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UNCITRAL LEGISLATIVE GUIDE ON INSOLVENCY LAW

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Background

In 1992, UNCITRAL held a congress under the title of "Uniform Commercial Law in the 21st Century" to consider what had been accomplished in the harmonization of international trade law in the past 25 years and, more importantly, to identify what was needed for the next 25 years. While UNCITRAL had not undertaken any work in the area of insolvency law, it was proposed as an area of possible future work. However, there were reservations. One participant was of the view that:

> "… it is not practical to think of harmonising the bankruptcy laws of .. different jurisdictions: in the evolution of international law we are simply too far away from any time when we could expect countries to have similar bankruptcy laws in an effort to stimulate international trade. ... in the area of international bankruptcy, we can reduce the problem to a much more manageable level …" (Professor Carl Felsenfeld)

The difficulties adverted to led to the search for an area of insolvency law where results could be achieved. At the time, there was growing interest in cross-border insolvency issues as a result of an increasing caseload of insolvencies involving international aspects. The absence of a formal framework within which issues of coordination and cooperation could be addressed pointed to an area of possible work for UNCITRAL and in 1997, UNCITRAL adopted the *UNCITRAL Model Law on Cross-Border Insolvency*.

The various financial crises of the 1990's exposed weaknesses in the insolvency and debtor-creditor laws of the affected countries and in the structure of the international financial system. The efficacy of insolvency laws and practices became a recurring theme in a number of international forums and it was increasingly recognized that there was a serious and urgent need to strengthen national insolvency regimes, not only as a means of crisis prevention but also of crisis management. A number of international groups and organizations started working on ways of improving and strengthening national insolvency regimes. What was regarded at the 1992 Congress as not possible had become, by the late 1990's, a necessity that was firmly on the international legal agenda.

The proposal

In 1999, UNCITRAL received a proposal from Australia to undertake work on harmonization of substantive insolvency law. The proposal was directed to UNCITRAL because of its successful conclusion of the UNCITRAL Model Law on Cross-border Insolvency and because of the opportunity for wide participation and discussion afforded by UNCITRAL working methods. The focus was on corporate insolvency, based on the key principles and features identified in the April 1998 report of the G22 Working Group on International Financial Crises, with the goal of fostering and encouraging countries to adopt effective national corporate insolvency regimes.

After preliminary work in late 1999, in mid 2000, UNCITRAL gave Working Group V (Insolvency Law) a mandate to prepare a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including 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.

To seek input from the international insolvency community on the key objectives and core features of an insolvency regime to be addressed in a legislative guide, an international colloquium, organized in conjunction with INSOL International and the International Bar Association, was held in December 2000. Over 150 insolvency experts from the academic community, private practice, the judiciary, numerous governments and governmental organizations attended the Colloquium. At the end of the three-day period, a consensus had been reached that not only was the project appropriate, but the primary elements of an effective insolvency system had been identified with a recommendation to the UNCITRAL Commission that the project should move forward.

Drafting the Legislative Guide

Working Group V considered the first draft of the legislative guide in July 2001 and the work developed through seven one-week meetings, the last of which took place in late March 2004. A total of 87 States, 14 inter-governmental organizations and 13 non-governmental organizations participated in the elaboration of the text. The final negotiations on the draft legislative guide were held during the 37th annual session of UNCITRAL in New York from 14 to 21 June 2004 and the text was adopted by consensus on 25 June 2004. The United Nations General Assembly endorsed the *Legislative Guide* by resolution 59/40 of 2 December 2004.

In view of the common interest in the treatment of security interests in insolvency, Working Group V collaborated (and continues to do so) with UNCITRAL's Working Group VI (Security Interests), which is developing a legislative guide on secured transactions.

The key element of the entire process was the continued interaction and cooperation between countries, inter-governmental and non-governmental organizations and the Secretariat, which enabled a consensus to be reached on the substance and content of the *Legislative Guide*. That consensus was based on input from both civil and common law jurisdictions, different cultural and political traditions and different language groups. The process resulted in a balanced approach to the interests of debtors, creditors and equity holders in insolvency, emphasizing the importance of reorganization of existing businesses and not just effectuating a liquidation or termination of those businesses, and promoting transparency and predictability.

