United Nations A/CN.9/WG.V/WP.57

General Assembly

Distr.: Limited
30 October 2001

Original: English

**United Nations Commission on International Trade Law**
Working Group V (Insolvency Law)
Twenty-fifth session
Vienna, 3-14 December 2001

# Draft legislative guide on insolvency law

## Report of the Secretary-General

## Contents



V.01-88160 (E)

*[Part Two II, III, IV, V and VI of the draft legislative guide appears in document A/CN.9/WG.V/WP.58*

# Background remarks

1. The Commission, at its thirty-second session (1999), had before it a proposal by Australia (A/CN.9/462/Add.1) on possible future work in the area of insolvency law. That proposal had recommended that, in view of its universal membership, its previous successful work on cross-border insolvency and its established working relations with international organizations that have expertise and interest in the law of insolvency, the Commission was an appropriate forum for the discussion of insolvency law issues. The proposal urged that the Commission consider entrusting a working group with the development of a model law on corporate insolvency to foster and encourage the adoption of effective national corporate insolvency regimes.

2. Recognition was expressed in the Commission for the importance to all countries of strong insolvency regimes. The view was expressed that the type of insolvency regime that a country had adopted had become a "front-line" factor in international credit ratings. Concern was expressed, however, about the difficulties associated with work at an international level on insolvency legislation, which involved sensitive and potentially diverging socio-political choices. In view of those difficulties, the fear was expressed that the work might not be brought to a successful conclusion. It was said that a universally acceptable model law was in all likelihood not feasible and that any work needed to take a flexible approach that would leave options and policy choices open to States. While the Commission heard expressions of support for such flexibility, it was generally agreed that the Commission could not take a final decision on committing itself to establishing a working group to develop model legislation or another text without further study of the work already being undertaken by other organizations and consideration of the relevant issues.

3. To facilitate that further study, the Commission decided to convene an exploratory session of a working group to prepare a feasibility proposal for consideration by the Commission at its thirty-third session. That session of the Working Group was held in Vienna from 6 to 17 December 1999.

4. At its thirty-third session in 2000 the Commission noted the recommendation that the Working Group had made in its report (A/CN.9/469, para. 140) and gave the Group the mandate to prepare a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including consideration of out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features, including a discussion of the alternative approaches possible and the perceived benefits and detriments of such approaches.

5. It was agreed that in carrying out its task the Working Group should be mindful of the work under way or already completed by other organizations, including the World Bank, the International Monetary Fund (IMF), the Asian Development Bank (ADB), INSOL International (INSOL) (an international federation of insolvency professionals) and Committee J of the Section on Business Law of the International Bar Association (IBA). In order to obtain the views and benefit from the expertise of those organizations, the Secretariat, in cooperation with INSOL and the IBA organized the UNCITRAL/INSOL/IBA Global Insolvency Colloquium in Vienna, from 4-6 December 2000.

6. At its thirty-fourth session in 2001, the Commission had before it the report of the Colloquium (A/CN.9/495).

7. The Commission took note of the report with satisfaction and commended the work accomplished so far, in particular the holding of the Global Insolvency Colloquium and the efforts of coordination with the work carried out by other international organizations in the area of insolvency law. The Commission discussed the recommendations of the Colloquium, in particular with respect to the form that the future work might take and interpretation of the mandate given to the Working Group by the Commission at its thirty-third session. The Commission confirmed that the mandate should be widely interpreted to ensure an appropriately flexible work product, which should take the form of a legislative guide. In order to avoid the legislative guide being too general or too abstract to provide the required guidance, the Commission suggested that the Working Group should bear in mind the need to be as specific as possible in developing its work. To that end, model legislative provisions, even if only addressing some of the issues to be included in the guide, should be included as far as possible.

8. The twenty-fourth session of the Working Group on Insolvency Law, which was held in New York from 23 July to 3 August 2001, commenced consideration of this work with the first draft of the legislative guide on insolvency law. The report of that meeting is contained in document A/CN.9/504.

