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Draft legislative guide on insolvency law

Note by the Secretariat

[The Glossary to the Guide appears in A/CN.9/WG.V/WP.63/Add.1; Part Two of the Guide appears in documents A/CN.9/WG.V/WP.63/Add.3-17]

Paragraph numbers in [..] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.57, the previous version of this introductory chapter.

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Part One

Designing the structure and key objectives of an effective and efficient insolvency regime

I. Introduction to insolvency procedures

1. [23] When a debtor is unable to pay its debts and liabilities as they become due, most legal systems provide a legal mechanism to address the collective satisfaction of the outstanding claims from all assets (whether tangible or intangible) of the debtor. A range of interests needs to be accommodated by that legal mechanism—firstly, the parties including the debtor, the owners and management of the debtor, the creditors who may be secured to varying degrees (including tax agencies and other government debtors), employees, guarantors of debt and suppliers of goods and services, as well as the legal, commercial and social institutions and practices that are relevant to the design of the insolvency law, including the institutional framework required for its operation. Generally, the mechanism must strike a balance not only between the different interests of these stakeholders but also between those interests and the relevant social, political and other policy considerations that impact upon the economic and legal goals of insolvency.

2. [23] Most legal systems contain rules on various types of proceedings (which are referred to in this Guide by the generic term "insolvency proceedings") that can be initiated to resolve a debtor's financial difficulties. While addressing that resolution as a common goal, these proceedings take a number of different forms, for which uniform terminology is not always used, and may include both "formal" and "informal" elements. Formal insolvency proceedings are commenced under the insolvency law and governed by that law. They generally include both a liquidation and a reorganization process. Informal insolvency processes are not regulated by the insolvency law and will generally involve negotiation between the debtor and some or all of its creditors. Often these processes have been developed through the banking and commercial sectors and typically, provide for some form of reorganization of the insolvent debtor. Whilst not regulated by an insolvency law, these informal reorganization processes nevertheless depend for their effectiveness upon the existence of an insolvency law which can provide some indirect incentive or persuasive force to achieve a reorganization (discussed further below).

A. Key objectives of an effective and efficient insolvency regime

3. Although country approaches vary, there is broad agreement that effective and efficient insolvency regimes should aim to achieve the key objectives identified below. Whatever design is chosen for an insolvency law that will meet these key objectives, the insolvency law must be complementary to, and compatible with, the legal and value systems of the society in which it is based and which it must ultimately sustain. Although insolvency law generally forms a distinctive regime, it ought not to produce results that are fundamentally in conflict with the premises upon which the general law is based. Where the insolvency law does seek to achieve a result that differs or fundamentally departs from the general law (e.g. with respect

to treatment of contracts, avoidance of antecedent acts and transactions or treatment of the rights of secured creditors) it is highly desirable that that result be the product of careful consideration and conscious policy in that direction.

1. Maximize value of assets

4. Participants in the insolvency process should have strong incentives to achieve maximum value for assets as this will facilitate higher distributions to creditors as a whole and reduce the burden of insolvency. The achievement of this goal is often furthered by achieving a balance between the risks allocated between the parties involved in an insolvency proceeding. The manner in which prior transactions are treated, for example, can ensure that creditors are treated equitably and enhance the value of the debtor's assets by recovering value for the benefit of all creditors. At the same time, the treatment afforded those transactions can undermine the predictability of contractual relations that is critical to investment decisions, creating a tension between the different objectives of an insolvency regime. Similarly, a balance has to be struck between rapid liquidation and longer term efforts to reorganize the business which may generate more value for creditors, between the need for new investment to preserve or improve the value of assets and the implications and cost of that new investment on existing stakeholders, and between the different roles allocated to the different stakeholders, in particular the discretion that can be exercised by the insolvency representative and the extent to which creditors can monitor the exercise of that discretion to safeguard the process.

2. Strike a balance between liquidation and reorganization

5. The first objective of maximization of value is closely linked to the balance to be achieved in the insolvency regime between liquidation and reorganization. [16] An insolvency regime needs to balance the advantages of near-term debt collection through liquidation (often the preference of secured creditors) against maintaining the debtor as a viable business through reorganization (often the preference of unsecured creditors). Achieving that balance may implicate other social policy considerations such as encouraging the development of an entrepreneurial class and protecting employment. [15] Insolvency law should provide for the possibility of reorganization of the debtor as an alternative to liquidation, where creditors would not involuntarily receive less than in liquidation and the value of the debtor to society and to creditors may be maximized by allowing it to continue. This is predicated on the basic economic theory that greater value may be obtained from keeping the essential components of a business organization together, rather than breaking them up and disposing of them in fragments. To ensure that the insolvency process is not abused by either creditors or the debtor, and that the procedure most appropriate to resolution of the debtor's financial difficulty is available, the insolvency law should also provide for conversion between the different types of proceedings in appropriate circumstances.