General Assembly endorsement

The General Assembly resolution recommending the *Legislative Guide* to States provides a compelling statement of the need for the *Guide*, its timeliness and its fundamental purpose. It recognizes the importance of strong insolvency regimes to all countries and that it is demonstrably in the public interest to have an effective and efficient insolvency regime as a means of encouraging economic development and investment. It takes account of the growing realization that reorganization regimes are critical to corporate and economic recovery, the development of entrepreneurial activity, the preservation of employment and the availability of venture capital and notes also that the effectiveness of reorganization regimes affects the availability of finance in the capital market, with comparative analysis of such systems becoming both common and essential for lending purposes, which affects countries at all levels of economic development. The importance of social policy issues, including the interests of stakeholders in an insolvent debtor, to the design of an insolvency regime is not forgotten. Finally, it recognizes that solutions to the key economic, legal and legislative issues raised by insolvency that are negotiated internationally through a process involving a broad range of constituents will be useful both to States that do not have an effective and efficient insolvency regime and to States that are undertaking a process of review and modernization of their insolvency regimes.

The General Assembly goes on to note that the *Guide* contributes significantly to the establishment of a harmonized legal framework for insolvency and will be useful both to States that do not have an effective and efficient insolvency regime and to States that are undertaking a process of review and modernization of their insolvency regimes and recommends that all States give due consideration to the *Guide* when assessing the economic efficiency of their insolvency regimes and when revising or adopting legislation relevant to insolvency.

Content and scope of the Legislative Guide on Insolvency Law

The purpose of the *Legislative Guide* is to assist the establishment of an efficient and effective legal framework to address the financial difficulty of debtors. It is intended to be used as a reference by national authorities and legislative bodies when preparing new laws and regulations or reviewing the adequacy of existing laws and regulations. The advice provided in the *Guide* aims at achieving a balance between the need to address the debtor's financial difficulty as quickly and efficiently as possible and the interests of the various parties directly concerned with that financial difficulty, principally creditors and other parties with a stake in the debtor's business, as well as with public policy concerns. The *Guide* discusses issues central to the design of an effective and efficient insolvency law, which, despite numerous differences in policy and legislative treatment, are recognized in many legal systems. It focuses on insolvency proceedings commenced under the insolvency law and conducted in accordance with that law, with an emphasis on reorganization, against a debtor, whether a legal or natural person, that is engaged in economic activity. Issues specific to the insolvency of individuals not so engaged, such as consumers, are not addressed.

The *Legislative Guide* also discusses the increasing use and importance of other tools for addressing insolvency, specifically restructuring negotiations entered into voluntarily between a debtor and its key creditors, which are not regulated by the insolvency law. In addition to addressing the requirements of domestic insolvency laws, the *Guide* includes the text and Guide to Enactment of the *UNCITRAL Model Law on Cross-Border Insolvency* to facilitate consideration of cross-border insolvency issues. It should be noted, however, that a model law generally would be used differently to a legislative guide. Specifically, a model law is a legislative text recommended to States for enactment as part of national law, with or without modification. As such, model laws generally propose a comprehensive set of legislative solutions to address a particular topic and the language employed supports direct incorporation of the provisions of the model law into a national law. The focus of a legislative guide, on the other hand, is upon providing guidance to legislators and other users and for that reason guides generally include a substantial commentary discussing and analysing relevant issues. It is not intended that the recommendations of a legislative guide be enacted as part of national law as such. Rather, they outline the core issues that it would be desirable to address in that law, with some recommendations providing specific guidance on how certain legislative provisions might be drafted.