9. This report sets forth the Introduction, Glossary, Part One *Key Objectives* and Part Two *Core provision of an effective and efficient insolvency regime,* section I of the draft legislative guide on insolvency law. Part Two *Core provision of an effective and efficient insolvency regime,* sections II-VI appear in document A/CN.9/WG.V/WP.58.

# Draft legislative guide on insolvency law

## Introduction

## 1. Organization and scope of the Guide

10. The purpose of this Guide is to assist in the development of efficient and effective legal frameworks for insolvency. The advice provided in the Guide aims at achieving a balance between, on the one hand, provisions necessary to encourage the early use of and access to an insolvency regime in order to maximise the utility of the tangible and intangible assets of a business entity on a fair and balanced basis to the stakeholders and avoid the erosion of value through delay and, on the other hand, various public interest concerns.

11. This note and document A/CN.9/WG.V/WP.58 set forth the draft legislative guide on insolvency law. This note contains the Introduction, note on terminology, glossary, key objectives and Part Two, section I *Introduction to insolvency procedures*. Part Two, sections II-VI which are set forth in document A/CN.9/WG.V/WP.58 deal with substantive core provisions of an effective and efficient insolvency regime. Each subject area is divided into two sections. The first section offers an analytical introduction to the issues raised by each core subject

area in respect of both liquidation and reorganization proceedings and discusses policy issues and comparative approaches. The second section provides a summary of the goals of legislative provisions on each core subject area and recommendations as to the approaches that may be taken. It is intended that this second section will also contain legislative provisions indicating how the recommendations can be implemented.

12. The Guide does not address questions of relevance to cross-border aspects of insolvency law, such as the treatment of foreign creditors. These matters are addressed in the UNCITRAL Model Law on Cross-Border Insolvency and it is recommended that that text be considered in addition to this Guide. The Guide is not intended to in any way modify or amend any provision of the Model Law.

## 2. Terminology used in the Guide and role of definitions

13. The following terms are intended to provide orientation to the reader of the Guide—many terms such as "secured creditor", "liquidation" and "reorganization" may have fundamentally different meanings in different jurisdictions and the inclusion of a definition in the Guide may assist in ensuring that the concepts as included in the draft Guide are clear and widely understood. The terms included in the draft Guide have not yet been discussed by the Working Group and contain a number of possible alternatives which appear between square brackets.

*References in the Guide to the "court"*

14. The draft Guide assumes that there is reliance on court supervision throughout the insolvency proceedings which may include the power to commence insolvency proceedings, to appoint the insolvency representative, to supervise its activities and to take decisions in the course of the proceedings. Although this reliance may be appropriate as a general principle, alternatives may be considered where, for example, the courts are unable to handle insolvency work (whether for reasons of lack of resources or lack of requisite experience) or supervision by an administrative agency is preferred. For the purposes of simplicity the draft Guide uses the word "court" in the same way as article 2(e) of the UNCITRAL Model Law on Cross-Border Insolvency to refer to a judicial or other authority competent to control or supervise an insolvency proceeding.

## 3. Glossary

| | |
|---|---|
| Avoidance action | action which allows transactions to be cancelled or otherwise rendered ineffective. Transactions that may be avoided include those (a) between a debtor and a creditor having the effect of creating a preference in favour of that creditor to the prejudice of the general body of creditors [other than in the normal course of trade], having taken place within [a specified period of time] before the commencement of the proceedings or (b) in which a debtor's assets were transferred for unfair value or (c) in which a debtor's assets were transferred fraudulently |