3. Ensure equitable treatment of similarly situated creditors

6. The objective of equitable treatment is based on the notion that in collective proceedings, creditors with similar legal rights should be treated equally, receiving a distribution on their claim in accordance with their relative priority and interests. [17] Equitable treatment recognizes that all creditors do not need to be treated

equally, but in a manner that reflects the different bargains they have struck with the debtor, although this becomes less relevant as a defining factor where there is no specific debt contract with the debtor, such as in the case of damage claimants (e.g. for environmental damage). To the extent that equitable treatment is modified by social policy on claim priorities and should give way to the prerogatives pertaining to holders of claims or interests that arise, for example, by operation of law, the principle of equitable treatment retains its significance by ensuring that the priority accorded to the claims of a similar class affects all members of the class in the same manner. The policy of equitable treatment permeates many aspects of an insolvency law, including the application of the stay or suspension, provisions to set aside acts and transactions and recapture value for the insolvency estate, classification of claims, voting procedures in reorganization, and distribution mechanisms. [17] The insolvency regime should address problems of fraud and favouritism that may arise in cases of financial distress, by providing, for example, that acts and transactions detrimental to equitable treatment of creditors can be avoided.

4. Provide for timely, efficient and impartial resolution of insolvency

7. [18] Insolvency should be addressed and resolved in an orderly, quick and efficient manner, with a view to avoiding undue disruption to the business and the activities of the debtor and to minimizing the cost of the proceedings. Achieving timely and efficient administration will support the objective of maximizing asset value, while impartiality supports the goal of equitable treatment. The entire process needs to be carefully considered to ensure maximum efficiency without sacrificing flexibility. At the same time, it should be focused on the goal of liquidating non-viable and inefficient businesses and the survival of efficient, potentially viable businesses.

8. [18] Quick and orderly resolution of a debtor's financial difficulties can be facilitated by an insolvency law that provides easy access to the insolvency process by reference to clear and objective criteria, provides a convenient means of identifying, collecting, preserving and recovering assets and rights that should be applied towards payment of the debts and liabilities of the debtor, facilitates participation of the debtor and its creditors with the least possible delay and expense, provides an appropriate structure for supervision and administration of the process (including both professionals and the institutions involved) and provides, as an end result, effective relief to the financial obligations and liabilities of the debtor.

5. Prevent premature dismemberment of the debtor's assets

9. [19] An insolvency regime should prevent premature dismemberment of the debtor's assets by individual creditor actions to collect individual debts. Such activity often reduces the total value of the pool of assets available to settle all claims against the debtor and may preclude reorganization or the sale of the business as a going concern. A stay of creditor action provides a breathing space for debtors, enabling a proper examination of its financial situation and facilitating both maximization of the value of the estate and equitable treatment of creditors. Some mechanism may be required to ensure that the rights of secured creditors are not impaired by a stay.

6. Provide for a procedure that is transparent and predictable and contains incentives for gathering and dispensing information

10. [20] The insolvency law should be transparent and predictable. This will enable potential lenders and creditors to understand how the insolvency process operates and to assess the risk associated with their position as a creditor in the event of insolvency. This will promote stability in commercial relations and foster lending and investment at lower risk premiums. Transparency and predictability will also enable creditors to clarify priorities, prevent disputes by providing a backdrop against which relative rights and risks can be assessed, and help define the limits of any discretion. Unpredictable application of the insolvency law has the potential to undermine not only the confidence of all participants in insolvency proceedings, but also their willingness to make credit and other investment decisions. [20] As far as possible, an insolvency law should clearly indicate all provisions of other laws that may affect the conduct of the insolvency proceedings (e.g. labour law; commercial and contract law; tax law; laws affecting foreign exchange, netting and set-off, debt for equity swaps; and even family and matrimonial law).

11. [20] The insolvency law should ensure that adequate information is available in respect of the debtor's situation, providing incentives to encourage the debtor to reveal its positions or, where appropriate, sanctions for failure to do so. The availability of this information will enable those responsible for administering and supervising the insolvency process (courts or administrative agencies, the insolvency representative) and creditors to assess the financial situation of the debtor and determine the most appropriate solution.

7. Recognize existing creditor rights and establish clear rules for ranking of priority claims

12. [21] Recognition and enforcement within the insolvency process of the differing rights that creditors have outside of insolvency will create certainty in the market and facilitate the provision of credit, particularly with respect to the rights and priorities of secured creditors. Clear rules for the ranking of priorities of both existing and post-commencement creditor claims are important to provide clarity to lenders, to ensure that the rules can be consistently applied, that there is confidence in the process and that all participants are able to adopt appropriate measures to manage risk. 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 should be avoided.

8. Establish a framework for cross-border insolvency

13. [22] To promote coordination among jurisdictions and facilitate the provision of assistance in the administration of an insolvency proceeding originating in a foreign country, insolvency laws should provide rules on cross-border insolvency, including the recognition of foreign proceedings, by adopting the UNCITRAL Model Law on Cross-Border Insolvency.

B. Balancing the key objectives

14. Since an insolvency regime cannot fully protect the interests of all parties, some of the key policy choices to be made when designing an insolvency law relate to defining the goals of the insolvency law and achieving the desired balance between the objectives identified above. Insolvency laws achieve that balance by reapportioning the risks of insolvency in a way that suits a country's economic, social and political goals. As such insolvency regimes can have widespread effects in the broader economy.

15. The first task for any insolvency system is to establish a framework of principles that determines how the estate of the insolvent debtor is to be administered for the benefit of all affected parties. The creation of such a framework and its integration with the wider legal process are vital to maintaining social order and stability. All parties need to be able to anticipate their legal rights in the event of a debtor's inability to pay, or to pay in full, what is owed to them. This allows both creditors and equity investors to calculate the economic implications of default by the debtor, and so estimate their risks.

