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Draft legislative guide on insolvency law

Note by the Secretariat

Contents

[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Add.3 and Add.4; Chapter III.A-F appear in documents A/CN.9/WG.V/WP.63/Adds.5-9; Chapter IV. A-D appear in Adds. 10-11, Chapter V appears in Add. 12, Chapter VI. A-C appear in Adds. 13-14, and Chapter VI. D-E will appear in Add.16]

* This document was submitted late because of the need to complete consultations and finalize consequent amendments.

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Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.

Recommendation numbers in [..] refer to relevant recommendations in A/CN.9/WG.V/WP.61 and A/CN.9/WG.V/WP.61/Add.1, the previous version of the recommendations. Additions to the recommendations are indicated in this document by underlined text.

Part Two (continued)

VII. Resolution of proceedings

A. Discharge

1. Discharge of the debtor in liquidation[1]

442. [256] Following distribution in the liquidation of the estate of an individual debtor, it is likely that a number of creditors will not have been paid in full. An insolvency law will need to consider whether these creditors will still have an outstanding claim against that individual debtor or, alternatively, whether the debtor will be released or "discharged" from those residual claims.

443. [257] When the debtor is a limited liability company, the question of discharge following liquidation does not arise; either the law provides for the disappearance of the legal entity or, alternatively, that it will continue to exist as a shell with no assets. The shareholders will not be liable for the residual claims and the issue of their discharge does not arise. If the debtor's business takes a different form, such as an individual (sole proprietorship), a group of individuals (a partnership), or an entity whose owners have unlimited liability, the question arises as to whether these individuals will still be personally liable for unsatisfied claims following liquidation.

444. There is an increasing awareness in some circles of the need to recognize business failure as a natural feature of the economy and to accept that both weak and good businesses can fail, albeit for different reasons, without necessarily involving irresponsible, reckless or dishonest behaviour on the part of the management of the business. A person who has failed in one business may have learned from that experience and some studies suggest that they are often very successful in later business ventures. For these reasons, a number of countries have taken the view that their insolvency regime needs to focus not only on addressing the administration of failure, but also upon facilitating a fresh start for insolvent debtors by clearing their financial situation and taking other steps to reduce the stigma associated with business failure, rather than upon punishment of the debtor. In addition to adapting the insolvency law to remove unnecessary conditions and restrictions on discharge, there is a need to encourage banks and the wider community to take a different view of business failure, and to provide assistance and support to those involved in business failure. At the same time, the insolvency regime needs to protect the public and the commercial community from those

[1] These paragraphs relate to discharge of a debtor who is an individual or natural person.

debtors whose conduct of their financial affairs has been irresponsible, reckless or dishonest.

445. [258] Insolvency laws adopt different approaches to the question of discharge. In some, the debtor remains liable for unsatisfied claims, subject to any applicable limitation periods (which in some cases might be quite long, for example, 10 years) and may also be subject to a number of conditions and restrictions relating to professional, commercial and personal activities. This type of rule emphasizes the value of a debtor-creditor relationship: the continued responsibility of the debtor following liquidation is intended to both moderate a debtor's financial behaviour and encourage a creditor to provide financing. At the same time, it may work to inhibit opportunity, innovation and entrepreneurial activity because the sanctions for failure are severe.

446. [258] Other insolvency laws provide for a complete discharge of an honest, non-fraudulent debtor immediately following liquidation. This approach emphasizes the benefit of the "fresh start" that discharge brings and is often designed to encourage the development of an entrepreneurial class. It is also a recognition that over-indebtedness is a current economic reality and should be addressed in an insolvency law. A third approach attempts to strike a compromise: discharge is granted after a period following distribution, during which the debtor is expected to make a good faith effort to satisfy its obligations.

