



INTERNATIONAL INSOLVENCY INSTITUTE

Twelfth Annual International Insolvency Conference

Supreme Court of France

Paris, France

RIGHTS AND ROLES OF UNSECURED CREDITORS

*DISCUSSION POINTS ON THE RIGHTS AND DUTIES OF UNSECURED CREDITORS IN
INSOLVENCY PROCEEDINGS*

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New York

June 21-22, 2012

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Introduction

Insolvency laws are designed to balance the rights and interests of the various stakeholders, including the debtor, its management, its employees, secured creditors, unsecured creditors, priority creditors and shareholders. How the scale is legislatively-balanced depends on the social, political and policy directives of the jurisdiction.

The analysis set forth below is preliminary and designed more to raise questions, rather than suggest solutions. We have started the process by conducting a survey on the relative rights and roles of unsecured creditors in different jurisdictions. There were 27 responses to the survey from 18 different jurisdictions, though not all were completed. Seventy percent of the responses were from civil law countries; thirty percent from common law countries. We would ask that those who did not complete the survey make an effort to do so. The more data we have, the more we can use it to make suggestions and discuss solutions to make the insolvency process fairer and more transparent for all constituents.

Some jurisdictions, such as the United States, have a well-defined statutory system where creditors' committees are appointed, paid for by the insolvent entity's estate and granted significant power and influence. However, in many other jurisdictions, especially where there is no debtor-in-possession concept, creditors are given little say because the view is that their interests are represented by the administrator or trustee. Interestingly, this view exists regardless of whether the third party administrator or trustee is put in place by a court or by the secured creditor. Sometimes practice varies by court, notwithstanding the lack of a statutory scheme. For example, in Canada, some courts take the view that because a Court-appointed officer is in charge, there is sufficient oversight and no need for creditor participation, while other courts are amenable to appointing a representative counsel. This type of flexibility is less prevalent in civil law countries where courts, regardless of their own thoughts on the subject, feel constrained by the applicable statutes.

Both UNCITRAL and the World Bank have taken the official position that creditors should be given more say in insolvency proceedings, especially in cross-border cases where there may be both language and distance barriers that effectively diminish the rights of creditors. In response to some of these concerns, unsecured creditors have been granted greater rights under the new German insolvency law that went into effect on 1 March 2012. How these changes will be implemented and what practical effect they will have on German insolvency proceedings remains to be seen.

UNCITRAL and World Bank Commentary: A Brief Summary

The UNCITRAL *Legislative Guide on Insolvency Law* (United Nations 2005) (referred to herein as “Guide”) and the World Bank *Principles for Effective Insolvency and Creditor Rights* (revised 2005) (referred to herein as “Principles”) contain numerous policy statements and concepts on the development of insolvency laws generally, and the rights of the constituents in insolvency proceedings.

Some of these are summarized below using the structural categories set out in the Guide:¹

1. Certainty and Transparency to Promote of Investment and Economic Growth (Guide Objective 1)

Insolvency laws should provide a mechanism for both the collection of debts and the rehabilitation of insolvent companies capable of continuing in operation as viable businesses. Jurisdictions that recognize the importance of these policies provide a degree of certainty that ultimately encourages economic growth through the availability of credit. *See* Guide, p. 10, Principles, p. 2.

In regards to the rights of unsecured creditors, a strong role for unsecured creditors is part of the mechanism available for enforcing debt. When the role of creditors is codified and predictable, the mechanism for enforcing debt becomes more reliable, and investments become less risky. This leads to more affordable credit for businesses, both in and outside of insolvency situations. Additionally, where the rights and roles of creditors are reliable and predictable, it becomes cost-effective for creditors to exercise their enforcement rights within the insolvency proceedings and actively participate in the proceedings. Conversely, where the role of creditors in an insolvency regime is unpredictable, investors will be hesitant to do business with entities in those jurisdictions. In Third World countries, such unwillingness creates self-perpetrating weak economic growth. Principles, pp. 2 - 5