16. There is no universal solution to the design of an insolvency regime because countries vary significantly in their needs, as do their laws on other issues of key importance to insolvency, such as security interests, property and contract rights, remedies and enforcement procedures. Although there may be no universal solution, most insolvency systems address the range of issues raised by the key objectives, albeit with different emphasis and focus. Some laws favour stronger recognition and enforcement of creditor rights and commercial bargains and give creditors more control over the insolvency process than the debtor (sometimes referred to as "creditor-friendly" regimes), while other laws lean towards giving the debtor more control over the process (referred to as "debtor-friendly" regimes). Some laws give more prominence to liquidation of the debtor to weed out inefficient and incompetent market players while others favour reorganization. The focus on reorganization may serve a number of different aims: as a means of enhancing the value of creditors' claims as part of an ongoing business concern, providing a second chance to the shareholders and management of the debtor; providing strong incentives for the adoption by entrepreneurs and managers of appropriate attitudes to risk; or protecting vulnerable groups, such as the debtor's employees, from the effects of business failure.[1]

17. But adopting a reorganization-friendly approach should not result in establishing a safe haven for moribund enterprises—enterprises that are beyond rescue should be liquidated as quickly and efficiently as possible. To the extent that some interests may be regarded as being of lower priority than others, the establishment of mechanisms outside of the insolvency regime may provide a better

[1] There is not necessarily a direct correlation between the debtor or creditor friendliness of an insolvency regime, the emphasis on liquidation or reorganization and the subsequent success or failure of reorganization. While it is beyond the scope of this Guide to discuss these issues in any detail, they are important for the design of an insolvency regime and deserve consideration. While the rate of successful reorganization varies considerably even among those regimes classified as creditor-friendly, research appears to suggest that the assumption that creditor-friendly regimes lead to fewer or less successful reorganizations than debtor-friendly regimes is not necessarily true.

solution than trying to address those interests under the insolvency regime. For example, where the insolvency law ranks employee claims lower than secured and priority creditors, insurance arrangements can be used to protect employee entitlements (see Part two, chapter ..).

18. Because society is constantly evolving, insolvency law cannot be static but requires reappraisal at regular intervals to ensure that it meets current social needs. Responses to perceived social change involve an act of judgement that can be informed by international best practice and those practices transposed into national insolvency regimes, taking into account the realities of the system and available human and material resources.

C. General features of an insolvency regime

19. [24] Designing an effective and efficient insolvency regime involves the consideration of a common set of issues relating to both the legal framework (rights and obligations of the parties, both substantively and procedurally) and the institutional framework (to implement these rights and obligations) required. The substantive issues, which are discussed in detail in Part two, chapters [..] of this Guide, include:

(a) Identifying the debtors that may be subject to insolvency proceedings, including those debtors that may require a special insolvency regime;

(b) Determining when insolvency proceedings may be commenced and the type of proceeding that may be commenced, the party that may request commencement and whether the commencement criteria should differ depending upon the party requesting commencement;

(c) The extent to which the debtor should be allowed to retain control of the business once insolvency proceedings commence or be displaced and an independent party (in this Guide referred to as the insolvency representative) appointed to supervise and manage the debtor, and the distinction to be made between liquidation and reorganization in that regard;

(d) Protection of the assets of the debtor against the actions of creditors, the debtor itself and the insolvency representative, and where the protective measures apply to secured creditors, the manner in which the economic value of the security interest be protected during the insolvency proceedings;

(e) The manner in which the insolvency representative may deal with contracts entered into by the debtor before the commencement of proceedings and in respect of which both the debtor and its counterparty have not fully performed their respective obligations;

(f) The extent to which set-off or netting rights will be suspended by the commencement of the insolvency proceedings;

(g) The manner in which the insolvency representative may use or dispose of assets of the insolvency estate;

(h) The extent to which the insolvency representative can avoid certain types of transactions that result in the interests of creditors being prejudiced;

(i) In the case of reorganization, preparation of the reorganization plan and the limitations, if any, that will be imposed on the content of the plan, the preparer of the plan and the conditions required for its approval and implementation;

(j) The ranking of creditors for the purposes of distributing the proceeds of liquidation; and

(k) Implementation of the reorganization plan, distribution of the proceeds of liquidation, discharge or dissolution of the debtor and conclusion of the proceedings.

20. [25] In addition to these specific subject areas, a more general issue to be considered is how an insolvency law will relate to other substantive laws and whether the insolvency law will effectively modify those laws. Relevant laws may include labour laws that provide certain protections to employees, laws that limit the availability of set-off and netting, laws that limit debt-for-equity conversions and laws that impose foreign exchange and foreign investment controls that may affect the content of a reorganization plan (see labour contracts and employees [Part two, chapter ..]; set-off and netting [Part two, chapter ..]; and content of reorganization plan [Part two, chapter ..]).

21. While the institutional framework is not discussed in any detail in this Guide, some of the issues are touched upon in Part two, chapter ... 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 roles are to be allocated among the various participants, particularly in terms of decision-making. To the extent that the insolvency law places considerable responsibility upon the institutional infrastructure to make key decisions, it is essential that that infrastructure be sufficiently developed to perform the required functions.

II. Types of insolvency proceedings

22. [26] Two main types of proceedings are common to the majority of insolvency regimes—liquidation (typically a formal proceeding) and reorganization (which may be a formal proceeding, an informal process or in some cases a process which combines informal and formal elements).

