor (but not the creditor) to initiate the proceedings even before the debtor has ceased making payments generally.

[4]Such a valuation being made on the basis of a liquidation sale and on the assumption that the enterprise cannot continue without rehabilitation or new financing.

[5]An important exception to this rule is foreign tax claims, which are normally not enforced in the

local courts.

[6]If such an approach is adopted, the moment of commencement would continue to be the point at which the exchange rate would be fixed for purposes of calculating voting.

[7]In its recent work, the IMF has found that, in some countries, the company law restricts debt-for-equity conversions, even when shareholder consent to such a conversion has been given.

[8]Some countries also allow for the creation of different classes of secured creditors on the basis that, depending on the nature of their claims, they may have different economic interests from each other.

[9]For this purpose, seniority is based on the ranking applicable in liquidation (secured creditors, priority creditors, general unsecured creditors, subordinated creditors).

[10]Since the interests of secured creditors are fully protected under law and cannot be impaired, it is not necessary to include them on the committee.

Appendix

UNCITRAL Model Law on Cross-Border Insolvency

(Information note prepared by the UNCITRAL Secretariat)

I. PURPOSE OF THE MODEL LAW

1. The UNCITRAL Model Law on Cross-Border Insolvency, adopted in 1997 by the United Nations Commission on International Trade Law (UNCITRAL), is designed to assist States to equip their insolvency laws with a modern, harmonized and fair framework to address more effectively and efficiently instances of cross-border insolvency.

2. The instances of cross-border insolvency to which the Model Law applies are those where the insolvent debtor has assets in more than one State or where some of the creditors of the debtor are from a State other than the State where the insolvency proceeding is taking place.

3. The Model Law respects the differences among national procedural laws and does not attempt a substantive unification of insolvency law. It offers solutions that help in several modest, but nonetheless significant ways. With its scope limited to some procedural aspects of cross-border insolvency cases, the Model Law is intended to operate as an integral part of the existing insolvency law in the enacting State.

4. By enacting the Model Law, the State would:

- provide access for the person administering a foreign insolvency proceeding ("foreign representative") to the courts of the enacting State, thereby permitting the foreign representative to seek a temporary "breathing space," and allowing the courts in the enacting State to determine what coordination among the jurisdictions or other relief is warranted for optimal disposition of the insolvency;

- determine when a foreign insolvency proceeding should be accorded "recognition," and what the consequences of recognition may be;

- provide a transparent regime for the right of foreign creditors to commence, or participate in, an insolvency proceeding in the enacting State;

- permit courts in the enacting State to cooperate more effectively with foreign courts and foreign representatives involved in an insolvency matter;

- authorize courts in the enacting State and persons administering insolvency proceedings in the enacting State to seek assistance abroad;

- provide for court jurisdiction and establish rules for coordination where an insolvency proceeding in the enacting State is taking place concurrently with an insolvency proceeding in a foreign State;

- establish rules for coordination of relief granted in favour of two or more insolvency proceedings that take place in foreign States regarding the same debtor.

5. Together with the Model Law, the Secretariat of the Commission has published a Guide to Enactment so as to assist legislators in preparing national legislative revisions and to provide insight to other users of the text, such as judges and insolvency practitioners.

II. BACKGROUND

6. The increasing incidence of cross-border insolvencies reflects the continuing global expansion of trade and investment. However, national insolvency laws have by and large not kept pace with this trend, and are often ill-equipped to deal with cases that involve cross-border insolvency. This frequently results in inadequate and non-harmonious legal approaches that hamper the rescue of financially troubled businesses, are not conducive to a fair and efficient administration of cross-border insolvencies, impede the protection of the assets of the insolvent debtor against dissipation, and hinder maximization of the value of those assets. Moreover, the absence of predictability in the handling of cross-border insolvency cases impedes capital flow and is a disincentive to cross-border investment.

7. An increasing problem, both in terms of frequency and magnitude, is fraud by insolvent debtors, in particular through means such as concealment of assets or transfer of assets to foreign jurisdictions. The modern interconnected world makes such fraud easier to conceive and carry out. The mechanisms for cross-border cooperation established by the Model Law are designed to confront such international fraud.

8. To the extent that there is a lack of communication and coordination among courts and administrators from those jurisdictions concerned, it is more likely that assets will be dissipated, fraudulently concealed, or possibly liquidated. By contrast, mechanisms in national legislation for coordinated administration of cases of cross-border insolvency make it possible to adopt solutions that are sensible and in the best interest of the creditors and the debtor; the presence of such mechanisms in the law of a State are therefore perceived as advantageous for foreign investment and trade in that State.