2. Maximization of Asset Value (Guide Objective 2)

All constituents – creditors, debtors, administrators and the court – should make the maximization of asset value a priority in an insolvency proceeding or out of court restructuring scenario. *See* Guide, pp. 10-11. To the extent creditors are excluded from actively participating in the insolvency process, creditors may be incentivized not to maximize value for the whole estate, but rather to seek to protect their own interests. This may result in creditors pressuring a debtor to prefer them over other similarly situated creditors or in costly and piecemeal litigation which can deplete both parties’ limited resources. Clearly defined creditors rights and the mechanisms for enforcement of those rights increases the bargaining power of creditors, but helps avoid the costs of expensive litigation, thereby preserving the value of the estate. Where insolvency administrators are

¹ See also, Principles at pp. 11-22

highly experienced and act in the interests of creditors, a lower degree of creditor involvement may reduce costly delays and organizational expenses. Guide, p. 191. However, where administrators are perceived to be protecting only their own or secured creditors' interests, unsecured creditors are either incentivized to waste assets through litigation or simply not to participate in the process.

3. Balance between Liquidation and Reorganization (Guide Objective 3)

Insolvency proceedings must balance the perceived advantages of rapid debt collection through liquidation with the longer term benefits of a restructuring. The preservation of a business as a going concern often yields a higher return for creditors, as well as creating the economic benefits of an ongoing business and employer. As there is no crystal ball for determining when a company has crossed the line from being capable of rehabilitation to no longer being viable, statutes must be flexible in allowing conversion from one type of proceeding to another. Unsecured creditors who may be regularly involved in the business, may be a valuable resource for the appropriate timing of a conversion from restructuring to liquidation. Principles, p. 6.

There is also a stated priority of promoting out-of-court settlements or restructurings. Principles at p. 5. Out-of-court restructurings often provide higher returns to creditors, and avoid the costs and uncertainty of the legal process. An insolvency regime that has adequate creditor remedies, rights and structures, incentives creditors to work with the debtor to reach agreement without fear of reprisal or loss of rights.

4. Ensure Equitable Treatment of Similarly Situated Creditors (Guide Objective 4)

Creditors, regardless of origin, should receive treatment commensurate with their status vis-à-vis other similarly situated creditors. Foreign investors may believe that indigenous investors can manipulate local insolvency processes to their own advantage. Local creditors may benefit from fraud or favoritism. Such favoritism, whether real or perceived, negatively impacts the credibility of the insolvency system. Active creditor participation in a proceeding may alleviate or eliminate such concerns. *See also*, Principles, p. 6.

5. Timely, Efficient and Impartial Resolution of Insolvency Proceedings (Guide Objective 5)

A speedy and efficient system for resolution of an insolvency proceeding is essential to both the goal of maximizing estate value, maximizing recoveries for creditors and fostering belief in the integrity of the system. Participation of creditors in the process should be viewed as enhancing the system, rather than inhibiting it. *See also*, Principles, p. 6

6. Preservation of the Insolvency Estate to Allow Equitable Distribution to Creditors (Guide Objective 6)

This objective is, in effect, the inverse of Objective 4. Insolvency laws should prevent and discourage a “run on the bank” by individual creditors for their own benefit. Statutory avoidance proceedings discourage and sanction this behavior while a transparent, fair and equitable distribution system disincentives it.

7. Transparency and Predictability (Guide Objective 7)

Creditors must be given access to sufficient financial and operational information to enable them to both assess a borrower’s or contracting party’s credit risk at the front end of a transaction, and to enable them to adequately assess the restructuring or liquidation scenarios at the back end. Statutes should not only set out the rights and remedies of creditors, but also be applied in a predictable and transparent fashion.

8. Recognition of Existing Creditor Rights (Guide Objective 8)

Pre-insolvency contractual rights, upon which the parties relied in doing business in the first place, must be enforced in insolvency proceedings. These include the relative priorities between secured and unsecured creditors and other aspects of the commercial bargain. Social and political concerns in an insolvency should not be allowed to modify the original priorities, and exceptions, such as for employees or taxing authorities, should be clearly identified.