23. [26] The traditional division or distinction between these two types of processes can be somewhat artificial and can create unnecessary polarization and inflexibility. It does not accommodate, for example, cases not easily situated at the poles—those cases where a flexible approach to the debtor's financial situation is likely to achieve the best result for both the debtor and the creditors in terms of maximizing the value of the insolvency estate. For example, the term "reorganization" is sometimes used to refer to a particular way of ensuring preservation and possible enhancement of the value of the insolvency estate in the context of liquidation proceedings, such as where the law provides for liquidation to be carried out by transferring the business to another entity as a going concern. In that situation, the term "reorganization" merely points to a technique other than traditional liquidation (i.e. straightforward, piecemeal sale of the assets), being used in order to obtain as much value as possible from the insolvency estate. Similarly, reorganization may require the sale of significant parts of the debtor's business or

[27] contemplate an eventual liquidation or sale of the business to a new company and the dissolution of the existing debtor.

24. [27] For these reasons, it is desirable that an insolvency law provide more than a choice between a strictly traditional liquidation process and a single, narrowly defined type of reorganization process. Since the concept of reorganization can accommodate a variety of arrangements, it is desirable that an insolvency law adopt an approach that is not prescriptive and supports arrangements that will achieve a result that provides more value to creditors than if the debtor was liquidated.

25. [28] In discussing the core provisions of an effective and efficient insolvency regime, this Guide focuses upon a liquidation procedure on the one hand and a reorganization procedure on the other. However, the adoption of this approach is not intended to indicate a preference for particular types of processes or a preference for the manner in which the different processes should be integrated into an insolvency law. Rather, the Guide seeks to compare and contrast the core elements of the different types of procedures and to promote an approach that focuses upon maximizing the result for the parties involved in an insolvency process. This may be achieved by designing an insolvency law that incorporates the traditional formal elements in a way that promotes both maximum flexibility and the use of informal processes where they will be most effective.

A. Liquidation

26. [29] The type of proceedings referred to as "liquidation" is regulated by the insolvency law and generally provide for a public authority (typically, although not necessarily, a judicial court acting through a person appointed for the purpose) to take charge of the debtor's assets, with a view to terminating the commercial activity of the debtor, transforming non-monetary assets into monetary form and subsequently distributing the proceeds of sale of the assets proportionately to creditors. The sale of assets may occur in a piecemeal manner or may involve sale of the business in productive units or as a going concern and these proceedings usually result in the dissolution or disappearance of the debtor as a commercial legal entity. Other terms used for this type of proceedings include bankruptcy, winding-up, *faillite*, *quiebra*, and *Konkursverfahren*.

27. [30] Liquidation proceedings tend to be close to "universal" in their concept, acceptance and application and normally follow a pattern that includes:

(a) An application to a court or other competent body either by the debtor or by creditor(s);

(b) An order or judgement that the debtor be liquidated;

(c) Appointment of an independent person to conduct and administer the liquidation;

(d) Closure of the business activities of the debtor;

(e) Termination of the powers of owners and management and the employment of employees;

(f) Sale of the debtor's assets, either piecemeal or as a going concern;

(g) Adjudication of the claims of creditors;

(h) Distribution of available funds to creditors (under some form of priority); and

(i) Dissolution of the debtor, where it is a corporation or has some other form of legal personality, or discharge, in the case of an individual debtor.

28. [31] There are a number of legal and economic justifications for the liquidation process. Broadly speaking, it can be argued that a commercial business that is unable to compete in a market economy should be removed from the market place. A principal identifying mark of an uncompetitive business is one that satisfies one of the tests of insolvency, that is, it is unable to meet its mature debts as they become due or its debts exceed its assets. More specifically, the need for liquidation procedures can be viewed as addressing inter-creditor problems (when an insolvent debtor's assets are insufficient to meet the claims of all creditors it will be in a creditor's own best interests to take action to recover its claim before other creditors can take similar action) and as a disciplinary force that is an essential element of a sustainable debtor-creditor relationship. An orderly and effective liquidation procedure addresses the inter-creditor problem by setting in motion a collective proceeding that seeks to avoid those actions that, whilst viewed by individual creditors as being in their own best self-interest, essentially lead to the loss of value for all creditors. A collective proceeding is designed to provide equitable treatment to creditors, by treating similarly situated creditors in the same way, and to maximize the value of the debtor's assets for the benefit of all creditors. This is normally achieved by the imposition of a stay on the ability of creditors to enforce their individual rights against the debtor and the appointment of an independent person whose primary duty is to maximize the value of the debtor's assets for distribution to creditors.

29. [32] An orderly and relatively predictable mechanism for the enforcement of the collective rights of creditors can also provide creditors with an element of predictability at the time when they make their lending decisions, as well as more generally promote the interest of all participants in the economy by facilitating the provision of credit and the development of financial markets. This is not to say that an insolvency regime should function as a means of enforcing the rights of individual creditors, although there is a clear and important relationship between the two types of processes. The efficiency and effectiveness of procedures for the individual enforcement of creditors' rights will mean that creditors are not forced to use the insolvency process for that purpose, especially since insolvency proceedings generally require a level of proof, cost and procedural complexity that make it unsuitable for use in that way. Nevertheless, an effective insolvency process will ensure that where debt enforcement mechanisms fail, creditors will have an avenue of final recourse that can operate as an effective incentive to a recalcitrant debtor to encourage payment of the particular creditor.