III. THE MODEL LAW APPROACH AS A VEHICLE FOR THE HARMONIZATION OF LAWS

9. A model law is a legislative text that is recommended to States for incorporation into their respective national laws. Unlike an international

convention, a model law does not require the enacting State to notify the United Nations or other States that may have also enacted it.

10. In incorporating the text of a model law into its system, the enacting State is free to modify or leave out some of the model provisions. Some modifications may be expected, in particular where the uniform text needs to be adapted to the national court and procedural system. In order to achieve a satisfactory degree of harmonization and certainty, however, it is recommended that States make as few changes as possible when incorporating a model law into their respective legal system.

IV. MAIN FEATURES OF THE MODEL LAW

A. Scope of Application

11. The Model Law applies in a number of cross-border insolvency situations. These include: (a) an inward-bound request for recognition of a foreign proceeding; (b) an outward-bound request from a court or administrator in the enacting State for recognition of an insolvency proceeding commenced under the laws of the enacting State; (c) coordination of concurrent proceedings in two or more States; and (d) participation of foreign creditors in insolvency proceedings taking place in the enacting State (art. 1).

B. Types of Foreign Proceedings Covered

12. To fall within the scope of the Model Law, a foreign insolvency proceeding needs to possess certain attributes. It should have its basis in insolvency-related law of the originating State, involve creditors collectively, provide for control or supervision of the assets and affairs of the debtor by a court or another official body, and reorganization or liquidation of the debtor should be the purpose of the proceeding (art. 2(a)).

13. Within those parameters, a variety of collective proceedings would be eligible for recognition, whether compulsory or voluntary, corporate or individual, whether for the purpose of winding-up or reorganization or those in which the debtor retains some measure of control over its assets, albeit under court supervision (e.g., suspension of payments; "debtor in possession").

14. An inclusive approach is used also as regards the possible types of debtors covered by the Model Law. Nevertheless, the Model Law refers to the possibility of excluding from its scope of application certain types of entities, such as banks or insurance companies specially regulated with regard to insolvency under the laws of the enacting State (art. 1(2)).

C. Foreign Assistance for an Insolvency Proceeding Taking Place in the Enacting State

15. In addition to equipping the courts of the enacting State to deal with incoming requests for recognition, the Model Law authorizes the courts of the enacting State to seek assistance abroad on behalf of a proceeding taking place in the enacting State (art. 25). Provisions that grant authorization for the courts of the enacting State to seek cooperation abroad may help to fill a gap in legislation in some States. Without such legislative authorization, in some legal systems, the courts feel constrained from seeking such assistance abroad, which creates potential

obstacles to a coordinated international response in case of cross-border insolvency.

16. Similarly, the Model Law may help an enacting State to fill a gap in its legislation as to the "outward" powers of persons appointed to administer insolvency proceedings under the local insolvency law. Article 5 authorizes those persons to seek recognition of, and assistance for, those proceedings from foreign courts.

D. Foreign Representative's Access to Courts of the Enacting State

17. An important objective of the Model Law is to provide expedited and direct access for foreign representatives to the courts of the enacting State. The Model Law avoids the need to rely on cumbersome and time-consuming letters rogatory or other forms of diplomatic or consular communications, which might otherwise be required. This facilitates a coordinated, cooperative approach to cross-border insolvency and enables fast action when necessary.

18. In addition to establishing the principle of direct court access for the foreign representative, the Model Law:

?? establishes simplified proof requirements for seeking recognition and relief for foreign proceedings, which avoid time-consuming "legalization" requirements involving notarial or consular procedures (art. 15);

?? provides that the foreign representative has procedural standing for commencing an insolvency proceeding in the enacting State (under the conditions applicable in the enacting State) and that the foreign representative may participate in an insolvency proceeding in the enacting State (arts. 11 and 12);

?? subject to other requirements of the enacting State, confirms access by foreign creditors to the courts of the enacting State for the purpose of commencing in the enacting State an insolvency proceeding or participating in such a proceeding (art. 13);

?? gives the foreign representative the right to intervene in proceedings in the enacting State where such proceedings concern individual actions affecting the debtor or its assets (art. 24);

?? provides that the mere fact of a petition for recognition in the enacting State does not mean that the courts in that State have jurisdiction over all the assets and affairs of the debtor (art. 10).