447. [259] In some circumstances, it may be appropriate to limit the availability of discharge. These may include those cases where, for example, the debtor has acted fraudulently; engaged in criminal activity; violated employment or environmental laws; failed to keep appropriate records; failed to participate in the insolvency proceedings in good faith or to co-operate with the insolvency representative; failed to provide or has concealed information; continued trading at a time when it knew it was insolvent; incurred debts with no reasonable expectation of being able to pay them; and concealed or destroyed assets or records after the application for commencement.

448. [259] Different approaches are taken to the conditions that will apply to discharge in these types of circumstances. In some countries, the period before a discharge is given may be quite long or conditions and restrictions will apply to the discharge, or a combination of both. In some of the countries where a discharge is given, certain debts may be excluded from the discharge, such as those arising from maintenance agreements (payments to a divorced spouse or to support children of the debtor); fraud; court fines; and taxes. Conditions may also be imposed upon the debtor, both during the proceedings or as a condition for a discharge, either by way of recommendation by the insolvency representative or by the court. These conditions may include restrictions on the ability of the debtor to obtain new credit, to leave the country, to carry on business for a certain period of time or a ban, where relevant, on practising its profession for a period of time. They may also include a discharge that is provided on the condition that the debtor does not subsequently acquire a substantial new fortune from which previous debts may be paid. The length of the application of these provisions will vary, depending upon the situation of the debtor. Other limitations relate to the number of times a debtor can be discharged. In some jurisdictions, a discharge is a once in a lifetime opportunity; in others there is a minimum waiting period, for example, 10 years, before a debtor will qualify for a new discharge, or even be able to enter insolvency proceedings

which may lead to a new discharge. A further approach restricts discharge where, for example, the debtor has been given a discharge within a certain period of time before commencement of the current proceedings and where the payments made in those proceedings were less than a fixed percentage.

449. Some insolvency laws also provide for a discharge to be suspended where the debtor fails to comply with an obligation, or revoked in certain circumstances such as where it was obtained by fraud, where the debtor fraudulently withheld information concerning property that should be property of the estate, or failed to comply with orders of the court.

450. [260] One issue that may need to be taken into account in considering discharge of individuals engaged in a business undertaking is the intersection of business indebtedness with consumer indebtedness. Recognizing that different approaches are taken to the insolvency of natural persons (in some countries a natural person cannot be declared bankrupt at all, in others there is a requirement for the individual to have acted in the capacity of a "merchant") and that many countries do not have a developed consumer insolvency system, a number of countries do have insolvency laws that seek to distinguish between those who are simply consumer debtors and those whose liabilities arise from small businesses. Since consumer credit often is used to finance small business either as start-up capital or for operating funds, it may not always be possible to separate the debts into clear categories. For that reason, where a legal system recognizes individual consumer and business debt, it may not be feasible to have rules on the business debts of individuals that differ from the rules applicable to consumer debts.

2. Discharge of debts and claims in reorganization

451. [298] To ensure that the reorganized debtor has the best chance of succeeding, an insolvency law can provide for a discharge or alteration of debts and claims that have been discharged or otherwise altered under the plan. This approach supports the goal of commercial certainty by giving binding effect to the forgiveness, cancellation or alteration of debts in accordance with the approved plan. The principle is particularly important to ensure that the plan provisions will be complied with by creditors that rejected the plan and by creditors that did not participate in the process. It also gives certainty to other lenders and investors that they will not be involved in unanticipated liquidation or have to compete with hidden or undisclosed claims. Thus the discharge establishes unequivocally that the plan fully addresses the legal rights of creditors.

Recommendations

Purpose of legislative provisions

The purpose of provisions on discharge is to:

(a) Enable an individual debtor to be finally discharged from liabilities for pre-commencement debts, thus providing the debtor with a fresh start;

(b) Establish the circumstances under which discharge will be granted and the terms of that discharge.