| | |
|---|---|
| Centre of main interests | the place where the debtor conducts the administration of its interests on a regular basis, as such ascertainable by third parties |
| Claim | enforceable right to money or assets |
| Collateral | asset subject to a security interest to the benefit of one or more creditors, who are entitled to sell the asset in the event of default (see secured claim) |
| Commencement of proceedings | [date as of which the effects of insolvency are applicable]<br>or [date as of which the judicial decision commencing insolvency proceedings becomes effective, whether it is a final decision or not] |
| Composition | [within the context of reorganization,] agreement between the debtor and the [majority of] creditors where the creditors agree with the debtor and between themselves to accept from the debtor payment of less than the amount due to them in full satisfaction of their claims or to a reduction or postponement of debts or the redefinition of payment terms |
| Court | a judicial or other authority competent to control or supervise an insolvency proceeding: UNCITRAL Model Law on Cross-Border Insolvency, art. 2(e) |
| Cram-down provision | a mechanism that will enable the support of one class of creditors for a reorganization plan to be used to make the plan binding on other classes without their consent |
| Creditor committee | representative body appointed by [the court] [the insolvency representative] [creditors as a whole] to act on behalf and in the interests of the creditors and having consultative and other powers as specified in the insolvency law |
| Debtor | person or entity engaged in a business and which meets the criteria for, and is subject to, insolvency proceedings, with the exception of entities subject to a special insolvency regime [including banking and financial institutions, insurance companies and [*other*]] |
| Discharge | a court order releasing a debtor from all liabilities that were, or could have been, addressed in the insolvency proceedings, including contracts that were modified as part of a reorganization |

| | |
|---|---|
| Establishment | any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services: UNCITRAL Model Law on Cross-Border Insolvency art. 2(f) |
| Going concern | the basis upon which a business is continued and sold as a working whole in liquidation, as opposed to a piecemeal sale of individual assets of the business |
| Initiation of proceedings | the making of an application for commencement of insolvency proceedings by the debtor; one or more creditors; the general public attorney; the insolvency court of its own motion |
| Insolvency | [when the debtor is [likely to become] unable or is no longer able to pay its debts and other liabilities as they fall due] or<br>[when the value of debts and liabilities of the debtor exceeds the value of assets] or [when the debtor generally ceases to pay or suspends payment of its debts and other liabilities as they fall due, the cash assets being insufficient] or<br>[when the debtor ceases to pay important and sensitive debts, such as rent, wages and social security payments] |
| Insolvency estate | assets of the debtor controlled by the insolvency representative and subject to the insolvency proceedings;<br>[goods and rights pertaining to the debtor as of and after the commencement of the proceedings which can be evaluated in money [and which constitute assets available for payment of creditors' claims] or [goods and rights pertaining to the debtor which can be evaluated in money [and are available for creditors as their security] |
| Insolvency proceedings | collective proceedings which involve the [partial or total] divestment of the debtor and the appointment of an insolvency representative [for the purpose of either liquidation or reorganization of the business] [including both liquidation and reorganization proceedings] |
| Insolvency representative | [person [or entity] appointed by the court which is in charge of administering the debtor's estate [and assisting and watching over the management of the business] with a view to either liquidation or reorganization of the business; or person [or entity] appointed by the insolvency court to whom the powers of the debtor['s management] to administer, sell or dispose of [assets included in] the insolvency |

| | |
|---|---|
| | estate are transferred as of the commencement of the proceeding, acting under the supervision of the court. Such powers include without limitation the following: determining or assisting in determination of creditors' claims; realizing the [assets pertaining to the] insolvency estate; making distributions of proceeds among to creditors; taking avoidance actions |
| Insolvency decision | decision of the court to commence an insolvency proceeding [and to appoint an insolvency representative] (see also commencement of proceedings) |
| Involuntary proceedings | insolvency proceedings commenced on the application of creditors or by the general public attorney's office or [*other*] |
| Liquidation | process whereby a debtor has its assets assembled, disposed of and distributed for the benefit of [the insolvency estate and] the creditors, including shareholders [followed by the dissolution of the legal entity], either by way of a piecemeal sale or a sale of all or most of the debtor's assets in productive operating units or as a going concern |
| Netting | In one form it can consist of set-off (see 'set-off') of non-monetary fungibles (such as securities or commodities deliverable on the same day, known as settlement netting) and in its more important form it consists of a cancellation by a counterparty of open contracts with the debtor, followed by a set-off of losses and gains either way (close-out netting) |
| Observation period | [within the context of a unitary (see Part Two) insolvency proceeding], the possibility or otherwise of successful reorganization must be established |
| *Pari passu* | principle according to which creditors of the same class are treated equally [and are paid proportionately out of the assets of the estate] |
| Pending contracts | contracts outstanding [and not or not fully performed] as of the commencement of the proceeding |
| Post-commencement creditor | creditor whose claim has arisen after commencement of the insolvency proceedings |
| Preference | a payment or other transactions made by an insolvent entity which places a creditor in a better position than it would have been otherwise |