E. Recognition of Foreign Proceedings

(a) Decision whether to recognize a foreign proceeding

19. The Model Law establishes criteria for determining whether a foreign proceeding is to be recognized (arts. 15-17) and provides that, in appropriate cases, the court may grant interim relief pending a decision on recognition (art. 19). The decision includes a determination whether the jurisdictional basis on which the foreign proceeding was commenced was such that it should be

recognized as a "main" or instead as a "non-main" foreign insolvency proceeding. Procedural matters related to notice of the filing of an application for recognition or of the decision to grant recognition are not addressed by the Model Law; they remain to be governed by other provisions of law of the enacting State.

20. A foreign proceeding is deemed to be the "main" proceeding if it has been commenced in the State where "the debtor has the centre of its main interests." This corresponds to the formulation in the European Union Convention on Insolvency Proceedings (art. 3 of that Convention), thus building on the emerging harmonization as regards the notion of a "main" proceeding. The determination that a foreign proceeding is a "main" proceeding may affect the nature of the relief accorded to the foreign representative.

(b) Effects of recognition and discretionary relief available to a foreign representative

21. Key elements of the relief accorded upon recognition of the representative of a foreign "main" proceeding include a stay of actions of individual creditors against the debtor or a stay of enforcement proceedings concerning the assets of the debtor, and a suspension of the debtor's right to transfer or encumber its assets (art. 20(1)). Such stay and suspension are "mandatory" (or "automatic") in the sense that either they flow automatically from the recognition of a foreign main proceeding or, in the States where a court order is needed for the stay or suspension, the court is bound to issue the appropriate order. The stay of actions or of enforcement proceedings is necessary to provide a "breathing space" until appropriate measures are taken for reorganization or fair liquidation of the assets of the debtor. The suspension of transfers is necessary because in the modern, globalized economic system it is possible for multi-national debtors to move money and property across boundaries quickly. The mandatory moratorium triggered by the recognition of the foreign main proceeding provides a rapid "freeze" essential to prevent fraud and to protect the legitimate interests of the parties involved until the court has an opportunity to notify all concerned and to assess the situation.

22. Exceptions and limitations to the scope of the stay and suspension (e.g. exceptions for secured claims, payments by the debtor made in the ordinary course of business, set-off, execution of rights *in rem*) and the possibility of modifying or terminating the stay or suspension are determined by provisions governing comparable stays and suspensions in insolvency proceedings under the laws of the enacting State (art. 20(2)).

23. In addition to such mandatory stay and suspension, the Model Law authorizes the court to grant "discretionary" relief for the benefit of any foreign proceeding, whether "main" or not (art. 21). Such discretionary relief may consist of, for example, staying proceedings or suspending the right to encumber assets (to the extent such stay and suspension have not taken effect automatically under art. 20), facilitating access to information concerning the assets of the debtor and its liabilities, appointing a person to administer all or part of those assets, and any other relief that may be available under the laws of the enacting State. Urgently needed relief may be granted already upon filing an application for recognition

(art. 21).

(c) Protection of creditors and other interested persons

24. The Model Law contains provisions, such as the following, which protect the interests of the creditors (in particular, local creditors), the debtor and other affected persons: the availability of temporary relief upon application for recognition of a foreign proceeding or upon recognition is subject to the discretion of the court; it is expressly stated that in granting such relief the court must be satisfied that the interests of the creditors and other interested persons, including the debtor, are adequately protected (art. 22(1)); the court may subject the relief it grants to conditions it considers appropriate; and the court may modify or terminate the relief granted, if so requested by a person affected thereby (art. 22(2) and (3)).

25. In addition to those specific provisions, the Model Law in a general way provides that the court may refuse to take an action governed by the Model Law if the action would be manifestly contrary to the public policy of the enacting State (art. 6).

26. Questions of notice to interested persons, while closely related to the protection of their interests, are in general not regulated in the Model Law. Thus, these questions are governed by the procedural rules of the enacting State, some of which may be of a public-order character. For example, the law of the enacting State will determine whether any notice is to be given to the debtor or another person of an application for recognition of a foreign proceeding and the time period for giving the notice.

F. Cross-border Cooperation

27. A widespread limitation on cooperation and coordination between judges from different jurisdictions in cases of cross-border insolvency is derived from the lack of a legislative framework, or from uncertainty regarding the scope of the existing legislative authority, for pursuing cooperation with foreign courts.