B. Reorganization

30. [33] An alternative to liquidation is a process that is designed to save a business rather than sell off its assets and terminate it. This process, which may take one of several forms and may be less universal in its concept, acceptance and application than liquidation, is referred to by a number of different names including reorganization, rescue, restructuring, turnaround, rehabilitation, arrangement, composition, *concordat préventif de faillite*, *suspensión de pagos*, *administración judicial de empresas*, and *Vergleichsverfahren*. For the sake of simplicity, the term "reorganization" is used in the Guide in a broad sense to refer to the type of proceedings whose ultimate purpose is to allow the debtor to overcome its financial difficulties and resume or continue normal commercial operations (even though in some cases it may include a reduction in the scope of the business, its sale as a going concern to another company or its eventual liquidation).

1. Formal reorganization proceedings

31. [34] As noted above, reorganization proceedings may be covered by the insolvency law or be an informal process or a process which combines both formal and informal elements. One of the justifications for including a formal reorganization procedure in an insolvency law is that not all debtors that falter or experience serious financial difficulty in a competitive market place should necessarily be liquidated; a debtor with a reasonable prospect of survival (such as one which has a potentially profitable business) should be given that opportunity where it can be demonstrated that there is greater value (and, by deduction, greater benefit for creditors in the long term) in keeping the essential business and other component parts of the debtor together. Reorganization procedures are designed to give a debtor 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. Where reorganization is possible, generally it will be preferred by creditors if the value derived from the continued operation of the debtor's business will enhance the value of their claims. Reorganization, however, does not imply that all of the stakeholders must be wholly protected or that they should be restored to the financial or commercial position that would have obtained had the event of insolvency not occurred. It does not imply that the debtor will be completely restored or its creditors paid in full, or that ownership and management of an insolvent debtor will maintain and preserve their respective positions. Management may be terminated and changed, the equity of shareholders may be reduced to nothing, employees may be retrenched and the source of a market for suppliers may disappear. In general, however, reorganization does imply that whatever form of plan, scheme or arrangement is agreed, the creditors will eventually receive more than if the debtor was to be liquidated.

32. Additional factors supporting the use of reorganization include that [38] the modern economy has significantly reduced the degree to which the value of the debtor's assets can be maximized through liquidation. In cases where technical know-how and goodwill are more important than physical assets, the preservation of human resources and business relations are essential elements of value that cannot be realized through liquidation. Also, long-term economic benefit is more likely to be achieved through reorganization procedures, since they encourage debtors to take action before their financial difficulties become severe. Lastly, there are social and

political considerations which are served by the existence of reorganization procedures which protect, for example, the employees of a troubled debtor.

33. [35] Reorganization procedures may take a number of different forms. They may include a simple agreement concerning debts (referred to as a composition) where, for example, the creditors agree to receive a certain percentage of the debts owed to them in full, complete and final satisfaction of their claims against the debtor. The debts are thus reduced and the debtor becomes solvent and can continue to trade. They may also include a complex reorganization under which, for example, debts are restructured (e.g., by extending the length of the loan and the period in which payment may be made, deferring payment of interest or changing the identity of the lenders); some debt may be converted to equity together with a reduction (or even extinguishment) of existing equity; the non-core assets may be sold; and the unprofitable business activities closed. The choice of the way in which reorganization is carried out is typically a response to the size of the business and the degree of complexity of the debtor's specific situation.

34. [36] Although the reorganization process is not as universal as liquidation, and may not therefore follow such a common pattern, there are a number of key or essential elements that can be determined:

(a) Submission of the debtor to the process (whether voluntarily or on the basis of an application by creditors), which may or may not involve judicial control or supervision;

(b) Automatic and mandatory stay or suspension of actions and proceedings against the assets of the debtor affecting all creditors for a limited period of time;

(c) Continuation of the business of the debtor, either by existing management, an independent manager or a combination of both;

(d) Formulation of a plan which proposes the manner in which creditors, equity holders and the debtor itself will be treated;

(e) Consideration of, and voting on, acceptance of the plan by creditors;

(f) Possibly, the judicial approval/confirmation of an accepted plan; and

(g) Implementation of the plan.

35. [37] The benefits of reorganization are increasingly accepted, and many insolvency laws include provisions on formal reorganization proceedings. The extent to which formal reorganization proceedings as opposed to some form of informal process are relied upon to achieve the objectives of reorganization varies between countries. It is generally recognized that the existence of a liquidation procedure can facilitate the reorganization of a debtor, whether by formal reorganization proceedings or informal means through an out-of-court process, by providing an incentive to both creditors and debtors to reach an appropriate agreement. Indeed, in many economies, reorganization largely takes place informally "in the shadow" of the formal insolvency regime.

36. [37] There is often, however, a correlation between the degree of financial difficulty being experienced by the debtor, the complexity of its business arrangements, and the difficulty of the appropriate solution. Where, for example, a single bank is involved, it is likely that the debtor can negotiate informally with that

bank and resolve its difficulties without involving trade creditors and without the need for formal proceedings to be commenced. Where the financial situation is more complex and requires the involvement of a large number of different types of creditors, a greater degree of formality may be needed to find a solution which addresses the disparate interests and objectives of these creditors [38] since out-of-court reorganization requires unanimity. Formal reorganization procedures may assist in achieving the desired goal where those procedures enable the debtor and a majority of creditors to impose a plan upon a dissenting minority of creditors, especially where there are creditors who "hold-out" during out-of-court negotiations.