| | |
|---|---|
| Preliminary insolvency representative | person or entity appointed by the insolvency court in case of a serious crisis of the debtor which prevents the normal operation of its business, required to ensure temporarily further carrying on the business in connection with suspension of the debtor or of the debtor's management (possibly in connection with reorganization) |
| Priming lien | a priority given to lenders of post-commencement credit which ranks ahead of all creditors, including secured creditors |
| Priority claim | a claim that will be paid out of available assets before payment of general unsecured creditors |
| Priority rules | the rules by which distributions are ordered among creditors and equity interests |
| Reorganization | process of restructuring an insolvent entity in order to [rescue the debtor and] restore the financial well being and the viability of the business, by way of various means possibly including debt forgiveness, debt rescheduling, debt-equity conversions and sale of the business or parts of it as a going concern |
| Reorganization plan | a plan to reorganize the business [and redress the debtor] submitted by [the debtor][the creditors][the insolvency representative] [and confirmed by the court], addressing issues such as timing of the process, commitments to be undertaken, terms of payment and securities to be offered to creditors, avoidance actions to be filed and treatment of pending contracts including employment contracts |
| Reservation of title (title financing) | provision of a contract for the supply of goods which purports to reserve ownership of the goods with the supplier until the goods are paid for |
| Secured claim | a claim assisted by a security taken as a guarantee for a debt enforceable in case of the debtor's default when the debt falls due |
| Secured creditor | a creditor holding either a security covering all or part of the debtor's assets or a security over a specific asset entitling the creditor to preference ahead of other creditors with respect to the encumbered assets |
| Secured debt | [aggregate amount of secured claims] or [claims pertaining to secured creditors] |

| | |
|---|---|
| Set-off | where a claim for a sum of money owed to a person is "set-off" (balanced) against a claim by the other party for a sum of money owed by that first person. May operate as a defence in whole or part to a claim for a sum of money |
| Stay of proceedings | suspension of the power of the creditors to commence or continue judicial, administrative or other individual actions for enforcement and recovery of their claims, or for obtaining possession of assets pertaining to the insolvency estate, or for creating, perfecting or enforcing any security over assets pertaining to the insolvency estate |
| Superpriority | a priority that will result in claims to which the priority attaches being paid before administrative claims |
| Unsecured debt | aggregate amount of claims not supported by security |
| Voluntary proceeding | insolvency proceedings commenced on the application of the debtor |

# Part One

# Key objectives of an effective and efficient insolvency regime

## 1. Maximize value of assets

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 maximised by allowing it to continue. The maximum value for creditors can often be obtained through reorganization rather than liquidation.

## 2. Strike a balance 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) and other social policy considerations such as encouraging the development of an entrepreneurial class and protecting employment. A broadly phrased “arrangement” or “method” which aims at maximising the return and minimizing the effects of insolvency and includes a range of possible insolvency techniques, would avoid implied preference for one technique over the other.

## 3. Ensure equitable treatment of similarly situated creditors

17. An insolvency regime should treat similarly-situated creditors, including both foreign and domestic creditors, equitably. 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, as well as the prerogatives pertaining to holders of claims or interests that arise by operation of law. The insolvency regime should address problems of fraud and favouritism that may arise in cases of financial distress, by providing that acts detrimental to equitable treatment of creditors can be avoided.

## 4. Provide for timely and efficient commencement of proceedings and for impartial resolution of insolvency

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. The law should facilitate easy access to the insolvency process by reference to clear and objective criteria, provide a convenient means of identifying, collecting, preserving and recovering property that should be applied towards payment of the debts and liabilities of the debtor, facilitate participation of the debtor and its creditors with the least possible delay and expense, provide an appropriate structure for supervision and administration of the process and provide, as an end result, effective relief to the financial obligations and liabilities of the debtor.

