Selected Legal Issues of E-Commerce

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INSOLVENCY LAW IN CYBERSPACE

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A. INTRODUCTION

To set insolvency law in a new context – namely cyberspace with its new media – touches on a number of issues. How, for example, contemporary insolvency administrators, trustees, and other bankruptcy officers could make use of those modern media? This in turn leads on to questions such as the organisation of a creditors’ assembly (or committee) via Internet or the lodging of claims by a click of a mouse-click. We may, indeed, learn much simply by investigating the specific bankruptcy problems of

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today's dot.com companies under current bankruptcy laws and practices and how bankruptcy officers cope with this most modern of bankruptcy phenomena.

In this paper, I will be discussing what changes to the present law will be necessary in order to enable bankruptcy regimes adjust this law to the specific needs of cyberspace commerce? Of course, this will only be an issue if e-commerce really becomes the huge world encompassing market which some predict.\textsuperscript{1} Based on this (somewhat shaky) assumption it is admitted right away, that the conclusions of this paper necessarily carry much speculation

B. \textbf{LOOKING INTO THE FUTURE}

In order to engage in this speculation, we need to clarify precisely the nature of this assumption. For this, it is helpful to adopt the position of a future legal historian looking at our present situation. He or she may characterize our present times as those when the legal world was captured by a mania for insolvency law. The year 1978 was the year when the US Bankruptcy Reform Act came into force, which, in turn, was the starting point of an ongoing reform of insolvency law all over the world. This mania intensified in the late 1990s when – following the East Asian financial crisis – global institutions such as the International Monetary Fund\textsuperscript{2} and the World Bank\textsuperscript{3} entered upon this stage and drafted general principles of insolvency law to form the basis for further insolvency legislation, both in transition economies as well as advanced, industrial countries. In addition, UNCITRAL developed model laws for both international insolvency law and domestic insolvency law\textsuperscript{4} to try to deal with the failure of enterprises in circumstances where the economies of different countries around the world were fast becoming more and more inter-dependent. These developments are likely to carry much weight with out future legal historian, given the strong authority of these organisations and the scholastic weight of those who helped shape the relevant proposals.

This future legal historian will recognize that, roughly at the same time, something like cyberlaw emerged and that e-commerce became a new branch of the general commercial law. And by correlating these parallel developments, he or she will discover that all the new insolvency laws – praised as modern and farseeing as they might have been at the time of their enactment – had at least one flaw - they had no adequate tool for dealing with the break-down of those firms or legal entities which acted in e-commerce. To be sure – in our present day, there is an even increasing number of insolvencies of dotcoms

\textsuperscript{1} Cf. Thomas Hoeren's article in this volume.

\textsuperscript{2} Orderly and Effective Insolvency Procedures, International Monetary Fund, Legal Department, 1999.

\textsuperscript{3} Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, 2001.

\textsuperscript{4} To be sure, whether this model law will be approved by the UN Plenary Assembly (and whether the draft will be propelled until that stage) or not is at the present time unpredictable.
and other actors in the telecommunication area. And of course, all these insolvencies are dealt with under existing insolvency laws. Yet it is already clear to us that these insolvency laws do not offer the tools, which would be appropriate to resolve the many new issues which the bankruptcy of these more or less virtual enterprises gives rise to. Our future legal historian, in other words, will probably note that all our very modern laws were already old fashioned at the time of enactment, although those who made the proposals and those who implemented them were unable to see this.

C. A TELLING HISTORICAL DEVELOPMENT

To help us speculate as to what future legal historians will say of our period, let us look back, into our own history. By having an idea as to where we come from should put us into the position of having some idea as to where we are heading. Thus, it becomes necessary to look at how insolvency law has developed so far – obviously, not in detail, but in rough outline.⁵

I. Liquidation

The beginning of any insolvency law is liquidation – first of the debtor’s physical person, thereafter – and this is important for our context – of the debtor’s assets. The ancient Romans had already subdivided these assets into movables, immovables and claims (mobilia, immobilia, nomina); and they had also prepared the legal instruments for transferring and alienating these goods. For almost two millennia such assets formed the main part of any estate. Thus, in order to satisfy, at least in part, the creditors of a bankrupt person, it sufficed to sell the debtor’s assets in the traditional manner and to hand over to the creditors the proceeds of such sale. This, in briefest outline, might be said to be the predominant scenery in a production-based economy.