The *Legislative Guide* does not provide a single set of model solutions to address the issues central to an effective and efficient insolvency law, but assists the reader to evaluate different approaches available and to choose the one most suitable in the national or local context. The first section of each chapter of the *Guide* contains a commentary identifying the key issues for consideration in formulating an insolvency law and discussing and analysing the various approaches adopted by insolvency laws. The second part of each chapter contains a set of recommended legislative principles that deals more specifically with the manner in which those key issues should be addressed in an insolvency law and includes both a statement of the purpose of including provisions on a particular topic in an insolvency law and an outline of the content recommended for inclusion in those provisions. These recommendations are intended to assist in the establishment of a legislative framework for insolvency that is both efficient and effective and reflects modern developments and trends in the area of insolvency. The recommendations adopt different levels of specificity, depending upon the issue in question. A number employ legislative language to detail the manner in which a particular issue should be addressed in an insolvency law, reflecting a high degree of consensus as to the particular approach to be adopted. Other recommendations identify key points to be addressed by an insolvency law with respect to a particular topic and offer

possible alternative approaches, indicating the existence of different policy and procedural concerns that might need to be considered.

The user is advised to read the legislative recommendations together with the commentary, which provides detailed background information to enhance understanding of the legislative recommendations, as well as a discussion of issues not specifically included as recommendations. In view of the key importance of secured creditors to insolvency proceedings and the policy considerations associated with their treatment under an insolvency law, the user of this *Legislative Guide* is also encouraged to consider the work of Working Group VI (Security Interests) and, when completed, the UNCITRAL legislative guide on secured transactions.

The recommendations included in the *Guide* do not deal with other areas of law, although, as discussed throughout the *Guide*, those other laws have an impact on both the design of an insolvency law and the conduct of insolvency proceedings commenced under that law. Moreover, the successful implementation of an insolvency regime requires various measures beyond the establishment of an appropriate legislative framework, especially an adequate institutional infrastructure, organizational capacity, technical professional expertise and appropriate human and financial resources. Although these matters are discussed in the commentary, they generally are not addressed in the legislative recommendations, except where they relate to the insolvency professional appointed to administer an insolvency estate.

Key Issues

Part two of the *Legislative Guide*, which deals with core features of an effective and efficient insolvency law, is divided into six chapters addressing eligibility and jurisdiction and commencement criteria (chapter I); treatment of assets on commencement (insolvency estate, application of a stay, use and disposition of assets, post-commencement finance, treatment of contracts, avoidance proceedings, setoff, netting and financial contracts - chapter II); participants (debtor, insolvency representative, creditors – chapter III); reorganization, including “expedited” reorganization (chapter IV); management of proceedings (claims; priorities and distribution, treatment of corporate groups – chapter V)); and conclusion of proceedings (discharge and closure of proceedings – chapter VI).

The *Guide* addresses a number of the issues to be addressed at FAIR 2006, including informal workouts; “expedited” reorganization; institutional infrastructure; priorities; creditor participation; treatment of corporate groups and cross-border insolvency. The following provides a brief introduction to the treatment of each of these topics in the *Guide*.

Informal workouts and “expedited” reorganization proceedings

(Part one, chapter II, paras. 2-18; Part two, chapter IV, paras. 76-94 and recommendations 160-168)

Although focusing upon formal insolvency proceedings conducted under the insolvency law, the *Legislative Guide* recognizes the importance of informal workouts (called “voluntary restructuring negotiations”) as one of the mechanisms for resolving a debtor’s financial difficulties. Although such processes are not based or reliant upon the provisions of the insolvency law, the *Guide* recognizes that use of this type of negotiation depends very largely for its success upon the existence and availability of an effective and efficient insolvency law and supporting institutional framework to provide sanctions that can assist to make the voluntary negotiations successful.

Building upon this recognition, the *Guide* includes a chapter on “expedited reorganization proceedings”, which deals with the use of a procedure that involves a combination of informal negotiation and formal insolvency proceedings and makes a number of recommendations addressing the content of legislative provisions on this procedure. Informal or out-of-court negotiation of a reorganization plan is often impeded by the need for

unanimous creditor consent to alter the terms of various classes of existing debt, by the ability of individual creditors to enforce their rights to the detriment of other creditors, and by the ability of creditors to refuse to agree to a reorganization plan that will be in the best interests of most creditors. In the context of informal negotiations, such a plan can only be implemented if some means can be found to modify the rights of those creditors who refuse to agree, without them consenting to the modification - a result which can be achieved in full court-supervised reorganization proceedings.