### 5. Prevent premature dismemberment of the debtor's assets by creditors

19. An insolvency regime should be orderly and 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. 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 contains incentives for gathering and dispensing information

20. An efficient and effective insolvency procedure 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. 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 insolvency law should be transparent and predictable, to 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. As far as possible, an insolvency law should clearly indicate all provision of other laws that may affect the conduct of the insolvency proceedings.

### 7. Recognize existing creditor rights and respect priority claims with a predictable process

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. 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 that they can be consistently applied, to ensure that there is confidence in the process and that all participants are able to adopt appropriate measures to manage risk.

### 8. Establish a framework for cross-border insolvency

22. To promote co-ordination 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.

# Part Two

# Core provisions of an effective and efficient insolvency regime

## I. Introduction to insolvency procedures[1]

### A. General features of an insolvency regime

23. When a debtor is unable to pay its debts and liabilities as they become due, the need arises to provide for a legal mechanism to address the collective satisfaction of the outstanding claims on all assets (whether tangible or intangible) of the debtor. A range of interests needs to be accommodated by that legal mechanism—the debtor, the owners and management of the debtor, the creditors who may be secured to varying degrees, employees, fiscal creditors, guarantors of debt and unsecured creditors, as well as government, commercial and social institutions and practices that are relevant to the design of the mechanism and to the institutional framework required for its operation. Most legal systems contain rules on various types of proceedings (which may be referred to by the generic term "insolvency proceedings") that can be initiated to resolve that situation. While addressing a common goal of resolving the debtor's financial difficulties, these proceedings take a number of different forms, including both formal and informal elements, for which uniform terminology is not always used.

24. Designing an effective and efficient insolvency law will require the consideration of a common set of issues, both of a substantive and institutional nature. The substantive issues, which are discussed in detail in Part Two of this Guide include:

(a) identifying the debtors that may be subject to insolvency proceedings and those debtors that may be subject to 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 who is requesting commencement;
(c) the extent to which the debtor should be allowed to retain control of the business once proceedings commence or whether it should be displaced and an independent party (in this Guide referred to as the insolvency representative) appointed to supervise and manage the debtor
(d) protection of the assets of the debtor against the actions of creditors, the debtor itself and the insolvency representative. Where a stay applies to commencement and continuation of actions by creditors once insolvency proceedings commence, should it also apply to secured creditors and if so, how will the value of their secured interest be protected during the insolvency proceedings;
(e) the extent to which the insolvency representative will have the authority to interfere with the terms of contracts entered into by the debtor before the commencement of proceedings and either not or not fully performed;

---

[1] The material in the following section draws on the work of the Asian Development Bank, the International Monetary Fund and the World Bank.

(f) the extent to which the insolvency representative can avoid certain types of transactions that are fraudulent, or otherwise result in the interest of creditors being prejudiced;
(g) preparation of the reorganization plan and the limitations, if any, that will be imposed on the content of the, the preparer of the plan and the conditions required for its approval and implementation;
(h) the ranking of creditors for the purposes of distributing the proceeds of liquidation; and
(i) […].

25. In addition to these specific subject areas, a more general issue to be addressed is whether an insolvency law will effectively modify other substantive laws. For example, whether an insolvency law will affect employment laws that provide certain protections to employees, laws that limit the availability of setoff 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 Employment contracts and employees paras. 113-114, 228-230; setoff and netting paras. 116-123; content of reorganization plan paras. 274, …).

## B. Types of insolvency proceedings

26. Two main types of proceedings can be identified—liquidation (typically a formal proceeding) and reorganization (which may be either a formal proceeding, an informal proceeding or in some cases a combination of informal and formal procedures). The traditional division between these two types of processes, however, is 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 (which may require a combination of processes, sometimes both formal and informal). In addition, the distinction between conventional liquidation and reorganization procedures is not always clear-cut. The term "reorganization", for example, 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. This is the case, for instance, whenever 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 sale of the assets), being used in order to obtain as much value as possible from the insolvency estate.