II. Reorganisation

At the end of the second millennium a new “invention” entered upon the insolvency stage – namely reorganisation of the debtor. It became famous because of the US legislation (the renowned chapter 11 proceedings) even though the concept of reorganisation as a mechanism for dealing with a bankruptcy other than by means of a complete financial destruction of the debtor and the alienation of all his or her or its assets can be traced back at least to the Roman emperor Augustus who introduced the “cessio bonorum”.

There are, of course, major differences between ancient and modern debtor reorganisation. The latter contemplates something quite specific - the fresh start of the debtor - and its debt to the history of the US and especially its pioneers who were willing to start a new business even though they had failed with their old one is almost palpable.

Even this modern idea of reorganization has already undergone some change as it becomes a worldwide phenomenon. As modern economies change from production into service societies (Dienstleistungsgesellschaften) the old division of assets into immovable, moveables and claims comes under pressure. When one considers, for example, a software developer, a music producer, or a premier league soccer team, one will not find too many of the old-fashioned assets. They will have been replaced by goods which might be as valuable as the assets of former times but which are not, for example, as trafficable. Consider, in this context, for example, goodwill, know-how, customers lists, to name but a few. Since these goods are generally closely linked with the debtor, the creditors are – at least in many cases – better helped, not by the attempted sale of such intangible assets, but by leaving them with the debtor and helping the debtor to get back into successful business. This is exactly what insolvency law calls reorganisation.

D. LESSONS FROM HISTORY

The point of this short and one-sided description of the history of insolvency law is the close connection between the general economic development of a society and its law. On this basis we could now seek to develop some basic speculations as to the future of the insolvency law governing cyberspace transactions. Of course, this must be done with care. As a first step, we must seek to clarify what the peculiarities of cyberspace might be, followed by considering what sort of problems are now apparent visible in today’s insolvency cases in the dotcom-area and finally seek to understand what can be done for the creditors in order to meet their demands as far as this is possible. We may than have some, perhaps somewhat difficult to discern clearly, vision of how such insolvency law might look like in the cyberspace era to come.

I. WHAT ARE THE PECULIARITIES OF CYBERSPACE?

Cyberspace is invisible.6 Even though we see something, for example, on our computer screens we know that this is just a glimpse into a world behind – a world, which is virtual and therefore ubiquitous. In this world the traditional borderlines on which so much

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domestic legal thought is predicated are non-existent, although has not stopped domestic legislatures from seeking to regulate this world with traditional forms of legislation.

It is important to make the point that if the predominant peculiarities of cyberlaw are, indeed, its virtualness and its ubiquity, we can readily observe that here there is nothing really new. Suffice it is to mention a simple claim of a creditor against his debtor. This claim is transferable and is in general treated by lawyers as if it were a corporeal thing. But as a matter of fact, it is as virtual and therefore as ubiquitous as cyberspace. We have never seen a claim, never touched one, yet, we have incorporated the notion of a claim into our daily legal toolbox to such a degree that it needs some effort to recall the artificiality of this legal instrument.

Why is this so? How can we have so incorporated the notion of a claim as to forget its virtualness? Clearly, we have found a way to deal with it so its real nature has become uninteresting or, at least, has lost its importance. Thus it has become legally manageable. The answer is that we have found a connecting point between the virtual phenomenon and the world of tangible things – something that might be called “reification”. Thus, if a creditor, assigns his or her claim to a third party, he or she does so by means of a contract, something which we recognise as a real legal act. For lawyers, this reification is the decisive thing – not the material substance of the claim. If this is a correct observation, the lawyers’ task in organizing cyberspace will be to develop cyberlaw by finding acceptable points of reification and thereby to organize cyberspace.

II. What Are The Problems Of Today’s Dotcom Insolvencies?

To be sure, virtualness and ubiquity are not the only peculiarities of cyberspace, yet they are probably its most distinctive. The failure of today’s dotcom companies also reveals that speed is a prominent factor to be taken into account. Since these companies act and – up to a certain point – even exist only in the virtual world of the net they share the latter’s fate, especially its speed. Worldwide communication without delay and prompt delivery of goods and services are just a few of the catchwords with which the net and, more specifically, e-commerce has represented the uniqueness of its operations. These are the big promise of the internet and all who use it to do business. Current studies now reveal that if the average user has to wait more than 20 seconds before the screen shows a selected homepage in full, he or she will have become uninterested and will search or surf elsewhere.