28. Experience has shown that, irrespective of the discretion courts may traditionally enjoy in a State, existence of a specific legislative framework is useful for promoting international cooperation in cross-border cases. Accordingly, the Model Law fills the gap found in many national laws by expressly empowering courts to extend cooperation in the areas governed by the Model Law (arts. 2527).

29. For similar reasons, provisions are included authorizing cooperation between a court in the enacting State and a foreign representative, and between a person administering the insolvency proceeding in the enacting State and a foreign court or a foreign representative (art. 26).

30. The Model Law lists possible forms of cooperation and provides the legislator with an opportunity to list additional forms (art. 27). It is advisable to preserve the list as an illustrative rather than an exhaustive list, when it is enacted, so as not to stymie the ability of courts to fashion remedies specific to the circumstances of each case.

G. Coordination of Concurrent Proceedings

(a) Jurisdiction to commence a local proceeding

31. The Model Law imposes virtually no limitations on the jurisdiction of the courts in the enacting State to commence or continue insolvency proceedings. Pursuant to article 28, even after recognition of a foreign "main" proceeding, jurisdiction remains with the courts of the enacting State to institute an insolvency proceeding if the debtor has assets in the enacting State. If the enacting State wishes to restrict its jurisdiction to those cases where the debtor has, in addition to assets, also an establishment in the enacting State, the adoption of such a restriction would not be contrary to the policy underlying the Model Law.

32. In addition, the Model Law deems the recognized foreign main proceeding to constitute proof that the debtor is insolvent for the purposes of commencing local proceedings (art. 31). This rule would be helpful in those legal systems in which commencement of an insolvency proceeding requires proof that the debtor is in fact insolvent. Avoidance of the need for repeated proof of financial failure reduces the likelihood that a debtor may delay the commencement of the proceeding long enough to conceal or carry away assets.

(b) Coordination of relief when more than one proceeding take place concurrently

33. The Model Law deals with coordination between a local proceeding and a foreign proceeding concerning the same debtor (art. 29) and facilitates coordination between two or more foreign proceedings concerning the same debtor (art. 30). The objective of the provisions is to foster coordinated decisions that would best achieve the objectives of both proceedings (i.e., maximization of the value of the debtor's assets or the most advantageous restructuring of the enterprise). In order to achieve satisfactory coordination and to be able to adapt relief to changing circumstances, the court is covered by the Model Law in all situations, including those which limit the effects of foreign proceedings in the face of local proceedings that are directed to cooperate to the maximum extent possible with foreign courts and the foreign representatives (arts. 25 and 30).

34. When the local insolvency proceeding is already underway at the time that recognition of a foreign proceeding is requested, the Model Law requires that any relief granted for the benefit of the foreign proceeding must be consistent with the local proceeding. Furthermore, the existence of the local proceeding at the time the foreign main proceeding is recognized prevents the operation of article 20. When there is no local proceeding pending, article 20 mandates the stay of individual actions or enforcement proceedings against the debtor and a suspension of the debtor's right to transfer or encumber its assets.

35. When the local proceeding begins subsequent to recognition or application for recognition of the foreign proceeding, the relief that has been granted for the benefit of the foreign proceeding must be reviewed and modified or terminated if inconsistent with the local proceeding. If the foreign proceeding is a main proceeding, the stay and a suspension, as mandated by article 20, must also be modified or terminated if inconsistent with the local proceeding.

36. When the court is faced with more than one foreign proceeding, article 30 calls for tailoring relief in such a way that will facilitate coordination of the foreign

proceedings; if one of the foreign proceedings is a main proceeding, any relief must be consistent with that main proceeding.

37. Coordination of concurrent proceedings is also enhanced by the rule on rate of payment of creditors (art. 32). It provides that a creditor, by claiming in more than one proceeding, does not receive more than the proportion of payment that is obtained by other creditors of the same class.

V. ASSISTANCE FROM THE UNCITRAL SECRETARIAT

38. The UNCITRAL Secretariat will assist States that request technical consultations for the preparation of legislation based on the Model Law. Further information may be obtained from the UNCITRAL Secretariat, Vienna International Centre, P.O. Box 500, A-1400 Vienna, Austria; telephone (43-1) 26060-4060; fax (43-1) 26060-5813; electronic mail: uncitral@unov.un.or.at; Internet home page: http://www.un.or.at/uncitral.