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 type of reorganization process. The concept of reorganization can accommodate a variety of arrangements which do not need to be specifically detailed in an insolvency law. It may be sufficient for the reorganization regime to permit a result that would achieve more than if the entity was liquidated (in fact, the reorganization may contemplate an eventual liquidation or sale of the business).

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 nor a preference for how 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 focusses upon maximizating the result for the parties involved in an insolvency process. This may be achieved by designing an insolvency law which 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.

## 1. Liquidation

29. The type of proceedings referred to as "liquidation" typically provides 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 proportionately to creditors. These proceedings usually result in liquidation or disappearance of the debtor as a commercial legal entity, although in some instances the assets may be sold together as an operating business. Other terms used for this type of proceedings include bankruptcy, winding-up, faillite, quiebra, Konkursverfahren.

30. This type of proceeding tends to be close to "universal" in its concept, acceptance and application. It normally follows a pattern that includes:[2]

(a) an application to a court or other competent body either by the entity or by creditor(s);
(b) an order or judgement that the entity be liquidated;
(c) appointment of an independent person to conduct and administer the liquidation;
(d) closure of the business activities of the entity;
(e) termination of the powers of owners and management and the employment of employees;
(f) sale of the entity's assets;
(g) adjudication of claims of creditors;
(h) distribution of available funds to creditors (under some form of priority); and
(i) dissolution of the entity.

31. There are a number of legal and economic justifications for the liquidation process. Broadly speaking, a commercial entity that is unable to compete in a competitive market economy arguably has no place in and should be removed from the market place. A principal identifying mark of an uncompetitive entity is one that becomes insolvent. 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 the creditors 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 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 and to maximize the

[2] "Law and Policy Reform at the Asian Development Bank", Report on RETA 5795: Insolvency Law Reforms in the Asian and Pacific Region, Asian Development Bank 2000, para. 35

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.

32. Liquidation procedures also constitute an important disciplinary force that is an essential element of a sustainable debtor-creditor relationship. They can provide, for example, an orderly and relatively predictable mechanism by which the rights of creditors can be enforced. These procedures not only provide creditors with an element of predictability when they make their lending decisions, but also more generally promote the interest of all participants in the economy by facilitating the provision of credit and the development of financial markets.

## 2. Reorganization

### (a) Formal reorganization proceedings

33. An alternative to liquidation is a process that is designed to save a business rather than 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 draft Guide in a broad sense to refer to they type of proceedings whose ultimate purpose is to allow the debtor to overcome its financial difficulties and resume or continue normal commercial operations.

34. One of the justifications for including a reorganization procedure in an insolvency law is to balance the rationale of a liquidation regime since not all entities that fail in a competitive market place should necessarily be liquidated. An entity with a reasonable prospect of survival (such as one which has a potentially profitable business) should be given that opportunity, especially 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 entity together. Reorganization procedures are designed to give an entity 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 entity will enhance the value of their claims. Reorganization, however, does not imply that the entity will be completely restored or its creditors paid in full. Nor does it necessarily mean that ownership and management of an insolvent entity will maintain and preserve their respective positions. 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 entity was to be liquidated.

35. That result may be achieved by using procedures which take a number of different forms. These 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 entity becomes solvent and can continue to trade. They may also include a complex reorganization under which, for example, the debts of the insolvent entity 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.

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:[3]

(a) voluntary submission of the entity to the process, which may or may not involve judicial proceedings and judicial control or supervision;
(b) automatic and mandatory stay or suspension of actions and proceedings against the assets of the entity affecting all creditors for a limited period of time;
(c) continuation of the business of the entity, 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 entity itself will be treated;
(e) consideration of, and voting on, acceptance of the plan by creditors;
(f) possibly, the judicial sanction of an accepted plan; and
(g) implementation of the plan.

37. While the benefits of reorganization are generally accepted, the extent to which formal reorganization procedures 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 an entity, whether by formal reorganization proceedings or informal means through an out-of-court process (the existence of the formal regime operating as 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. There is often, however, a correlation between the degree of financial difficulty being experienced by the debtor 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. 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 find a solution which addresses the disparate interests and objectives of these creditors.