9. Framework for Cross-Border Insolvencies (Guide Objective 9)

A framework for addressing cross border insolvencies should be put in place effectuating the above principles. As companies become more international in scope and operation, the concepts of transparency, corporate governance, and consistent application of insolvency laws become more important.

The Guide expands on these general policy statements by creating a lengthy guideline for a statutory restructuring scheme, encompassed in which is a section on the rights of creditors. See Guide, pp 190-204, Recommendations 126-136. Section C, entitled “Creditors: participation in insolvency proceedings,” expresses a clear policy statement that creditors, as the main economic stakeholders in an insolvency proceeding, should have some type of say in the outcome of the proceedings. Similar statements are included in the Principles. The actual extent of this participating is suggested but not proscribed.

Both the Guide and the Principles are included in the materials, and make for interesting reading.

Discussion Points

Some thoughts for discussion purposes on the recommendations and the survey results are:

1. Creditors in civil law countries seem to have more rights in liquidation proceedings than in restructuring proceedings – why is this and is it necessary?
2. People seem generally happy with their systems as they exist – is that real or fear of the unknown?
3. While everyone supports the general concepts of the need for predictability and transparency, there is a concern that in practice, some administrators are more out for themselves than for protecting and getting a recovery for creditors. Yet there is also great suspicion as to the motives and capabilities of creditors, notwithstanding that they should be one of the most important constituencies in a proceeding.
4. The fact that the administrator’s fees are in the control of creditors seems to be of dubious value since how often does a creditor oppose fees of administrator if it has to pay its own way to do it and had no ability to appear in court
5. What is the real impact of a high degree of active creditor participation in the restructuring process?
6. What is real impact of low or no creditor participation in restructuring process other than to vote for or against a proposed plan
7. Cost issue: belief that increased creditor participation adds cost to the process, but that the administrative cost is offset by better results.
8. Balance the involvement of creditors against the interest in efficiency and cost-effectiveness. While both the Guide and the Principles support enhanced creditor participation and express frustration about a lack of creditor interest in participating in the process in many jurisdictions, neither take a position on who should pay for creditor participation. Does this create a somewhat self-fulfilling prophecy – if you don’t let creditors hire counsel and experts at the expense of the debtor, then they wont participate or wont be able to do so effectively.
9. What types of events should creditors have an absolute say over: appointment of the trustee or administrator, asset sales, plans of restructuring or reorganization, post-filing financing, secured creditor take back actions, compensation of officers and directors and administrators, retention of professionals, assumption and rejection of contracts, litigation as an asset of the estate? Where should the line be drawn?
10. Policy vs. Practice: what works and what does not work. Eg.:

“To the greatest extent possible, those priorities should be based upon commercial bargains and not reflect social and political concerns that have the potential to distort the

outcome of insolvency. According priority to claims that are not based on commercial bargains therefore should be minimized.” Guide, p 13.

- a. Notwithstanding that this policy has been part of the US creditor’s rights scheme, is there starting to be backlash. Are some courts now inferring bad motives on the part of, for example, certain classes of unsecured creditors such as distressed debt buyers – *GM, Chrysler, Vitro*. How does that correspond with the policy of consistent application of the law and enforcement of pre-insolvency contractual rights?
 - b. Balance consistency in the law with exceptions for public policy goals – *GM*
11. Should control of the estate go to participants who have expertise and knowledge of the debtor’s business? Creditors may best be able to give advice and guidance vis-à-vis the debtor’s business. They may also be competitors who do not have the best interests of the debtor at heart, or even care if they are repaid.
 12. Should creditors or their representative have an unlimited right to be heard or should it be limited to those issues that directly impact them? How is that determination made since arguably, the entire proceeding impacts creditors?
 13. Should judges and courts be granted a larger role to serve as the final check and balance between the rights of creditors and the other constituencies? Do judges want this role?