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Insolvency law

Possible future work in the area of insolvency law

Proposal by the International Insolvency Institute (III), Committee on
Commercial Fraud

Proposal for Study and Recommendations in the Area of Commercial Fraud

Background

1. The scale of damage done by commercial fraud is incalculable but, conservatively, losses to commercial fraud and its consequences are certainly in the trillions of Euros and dollars every year.
2. It will never be possible to eliminate commercial fraud. But it is possible to contemplate developing structures and systems that will reduce the opportunities for commercial fraud, reduce the potential rewards from fraudulent transactions and mitigate the negative consequences of fraudulent activities.
3. Commercial fraud often culminates in insolvencies or major restructurings, and one of the productive areas in which anti-fraud systems and procedures could be developed is in the area of insolvency and reorganizations. There are many advantages to focussing attention on remedies against commercial fraud in the insolvency area. Some of them would include:

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- Many countries have procedures and systems in place to deal with insolvencies and several countries are now either developing such procedures or are significantly updating such procedures;
- Insolvency is a focussed and coherent discipline where support for reforms to reduce the effects of commercial fraud would be universally supported;
- The framework of insolvency legislation is ideal for dealing with the consequences of commercial fraud. In fact, most insolvency systems already contain measures intended to limit the consequences of commercial fraud;
- Recommendations dealing with changes to discourage commercial fraud and to diminish the availability of advantages from fraudulent activity in an insolvency context could easily be built upon, incorporated into or developed as an adjunct to the *UNCITRAL Legislative Guide on Insolvency Law*;
- UNCITRAL has already had considerable success in the insolvency area with two major projects successfully completed in a very short period of time; and
- The UNCITRAL Working Group on Insolvency is a welcome example of a forum in which dozens of countries have worked together successfully for several years on important projects and share a common vision on the need for improvement in international systems and procedures. The fact that a group of this kind with this kind of background and participation is already in place would shorten the learning curve on any new project that UNCITRAL might consider in this area.

4. The III's proposal focuses on work in the insolvency area and the area of creditors' remedies with a view to creating systems and procedures that will serve as deterrents to fraudulent activity in commercial transactions. This work would not duplicate or overlap with any of the valuable work that the United Nations Office on Drugs and Crime (UNODC) is doing in this area which focuses on activities that are more in the field of criminal and quasi-criminal activity and on activities that are contrary to public order. However, criminal proceedings associated with punishment of fraudulent activities often significantly impact the insolvency process. For example, it is not uncommon for insolvency proceedings to be partially or completely suspended pending criminal investigations. Obviously, protection of the criminal process and the needs of public authorities are extremely important, however, the effect of such actions on creditors and the insolvency process can be substantial. UNCITRAL analysis of this issue could result in facilitating changes to accommodate the needs of the prosecutorial authorities while maximizing the value of the insolvent entity for the benefit of employees, creditors and other parties in interest.

5. The III suggests that UNCITRAL study the means by which insolvency legislation can be amended to create disincentives to fraudulent activity, and the use of fraudulent schemes, and to reduce the impact of fraudulent activity on creditors and other parties in interest. The III believes that this can be done through a combination of approaches to the problem. First, in the insolvency context, UNCITRAL should study how best to put in place measures that would treat creditors who participate in or facilitate fraudulent transactions on a basis that would be either subordinate to that of ordinary creditors or otherwise sufficiently unattractive that it would create a disincentive to pursue activities that are commercially

fraudulent. On the other hand, responsible commercial activities and parties should be protected from unwarranted negative consequences of engaging in transactions with fraudsters.

6. Second, UNCITRAL should study and make recommendations as to remedies in insolvency procedures and practice that would be available to either an insolvency administrator or to creditors who are willing to pursue recoveries against parties who have participated in transactions that are avoidable under domestic insolvency legislation. Activities such as insider transactions, improper payments while insolvent, and transfers at under-valuations or over-valuations would be discouraged if insolvency systems provided for sanctions against those who seek to profit from them. The obligations of parties who participate in normal commercial activities with fraudsters to discover and prevent fraud should be studied and clarified. While active participation in fraud should be discouraged, engaging in normal commercial transactions should not be condemned simply because other parties to the transactions engaged in fraudulent activities. A balance should be achieved and little analysis has been made of this issue, which is becoming common in connection with international fraudulent insolvencies. This is consistent with the *UNCITRAL Legislative Guide on Insolvency Law* which mandates that insolvency systems should discourage conduct that is preferential to one creditor over others: see Part 2, II at Paras. 148 ff., especially para. 151. The *UNCITRAL Legislative Guide* did not recommend specific measures of this kind but they would make an ideal and highly constructive topic for future work in the insolvency area and would be a valuable adjunct to the *Legislative Guide*.

7. Third, to aid in discouraging activities that are commercially fraudulent, UNCITRAL, should consider and study means by which insolvency administrators could be given enhanced recovery procedures and expedited remedies that would be effective against parties who participate in fraudulent activities. Again, virtually all insolvency systems already have provisions in place to enhance recoveries by insolvency administrators from parties who have engaged in improper transactions with the debtor prior to its insolvency but many of these provisions are difficult to enforce in the event of a multinational insolvency. Also, these, and other powers of enforcement must be consistent with the objectives of the insolvency process and must not impede the commercial realities that maximize value and enhance recoveries. Undue administrative cost and burden must be carefully considered.

8. A related area of interest would be the appropriate ranking of the claims and rights of the regulatory and criminal enforcement authorities in insolvency proceedings involving fraud and the proper use of the criminal process when the rights of creditors and others are involved.

9. A distinct advantage of work in the insolvency area is that the insolvency area covers and applies to fraudulent activity of all kinds. By way of contrast, it would be possible to deal with fraudulent use of bills of exchange or documentary credits by building procedures into the systems that apply to those items. This could be done in literally dozens of areas of commercial endeavour, thus providing several dozen individually and specifically designed solutions to several dozen independent and distinct areas with different procedures, different rules and different remedies. While these procedures may be appropriate on a stand alone basis involving solvent entities, they may conflict with other competing procedures in the

event of an insolvency. Anticipation of the insolvency of one or more of the parties involved in a commercial fraud is required in order to appropriately resolve the rights of all of the affected parties. The advantage of focusing on systems in the insolvency area is that the insolvency area ultimately applies to *all* activities whenever an insolvency or reorganization occurs. Although commercial fraud is not restricted to situations in which there is an insolvency, it makes sense to focus the relatively scarce resources available on an area that is best situated to bring about the largest amount of improvement in the shortest time, i.e., the insolvency area.

10. The III submits this proposal to UNCITRAL in the view that UNCITRAL is in an ideal and unique position to be able to give detailed consideration to the very important issues in this area and to produce a set of principles or guidelines that would draw the attention of the world-wide commercial community to the need to reform and improve insolvency systems as they relate to the prevention and avoidance of commercial aid fraudulent activities and provide an internationally accepted basis for doing so.