VI. LEGISLATIVE HISTORY OF THE MODEL LAW

39. The project that culminated in the Model Law on Cross-Border Insolvency was initiated in UNCITRAL in close cooperation with the International Association of Insolvency Practitioners (INSOL) and benefited from its expert advice during all stages of the preparatory work. Active consultative assistance during the formulation of the Model Law was received also from Committee J (Insolvency) of the Section on Business Law of the International Bar Association (IBA).

40. Prior to the decision by the Commission to undertake work on cross-border insolvency, UNCITRAL and INSOL held two international colloquia of insolvency practitioners, judges, government officials and representatives of other interested sectors.[1] The suggestion arising from those meetings was that work by the Commission should have the limited but useful goal of facilitating judicial cooperation, court access for foreign insolvency administrators and recognition of foreign insolvency proceedings.

41. When the Commission decided in 1995 to develop a legal instrument relating to cross-border insolvency, it entrusted this task to the Working Group on Insolvency Law, one of the Commission's three inter-governmental subsidiary bodies.[2] The Working Group devoted four two-week sessions to the project.[3]

42. Before the session of the Commission in May 1997, at which the Model Law was adopted, another international meeting of practitioners was held to discuss the draft text as prepared by the Working Group. The participants (mostly judges, judicial administrators and government officials) generally considered that the model legislation, when enacted, would constitute a major improvement in dealing with cross-border insolvency cases.[4]

43. The final negotiations on the draft text took place during the thirtieth session of the Commission (Vienna, Austria, 12-30 May 1997) and the Model Law was adopted by consensus on 30 May 1997.[5] In addition to the 36 States members of the Commission, representatives of 40 observer States and 13 international organizations participated in the deliberations of the Commission and the Working Group.

[1]The first was the UNCITRAL-INSOL Colloquium on Cross-Border Insolvency, Vienna, 1719 April 1994 (report on the Colloquium: doc. A/CN.9/398, *UNCITRAL Yearbook*, vol. XXV: 1994, part two, V, B; the proceedings of the Colloquium are published in *International Insolvency Review*, Special Conference Issue 1995, vol: 4; considerations of the Commission relating to the Colloquium: doc. A/49/17, paras. 215222, *UNCITRAL Yearbook*, vol. XXV: 1994, part one, A). Subsequently, an international meeting of judges was held specifically to elicit their views: the UNCITRAL-INSOL Judicial Colloquium on Cross-Border Insolvency, Toronto, 2223 March 1995 (report on the Judicial Colloquium: doc. A/CN.9/413, *UNCITRAL Yearbook*, vol. XXVI: 1995, part two, IV, A; considerations of the Commission relating to the Judicial Colloquium: doc. A/50/17, paras. 382393, *UNCITRAL Yearbook*, vol. XXVI: 1995, part one, A).

[2]*Official Records of the General Assembly, Fiftieth Session, Supplement No. 17* (A/50/17) (*UNCITRAL Yearbook*, vol. XXVI: 1995, part one, A), paras. 392 and 393.

[3]The eighteenth session (Vienna, 30 October 10 November 1995), report: document A/CN.9/419 (*UNCITRAL Yearbook*, vol. XXVII: 1996, part two); nineteenth session (New York, 112 April 1996), report: document A/CN-9/422 (*UNCITRAL Yearbook*, vol. XXVII: 1996, part two); twentieth session (Vienna, 718 October 1996), report: document A/CN.9/433 (*UNCITRAL Yearbook*, vol. XXVIII: 1997, part two); twenty-first session (New York, 20-31 January 1997), report: document A/CN.9/435 (*UNCITRAL Yearbook*, vol. XXVIII: 1997, part two).

[4]The Second UNCITRAL-INSOL Multinational Judicial Colloquium on Cross-Border Insolvency was held from 22 to 23 March 1997 in conjunction with the 5th World Congress of INSOL, New Orleans, 2326 March 1997. A brief account of the Colloquium appears in doc. A/52/17, paras. 1722 (*UNCITRAL Yearbook*, vol. XXVIII: 1997, part one, A).

[5]The Model Law is also published in *Official Records of the General Assembly, Fifty-second Session, Supplement No. 17* (A/52/17, annex I) (*UNCITRAL Yearbook,* vol. XXVIII: 1997, part three). The discussion at the thirtieth session concerning the Model Law is reproduced in doc. A/52/17, paras. 12225 (*UNCITRAL Yearbook,* vol. XXVIII: 1997, part one, A).