38. Notwithstanding the prevalence of informal processes, formal reorganization procedures can provide a mechanism for enterprise reorganization that serves the interests of all participants in the economy. First, since out-of-court reorganization requires unanimity of creditors, recourse to formal reorganization procedures may assist in achieving restructuring where they 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. Secondly, the modern economy has significantly reduced the degree to which an entity's value 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

[3] see Note 2, para. 41

elements of value that cannot be realised through liquidation. Thirdly, 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 entity.

**(b) Informal reorganization proceedings**

39. Informal processes were developed some years ago by the banking sector, as an alternative to formal reorganization processes. Led and influenced by internationally active banks and financiers, the informal process has gradually spread to a considerable number of jurisdictions. 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 lender and the debtor for the reorganization of the debtor entity, with or without the 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 pro-active response from creditors than would normally be possible under formal regimes and avoiding the stigma that often attaches to insolvency. It does, however, rely upon the existence of the formal insolvency framework to provide sanctions that assist to make the informal process successful. Unless the debtor and its bank and finance creditors take the opportunity to join together and commence the informal process, the debtor or the creditors can invoke the formal insolvency law, with the potent for detriment to both the debtor and its creditors.

40. Informal processes may take various forms, ranging from a completely informal process based upon non-binding principles which support a collective negotiating framework and do not involve the judicial system (although relying on the existence of an efficient and effective formal system for leverage), to those which utilize a judicial administration mechanism to enforce a plan reached by informal negotiations and to bind creditors to that plan. Where the negotiations take place out-of-court and the debtor and the majority of creditors agree to the plan, a fast track mechanism can be used for the approval process.

41. Issues to be addressed:

[*conditions necessary for effective informal procedures and processes required to conduct informal proceedings*]

*[A/CN.9/504, para. 161: It was noted that some of those considerations intersected with the Working Group's development of a legislative guide on a formal insolvency regime and consideration would need to be given to how that intersection could be achieved. In particular, it was suggested that the draft Guide should consider the different options, offering a discussion of the advantages and disadvantages of each and indicating how they could be integrated into a reorganization regime. It was noted in that regard that there was a correlation between the degree of financial difficulty being experienced by the debtor and the difficulty of the appropriate solution. Where, for example, a single bank was involved, it was likely that the debtor could negotiate informally with that bank and resolve its difficulties without*

*involving trade creditors. Where the financial situation was more complex and required the involvement of a large number of different types of creditors, a greater degree of formality might be needed. It was suggested that that approach might be a way of presenting the different procedures to legislators. It was agreed that those considerations should be taken into account in the Working Group's consideration of the reorganization sections of the draft Guide, and in particular that the subject of expedited reorganization procedures to implement restructurings of the type addressed in document A/CN.9/WG.V/WP.55 (including both cross-border and domestic arrangements) be addressed in the draft Guide.]*

*(i) Completely Informal processes*

42. Issues to be addressed:

*[A/CN.9/504, para. 159: With respect to the completely informal processes, it was suggested that the Working Group should consider the work being undertaken by other organizations, such the INSOL Lenders Group's Statement of Principles for a global approach to multi-creditor workouts (set forth in document A/CN.9/WG.V/WP.55) and other similar types of guidelines.]*

43. One method is the "London Approach" which is based on non-binding guidelines issued by the Bank of England to commercial banks. 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.

*(ii) Administrative processes*

44. Issues to be addressed:

*[A/CN.9/504, para. 160: With regard to administrative frameworks, three types of experience were noted and it was suggested that the draft Guide should consider the relevant examples and the circumstances in which they had proven to be useful and where they might appropriately be used in the future. In particular, it was pointed out that they had been of assistance in situations where the courts were inadequate to deal with the issues or simply overwhelmed by the extent of systemic failure.]*

45. 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 statutory agency which has extremely wide powers 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.