Therefore, efficient and successful commercial performance on and via the internet requires presence at any time without any interruption. And if a participant suffers a financial crisis, these very wonders of the internet - its speed, its immediacy, its constant presence, will, in turn, become the source of its enemy. The causes of financial crisis are obvious: The connecting line (whether to the provider, to the common telecommunication net, elsewhere) might be interrupted on account of a payment delay; or the transporter of goods sold over the internet may be refusing to deliver goods ordered on account of an
unsettled account for a previous delivery. In the traditional world, there may be a little
time to sort out these financial embarrassments but now speed and its companion, all-
time omnipresence, will have raised the customers' expectations who, with the benefits
(if such they are) due to the increasing and worldwide competition, are likely to seek
attention from one of the many alternative providers at hand. Even a short absence from
constant availability may lead to an increasing number of disastrous losses of customers
which in turn will accelerate the financial decline moving swiftly to insolvency
proceedings.

III. How Might Creditors Get Their Money?

Quite often such an insolvency proceeding will result in the distribution of little or
nothing, given the relative valuelessness of the rather few assets. Dotcom-companies
generally do not have many goods in the traditional sense to be transformed into money
in, order to satisfy their creditors. Their assets are more likely to be an idea and, maybe,
connections or addresses, assets which I have already described as being of value
primarily only when linked to the person of the debtor. Therefore, seen from the
creditors’ point of view, it would appear to be preferable to try to get the debtor’s
business back on track rather than to liquidate the assets.

But unlike the case of a common service enterprise or company, the usual plan
proceeding is probably not the appropriate tool. This is likely to be too time consuming in
that it requires the debtor’s insolvency, followed by a certain period of plan drafting,
thereafter a plan discussion and, finally, its acceptance by means of a somewhat
complicated voting procedure. If an e-commerce participant were to be put through these
proceedings, it will be long forgotten long before the proceedings are completed.

E. What Will The Insolvency Law Of The Future Look Like?

I. General Observations

What lessons can be learned from what has been described? Obviously, an appropriate
insolvency regime for cyberlaw has to provide an extremely speedy proceeding, which,
therefore, must be simplified in comparison to the present shape of reorganisation.\textsuperscript{7}
To be
sure, there are already attempts to speed up reorganisation proceeding, especially by

\textsuperscript{7} In case of a liquidation, nothing needs to be changed because speed is there only of secondary interest.
means of the so called “option model”. However, this trading of share-options after a “debt for equity swap” is still quite time consuming, leaving aside the general questionability of the underlying idea.

In terms of speed, the optimal solution would be that an option should be at hand as soon as the company’s financial difficulties arise, thereby avoiding the hiatus which would inevitably arise at this point were traditional insolvency proceedings to ensue. Indeed, the insolvency option should be clear right from the start of an internet company's existence. Ideally, it should appear in the foundation charter of any such enterprise. This, of course, is quite a dramatic shift from today’s realities. Here, usually, the foundation of a company gives reason to dream about a flourishing future with minor obstacles on the path to prosperity; the thought of the opposite - however realistic - is ignored and suppressed. The company’s insolvency is rarely the subject of any consideration at this point of time. Sober balancing of possible options is replaced by wishful thinking.

II. Current Similarities

The proposed idea - anticipating insolvency at the start-up stage - is not completely new. In some countries - perhaps more in the US more than elsewhere - insolvency proceedings are used as a strategic tool. Developed insolvency systems have what is sometimes called a pre-packaged plan, bearing a close resemblance to what I have suggested is needed in e-commerce: Before the company reaches financial turmoil, a plan is prepared as to how it is to be restructured, transferred or whatever; and when the proceedings commence - generally on the grounds of an imminent illiquidity - the plan is swiftly put in place according to the previously secured agreement of all interested parties.