2. Informal reorganization processes *[to be coordinated with paras. 363-366, A/CN.9/WP.63/Add.12*]

37. [39] Informal processes were developed some years ago by the banking sector, as an alternative to formal reorganization proceedings. Led and influenced by internationally active banks and financiers, the informal process has gradually spread to a considerable number of jurisdictions, although use of such processes varies—in some jurisdictions they are reported to be rarely used, whilst in others most reorganizations are reported to be conducted informally. To some extent these results may reflect the existence (or not) of what is sometimes described as a "rescue culture"—the degree to which participants regard informal processes as likely to be successful, irrespective of the formal absence of features of proceedings under the insolvency law, such a moratorium, and the need to achieve consensus among creditors in order for an informal agreement to be achieved.

38. [39] The application of the informal process has generally been limited to cases of corporate financial difficulty or insolvency in which there is a significant amount of debt owed to banks and financiers. The process is aimed at securing an agreement both between the lenders themselves and the lenders and the debtor for the reorganization of the debtor, with or without rearrangement of the financing. An informal reorganization can provide a means of introducing flexibility into an insolvency system by reducing reliance on judicial infrastructure, facilitating an earlier proactive response from creditors than would normally be possible under formal regimes and avoiding the stigma that often attaches to insolvency. While not based or reliant upon the provisions of the insolvency law, informal processes do rely upon the existence and availability of the formal insolvency framework to provide sanctions that can assist to make the informal process successful. Unless the debtor and its bank and financial creditors take the opportunity to join together and commence the informal process, the debtor or the creditors can invoke the formal insolvency law, with some potential for detriment to both the debtor and its creditors in terms of delay, cost and outcome.

39. Although not regulated by the insolvency law, many legal systems do contemplate that a debtor can enter into agreement or arrangements with some of all of its creditors which may be governed by, for example, contract law, company or commercial law or civil procedural law, or in some cases relevant banking regulations. However, there are a few jurisdictions which do not allow reorganization to occur outside of the court system or the insolvency law or which would regard the steps associated with such informal reorganization as sufficient for the courts to make a declaration of insolvency. Similarly, there are a number of jurisdictions which, because they impose on the debtor an obligation to commence

formal insolvency proceedings within a certain time after a defined event of insolvency, restrict the conduct of such informal proceedings to circumstances where the formal conditions for commencement of proceedings have not been met. [Nevertheless, it is suggested that banks and other creditors in these jurisdictions do often use various techniques to achieve some form of reorganization of debtors.]

(a) Necessary preconditions

40. The informal reorganization depends for its effectiveness on a number of well-defined initial premises. These may include:

(a) A significant amount of debt owed to a number of main banks or financial institution creditors;

(b) The present inability of the debtor to service that debt;

(c) Acceptance of the view that it may be preferable to negotiate an arrangement, as between the corporate debtor and the financiers and also between the financiers themselves, to resolve the financial difficulties of the corporate debtor;

(d) The use of relatively sophisticated refinancing, security and other commercial techniques that might be employed to alter, rearrange or restructure the debts of the debtor or the debtor itself;

(e) The sanction that if the negotiation process cannot be started or breaks down there can be swift and effective resort to the insolvency law;

(f) The prospect that there may be a greater benefit for all parties through the negotiation process than by direct and immediate resort to the insolvency law (in part because the outcome is subject to the control of the negotiating parties and the process is less expensive and can be accomplished quickly without disrupting the debtor's business);

(g) The debtor does not need relief from trade debts, or the benefits of formal insolvency, such as the automatic stay or the ability to reject burdensome debts; and

(h) Favourable or neutral tax treatment for reorganization both in the debtor's jurisdiction and the jurisdictions of foreign creditors.

(b) Main processes

41. To be effective, an informal reorganization process requires a number of different steps to be followed and range of skills to be employed. The main elements in the process are discussed below.

(i) Commencing the process

42. The informal process essentially involves bringing together the debtor and creditors or at least the main creditors, one or more of whom must initiate the process (as there can be no reliance upon a law or a facilitator for initiation, imposition or assistance of the process). A debtor might be unwilling to commence a dialogue with creditors or at least with all of its creditors and creditors, while concerned for their own position, may have little interest in a collective process. It is at this point that the availability and effectiveness of individual creditor remedies

or formal insolvency proceedings can be used to encourage the commencement and progress of the informal process. A debtor who remains reluctant to participate may find itself subject to individual debt or security enforcement actions or even insolvency proceedings, which it will not be able to defeat or delay. At the same time, creditors may also find themselves subject to formal insolvency proceedings which effectively prevent them from enforcing their individual rights and might not represent the optimal process for recovery of their debt. Creating a forum in which the debtor and creditors can come together to explore and negotiate an arrangement to deal with the debtor's financial difficulty therefore is crucial to this type of process.

(ii) Coordinating participants—appointing a lead creditor and steering committee

43. The reorganization should involve all key constituencies; generally the lenders group and sometimes key creditor constituencies who may be affected by the reorganization are critical to the process. To better coordinate negotiations, a principal creditor should be appointed to provide leadership, organization, management and administration. This creditor typically reports to a committee that is representative of creditors (a steering committee) and can provide assistance and act as a sounding board for proposals regarding the debtor.

(iii) Agreeing a "standstill"

44. To allow business operations to continue and to ensure that sufficient time is available to obtain and evaluate information about the debtor and to formulate and assess proposals to resolve the debtor's financial difficulties, a contractual agreement to suspend adverse actions by both the debtor and the main creditors may be required. That agreement would generally need to endure for a defined, usually short period, unless inappropriate in a particular case.