*(iii) Hybrid processes*

46. Issues to be addressed:

*[A/CN.9/504, para. 159: In regard to those processes that combined informal and formal elements, the Working Group might consider how those processes had been developed around the world and in particular examine the role that was taken by judicial and administrative authorities and the point at which intervention occurred.]*

47. Some countries have adopted what can be described as "pre-insolvency" procedures that are, in effect, a hybrid of out-of-court reorganization and formal reorganization procedures. Under one insolvency law, regulations have been issued that allow the court to approve a reorganization plan under the insolvency law even though the support required from creditors as a condition for court approval under the insolvency law was obtained through a vote that occurred before the actual commencement of the formal reorganization proceedings. Such "prepackaged" insolvency regulations are designed to minimize the cost and delay associated with formal reorganization procedures while providing a means by which a reorganization plan can be approved absent unanimous support of the creditors.

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 of up to two years to the debtor.

49. Issues to be addressed:

*[A/CN.9/WG.V/WP.55, paras. 22 and 23: [Another approach is based upon] a statutory framework that would provide for expedited insolvency proceedings to implement a voluntary restructuring of borrowed money indebtedness (institutional lender debt and bonds) of insolvent international business enterprises based upon approval of the restructuring by a requisite supermajority of each affected class, and judicial review of the adequacy of the restructuring assessed against*

*appropriate international restructuring standards. The principle features of that approach include: the ability to declare a brief moratorium to permit voluntary restructuring discussions to be completed; solicitation of creditor approvals for a restructuring before the commencement of legal proceedings; an approval requirement of 75% in number and value of affected classes of creditors; expedited insolvency procedures for approval of the restructuring by an insolvency court to make it binding on dissenting creditors; and minimum legal criteria for court approval of the restructuring.]*

## C. Relationship between liquidation and reorganization proceedings

50. Under certain circumstances, the needs arising in connection with the insolvency of a debtor are best addressed by the liquidation of all of the debtor's assets and the subsequent distribution of proceeds among creditors. Under other circumstances, however, liquidation may not be the best way to maximize the value of the resources of the insolvent debtor. In reality, as noted above, straight liquidation of the assets often results in creditors receiving only a portion of the nominal value of their claims. In those cases, the reorganization of the business to preserve its human resources and goodwill may prove more effective in maximizing the value of the creditors' claims, allowing them to receive more favourable treatment or even to be paid in full. This may be especially true when, for example, the value of the business relies on intangibles (such as intellectual property rights) rather than tangible assets.

51. Reasons for preferring reorganization as opposed to liquidation may also arise in connection with the political and social background of a legal system. Some countries consider reorganization proceedings as serving a broad social interest, not only encouraging debtors to resort to reorganization before their financial difficulties become too severe, but also offering them a "second chance", thus ultimately enhancing economic development and growth. Similarly, protection of the employees of a troubled business may be an important consideration which influences both the design of the insolvency law and the choice of reorganization over liquidation. Because of the importance attached to these political and social objectives in some legal systems, many countries recognize that a functioning and effective insolvency regime needs to include both liquidation and reorganization procedures.

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 one of these outcomes. Some insolvency laws provide for a unitary, flexible insolvency proceeding, 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.

53. Those laws which 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 (see …). 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.

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. Hence the need for the law to provide linkages between the two proceedings, with a view to allowing conversion of one type of proceeding to the other in certain specific circumstances, and to include devices designed to prevent the abuse of insolvency process, such as commencing reorganization proceedings as a means of avoiding or delaying liquidation (see …).

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 for a mechanism enabling reorganization to be converted into liquidation upon a determination that reorganization is not likely to 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.

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; 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. 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.

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. Under the “unitary” approach there is an initial period (usually referred to as “observation period”, which in existing examples of unitary laws may last up to three months) during which no presumption as to whether the business will be eventually reorganized or liquidated is made. The choice between liquidation or reorganization

proceedings only occurs once a determination as to whether reorganization is actually possible has been made. The basic advantage offered by this approach relies on its procedural simplicity. A simple, unitary procedure, allowing both reorganization and rehabilitation, may result also in encouraging early recourse to the proceedings by debtors facing financial difficulties, thus enhancing the chances of successful rehabilitation.