A striking example of the likely applicability of some current insolvency practices to insolvency in cyberspace, can be seen in the US, in the insolvency of Toysmart.com, whose major investor was the Walt Disney Co. This dotcom company announced its plans to sell its database of customer information in order to raise money. This, however, created such an enormous public outcry, that it will probably lead to an amendment of the Bankruptcy Code so as to provide some data protection for customers of a bankrupt entity. What is interesting is that as a consequence of the Toysmart proceedings, some

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9 The basic idea of the debt-equity swap and the succeeding tradability of options shifts those tasks to the creditors, who then become part of the administrator’s business. Whether this form of job swap is a prudent idea remains to be seen.
websites in the US have now changed their appearance so as to describe their privacy policy including information as to how they would handle customers’ personal informations in the case of bankruptcy. This might be seen as an example of envisaging one’s own insolvency and inviting the consumers to decide whether or not they are willing to accept this proposal. If they do not like it, they will look for another provider.

This is now a notion which is the subject of quite intense debate in the US. Some argue that substantial areas of insolvency law – including its procedural rules – should be subject to pre-insolvency contractual agreements. Thus, it should be possible for example, effectively to exclude certain assets from the automatic stay. This view, however, ignores the essential feature of any insolvency law – namely to be ius cogens, to be a law which can be contractually changed only to a very limited degree and by specified means alone. The reason and justification for this enforcement character of insolvency law is, seen from a very general perspective, to ensure that from the commencement of an insolvency proceeding law the creditors collectively will replace the debtor as the dominant interest in the enterprise. Because of this plurality of interests, the existing insolvency rules must necessarily be fixed or changed – if at all – only by an agreement of all parties involved.

III. Possible Solutions

At this point of the discussion we might be in the position to develop some considerations about the future shape of an insolvency law for the new market of e-commerce. The contractual approach as described suprabove will not do because of the lack of the indispensable consent of all those who happen to be creditors of the debtor in question at the commencement of the proceeding. This is true for both alternatives as described above, namely restricted to what will happen to creditor information or more widely than that. Even if stated in the general terms of agreement as to what will happen with the debtor’s assets, this does not bind the insolvency administrator. Once a proceeding has been initiated, the power to dispose of such assets is solely with the person in charge according to the applicable insolvency law.

However, it is undeniable that such a pre-packaged solution as to what should be done in the case of the debtor’s insolvency, increases the speed of the proceeding dramatically.

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12 To be sure, this is only a very rough outline of the concept of the existing insolvency laws in this world. Nevertheless, as a fundamental consideration the outline holds true.
Therefore, a clause like the one described above need not necessarily be null and void; it has to be made subject to the approval of the administrator of the insolvency proceeding or the creditors. If this condition is fulfilled, nothing prevents insolvency law from accepting this general contractual term as a kind of pre-packaged plan with respect to certain assets. As a matter of fact, such "sales offers" might be feasible especially by group (Konzern) members, who might thereby, declare another member of the group (for example the mother company) to be the offeree.

Thus, if such a group member goes bankrupt, the sale will be perfected if the person in charge – the administrator and/or the creditors – gives his or their consent. However, this acceleration of the proceeding need not be restricted to group member insolvencies and to sales of assets. The insolvency law in general could provide for incentives to prepare such pre-packaged solutions, for example, by reducing the minimum period before which the first creditors' assembly has to meet, or by changing the necessary quorum for the creditors' consent, or by reducing the time span between the filing of the petition and the initiation of the proceeding.

The latter idea, however, demonstrates where the borders are of the idea in the present paper. The insolvency law cannot waive the fundamental requirement that the debtor has to be insolvent, however that might be defined, and to have it replaced by such a pre-package clause. While the latter approach would certainly lead to an immense acceleration of the process in dealing with an insolvent debtor, it would be open to widescale abuse by a debtor who might seek to make use of it at practically any time.\textsuperscript{13} To allow this would be in clear contradiction of what has been said above as to the peculiarity of insolvency law – namely the replacement of the debtor by his creditors as the dominant interest in the business. This is only justified if the debtor is proved to have failed according to common commercial standards. These standards do not allow a "flight" into the protected area of insolvency law and to, thereby, escape competition, etc. If this were permissible it would be consistent to introduce the above-mentioned contractual insolvency system. Since then insolvency law were just one more tool in the surrounding of the ordinary course of business.

\textsuperscript{13} This is, as a matter of fact, the big attraction of the US chapter 11 proceeding.