(iv) Engaging advisors

45. Few, if any, attempts are made at an informal reorganization without the involvement of independent experts and advisors from various disciplines (e.g. legal, accounting, finance and business regulation, marketing). While it may be suggested that this involvement will lead to unnecessary cost and intrusion into the affairs of the debtor and creditors, as well as a loss of control, it is generally necessary to ensure the provision of information, independently verified, as well as professionally developed plans for refinancing, restructuring, management and operation that are essential to the success of the process.

(v) Ensuring adequate cash flow and liquidity

46. A debtor that becomes a candidate for a possible informal reorganization will often require continued access to established lines of credit or the provision of fresh credit. Provision of credit by existing secured creditors may not present a problem. Where this is not available, however, and fresh credit is required, there may be difficulties in guaranteeing the eventual repayment of the fresh credit if the reorganization fails. While this issue can be addressed under the insolvency law by providing some form of priority for such ongoing lending (see Part two, chapter VI.B), the law will not generally extend to such an arrangement under an informal process.

47. Those creditors who participate in an attempted reorganization, nevertheless, can agree amongst themselves that if one or more of them extends further credit the others will subrogate their claims to enable the new credit to be repaid ahead of their own claims. Thus, as between those creditors, there will be a contractual agreement for the repayment of new money where the reorganization is successful. Where the reorganization fails, however, and the debtor is liquidated, the creditor who has provided the fresh credit may be left with an unsecured claim (unless security was provided) and receive only partial repayment along with other unsecured creditors.

(vi) Access to complete, accurate information on the debtor

48. This is essential to enable proper evaluation to be made of the financial position of the debtor and any proposals to be made to relevant creditors. Information concerning the assets, liabilities and business of the debtor should be made available to all relevant creditors but unless already publicly available, may need to be treated as confidential.

(vii) Dealing with creditors

49. The complexity of the interests of creditors often presents critical problems for informal processes. Providing for those differing interests, and persuading those creditors that have already commenced recovery or enforcement action against the debtor that they should participate in the informal process may be possible only if there is a prospect of a better result through the informal process or if the threat of formal insolvency proceedings will restrain creditors from pursuing their individual rights.

50. In many cases, however, it will not be possible (or indeed necessary) to involve every creditor in the informal process, either because of their number and diverse interests or because of the inefficiency of involving creditors who are owed only small amounts of money or who do not have the commercial expertise, knowledge or will to participate effectively in the process. While creditors who fall into these categories often may be left out of the process, they cannot be ignored as they may be important to the continued operation of the business (as suppliers of essential goods or services or as participants in essential parts of the debtor's production process) and there are no rules which can compel such creditors to accept the decision of a majority of their number.

51. Often in an informal reorganization, trade and small creditors recover payment in full. Although this suggests unequal treatment, it may make commercial sense to a group of major creditors. An alternative approach is to secure agreement of the main creditors to a reorganization plan and then use the plan as the basis of a formal court supervised reorganization process in which other creditors participate (sometimes referred to as a "pre-packaged" plan—see Part two, chapter V.B). This plan can then bind the other creditors. Without an effective formal insolvency regime, this result could not be achieved.

(c) Rules and guidelines for informal reorganization

52. [43] To assist the conduct of informal reorganization, and in particular to address the problems noted above in the context of complex, multinational businesses, a number of organizations have developed non-binding principles and

guidelines. One such approach is called the "London Approach" named after the non-binding guidelines issued to commercial banks by the Bank of England. 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 that would be involved in any agreement as to the future of the debtor. 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 debtor entity should be given a financial lifeline. Similar guidelines have been developed by the central banks of other countries. [A/CN.9/WP.63/Add.12, para. 365] An international organization which has undertaken work in this area is the International Federation of Insolvency Professionals (INSOL) which has developed Principles for a global approach to multi-creditor workouts. The Principles are designed to expedite informal processes and increase the prospects of success by providing guidance to diverse creditor groups about how to proceed on the basis of some common agreed rules.

3. Reorganization processes which include both informal and formal elements

53. [47] Some countries have adopted what can be described as "pre-insolvency" or "pre-packaged" procedures that are, in effect, a combination of informal reorganization processes and formal reorganization proceedings. Under one insolvency law, for example, regulations have been issued that allow the court to formally approve a reorganization plan that was negotiated informally and approved by creditors through a vote that occurred before the commencement of formal proceedings. Such processes are designed to minimize the cost and delay associated with formal reorganization proceedings while at the same time providing a means by which a reorganization plan negotiated informally nevertheless can be approved in the absence of unanimous support of the creditors. Such a process allows the work undertaken in the informal negotiations to be used to achieve a reorganization that will bind all creditors, whilst at the same time providing the protections of the insolvency law to affected creditors.

54. [48] Another insolvency law provides that in order 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 judgement, 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 non-participating creditors by providing a grace period to the debtor of up to two years.