Content of legislative provisions

Liquidation

(172) [(122)] Where the insolvency law allows the insolvency of individuals engaged in business activity, the issue of discharge of the debtor from liability for pre-commencement debts following [liquidation of the assets of the estate] [termination of the liquidation proceedings] should be addressed. Different approaches may be taken:

(a) The debtor may be discharged completely and immediately where the debtor [is honest] [and] has not acted fraudulently] [acts in good faith];

(b) The discharge may not apply until after the expiration of a specified period of time following [distribution] [commencement], during which period the debtor is expected to make a good faith attempt to satisfy its obligations;

(c) Certain debts may be excluded from the discharge, such as those that were not disclosed by the debtor;[2]

(d) The discharge may be subject to certain conditions, such as restricting access to new credit or preventing the carrying on of business for a certain period of time.

Reorganization

(173) (138) Once the plan has been fully implemented, the debtor should be discharged from all debts that have been provided for in the plan.

B. Conclusion of proceedings

452. Insolvency laws adopt different approaches to the manner in which a proceeding is to be concluded or closed, the pre-requisites for closure and the procedures to be followed.

1. Liquidation

453. A number of insolvency laws adopt an approach that generally requires, following realisation of assets and distribution, that the insolvency representative call a meeting of creditors and present a final accounting. Provided that creditors agree to the accounting, all that is then required under some laws (where the debtor is a corporate entity) is that the final accounts and a report of the final meeting be filed with the administrative body responsible for registration of corporate entities and the debtor entity will be dissolved, while other laws require a formal application to the court for an order for dissolution. Some variations on this general approach include slightly different procedures for voluntary and involuntary proceedings.

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[2] Where the insolvency law provides that certain claims will not be affected by the insolvency proceedings, those claims will be excluded from the discharge, but do not need to be specifically referred to in this section: see recommendations on treatment of creditor claims: see Part two, chapter VI.A.

2. Reorganization

454. [299] In general, insolvency laws adopt one of two or three approaches to the conclusion of reorganization proceedings. Reorganization proceedings may be treated as concluded where the reorganization plan is not approved (whether by creditors or the court) (see Part two, chapter V.A.6); where the liabilities have been discharged in accordance with the plan and the plan has otherwise been fully implemented (with or without the need for a formal court order, although some laws make provision for the insolvency representative to be discharged from its duties by a formal order of the court); and where the court orders the proceedings to be terminated because of a failure of implementation (because the plan cannot be implemented or because there is a continuing deterioration in the debtor's financial condition). Proceedings may also be terminated in accordance with the terms of the plan or some other contractual agreement with creditors. Where the proceedings are terminated without implementation of the reorganization plan, the insolvency law may provide, and the court may also make an order, for the proceedings to be converted to liquidation, in order to avoid the debtor being left in an insolvent state with its financial situation unresolved. A number of insolvency laws adopt a different approach, providing that the reorganization proceedings will conclude once creditors have approved the plan. In this situation, the enforcement of rights and obligations provided for in the plan will be under non-insolvency law.

Recommendations

Purpose of legislative provisions

The purpose of provisions on conclusion is to:

(a) ensure that the insolvency law includes a procedure for ending the proceedings once the goal of those proceedings has been achieved or addressing the situation where the goal of those proceedings cannot be achieved;

(b) provide for the dissolution of the debtor, where relevant.

Content of legislative provisions

Liquidation

(174) [(123)] After an insolvency estate is fully administered [and the insolvency representative discharged] provision should be made for the insolvency proceedings to be closed.

~~(124) [*reopening*]~~

Reorganization

(175) (139) The insolvency law should make provision for reorganization proceedings to be concluded when the reorganization plan is fully implemented. The court may order the proceedings to be terminated where implementation of the plan fails, where the plan cannot be implemented or because there is a continuing deterioration in the debtor's financial condition. [Where the proceedings are terminated without implementation of the plan, the insolvency law should make provision for conversion of the proceedings to liquidation.] ~~After an insolvency estate is fully administered [and the insolvency representative discharged] the court should close the proceedings.~~

~~(140) [reopening]~~