55. These types of procedures are discussed in more detail in Part two, chapter V.B.

C. Administrative processes

56. [44] In recent years a number of crisis-affected jurisdictions have developed semi-official "structured" forms of informal processes, largely inspired by government or central banks, to deal with systemic financial problems within the banking sector. These processes have been developed on a similar pattern. First, each has a facilitating agency to encourage and, in part, coordinate and administer informal reorganization to provide the incentive and motivation necessary for development of the informal processes. Second, each process is underpinned by an agreement between commercial banks in which the participants agree to follow a set of "rules" in respect of corporate debtors who are indebted to one or more of the banks and which may participate in the process. The rules provide the procedures to be followed and the conditions to be imposed in cases where corporate reorganization is attempted. In some of the jurisdictions, a debtor corporation that seeks to negotiate an informal reorganization is required to agree to the application of these rules. Third, time limits are provided for various parts of the procedures and, in some cases, agreements in principle can be referred to the relevant court for a formal reorganization to occur under the law. In addition, one jurisdiction established a special agency which has extremely wide powers under its governing legislation to acquire non-performing loans from the banking and finance sector and then to impose extra-judicial processes upon a defaulting corporate debtor, including a forced or imposed reorganization.

57. Both because these processes are relatively complex and involve the development of special rules and regulations and because they address particular situations of systemic failure they are not discussed in any detail in the Guide.

D. The structure of the insolvency regime

58. [52] Although many insolvency laws include both liquidation and reorganization proceedings, approaches differ widely as to the structure of the procedure which leads to the choice of one of these processes. Some insolvency laws provide for a unitary, flexible insolvency proceeding with a single commencement requirement alternatively resulting in liquidation or reorganization depending on the circumstances of the case. Other laws provide for two distinct proceedings, each setting forth its own access and commencement requirements, with different possibilities for conversion between the two proceedings.

59. [53] Those laws that treat liquidation and reorganization procedures as distinct from each other do so on the basis of different social and commercial policy considerations and with a view to achieving different objectives. However, a significant number of issues are common to both liquidation and reorganization, resulting in considerable overlaps and linkages between them, in terms of both procedural steps and substantive issues, as will become evident from the discussion in Part Two which follows.

60. [54] Where two distinct procedures are provided in the insolvency law, the determination of whether the business of the insolvent debtor is viable should determine, at least in theory, which procedure will be used. As a matter of practice, however, at the time of commencement of either procedure, it is often impossible to

make a final evaluation as to the financial viability of the business. Some of the disadvantages of this approach are that it may create an undesirable degree of polarization between liquidation and reorganization and can result in delay, increased expense and inefficiency, especially, for example, where the failure of reorganization requires a new and separate application to be made for liquidation. This inefficiency can be overcome, to some extent, by providing linkages between the two proceedings, with a view to allowing conversion of one type of proceeding to the other in certain specific circumstances, and by including devices designed to prevent the abuse of insolvency process, such as commencing reorganization proceedings as a means of avoiding or delaying liquidation (see …).

61. [55] As to the question of choice of procedures, some countries provide that the party applying for the insolvency proceedings will have the initial choice between liquidation and reorganization. When liquidation proceedings are initiated by one or more creditors, the law will often provide a mechanism which enables the debtor to request conversion into reorganization proceedings where this is feasible. When the debtor applies for reorganization proceedings, whether on its own motion or as a consequence of an application for liquidation by a creditor, the application for reorganization should logically be decided first. With a view to protecting creditors, however, some insolvency laws will provide a mechanism enabling reorganization to be converted into liquidation upon a determination, either at an early stage of the proceedings or later, that reorganization is not likely to, or cannot, succeed. Another mechanism of protection for creditors may consist of setting forth the maximum period for which reorganization against the will of the creditors may be granted.

62. [56] As a general principle, although usually presented as separate procedures, liquidation and reorganization procedures are normally carried out sequentially, that is, a liquidation procedure will only run its course if reorganization is unlikely to be successful or if reorganization efforts have failed. In some insolvency systems, the general presumption is that a business should be reorganized and liquidation procedures may be commenced only when all attempts to reorganize the entity have failed. In insolvency systems providing for conversion, a request for reorganization to be converted into liquidation may be made by the debtor, the creditors or the insolvency representative, depending upon the circumstances set forth by the law. These circumstances may include where the debtor is unable to pay post-petition debts as they fall due; where the reorganization plan is not approved by creditors or the court; where the debtor fails to fulfil its obligations under an approved plan; or where the debtor attempts to defraud creditors (see Part two, chapter ..). Whilst it is often possible for reorganization proceedings to be converted to liquidation proceedings, most insolvency systems do not allow reconversion to reorganization once conversion of reorganization to liquidation has already occurred.

63. [57] Difficulties of determining at the very outset whether the debtor should be liquidated rather than reorganized have led some countries to revise their insolvency laws by replacing separate proceedings with “unitary” proceedings.[2] Under the “unitary” approach there is an initial period (usually referred to as an “observation period”, which in existing examples of unitary laws may last up to

[2] Where a unitary system is chosen, some changes will need to be made to the various core elements of the insolvency law. These are identified in Annex ...

three months) during which no presumption is made as to whether the business will be eventually reorganized or liquidated. The choice between liquidation or reorganization proceedings only occurs once a determination has been made as to whether reorganization is actually possible. The basic advantages offered by this approach are its procedural simplicity, its flexibility and possible cost-efficiency. A simple, unitary procedure, allowing both reorganization and rehabilitation, may also encourage early recourse to the proceedings by debtors facing financial difficulties, thus enhancing the chances of successful rehabilitation. A disadvantage of this procedure, however, may be the delay that occurs between the decision to commence and the decision as to which procedure should be followed, and the consequences for the debtor's business and the value of the debtor's assets that may flow from that delay.

64. However the insolvency law is arranged in terms of liquidation and reorganization, it should ensure that once a debtor is in the system, it cannot exit without some final determination of its future.