The purpose of an "expedited" procedure is to take the negotiated agreement and commence proceedings in the court to enable that agreement to be approved. Once proceedings commence, it should be possible to expedite them by taking advantage of the agreement achieved out of court. Certain provisions of the insolvency law need not apply, e.g. provisions concerning making of claims, appointment of an insolvency representative and plan approval; while other provisions would apply, e.g. application of the stay, effect of the plan and discharge of claims.

Expedited proceedings generally would not involve all creditors. Large institutional creditors typically would be included, while trade creditors and employees, for example, would usually continue to be paid in the ordinary course of business, unless their agreement was required for implementation of the agreed plan. Debtors eligible to apply for expedited proceedings generally would be those that satisfied the requirements for commencement of court-supervised proceedings or were in a position of financial distress where it was likely they would be unable to pay their debts as they matured. The *Guide* recognizes that the protections afforded under an expedited proceeding to creditors who have not agreed to a negotiated plan should be substantially the same as those available to dissenting creditors in full reorganization proceedings.

The *Guide* includes the following recommendations on expedited reorganization.

Purpose of legislative provisions

The purpose of provisions relating to insolvency procedures that combine voluntary restructuring negotiations and acceptance of a plan with an expedited procedure conducted under the insolvency law for court confirmation of that plan is:

(a) To recognize that voluntary restructuring negotiations, which typically involve restructuring of the debt due to lenders and other institutional creditors and major non-institutional creditors where their participation is crucial to the restructuring, but not involving all categories of creditor, is a cost-effective, efficient tool for the rescue of financially troubled businesses;
(b) To encourage and facilitate the use of informal negotiation;
(c) To develop a procedure under the insolvency law that will:
(i) To preserve the benefits of voluntary restructuring negotiations where a majority of each affected class of creditors agree to a plan;
(ii) To minimize time delays and expense and ensure that the plan negotiated and agreed in voluntary restructuring negotiations is not lost;
(iii) To bind those minority members of each affected class of creditors and equity holders who do not accept the negotiated plan;
(iv) To be based upon the same substantive requirements, but shortened time periods, as reorganization proceedings under the insolvency law, including essentially the same safeguards; and
(d) To suspend, with appropriate safeguards, requirements in other laws that may prevent or inhibit the use of processes that delay the invocation of the insolvency law.

Content of legislative provisions

Commencement of expedited reorganization proceedings

160. The insolvency law should specify that expedited proceedings can be commenced on the application of any debtor that:

(a) Is or is likely to be generally unable to pay its debts as they mature;

(b) Has negotiated a reorganization plan and had it accepted by each affected class of creditors; and

(c) Satisfies the jurisdictional requirements for commencement of full reorganization proceedings under the insolvency law.

161. The insolvency law may additionally specify that an expedited proceeding can be commenced on the application of any debtor if:

(a) The debtor's liabilities exceed or are likely to exceed its assets; and

(b) The requirements of recommendation 160 subparagraphs (b) and (c) are satisfied.

Application requirements

162. The insolvency law should specify that the following additional materials should accompany an application for commencement of expedited reorganization proceedings:

(a) The reorganization plan and disclosure statement;

(b) A description of the voluntary restructuring negotiations that preceded the making of the application for commencement, including the information provided to affected creditors to enable them to make an informed decision about the plan;

(c) Certification that unaffected creditors are being paid in the ordinary course of business and that the plan does not modify or affect the rights or claims of unaffected creditors without their agreement;

(d) A report of the votes of affected classes of creditors demonstrating that those classes have accepted the plan by the majorities specified in the insolvency law;

(e) A financial analysis or other evidence that demonstrates that the plan satisfies all applicable requirements for reorganization; and

(f) A list of the members of any creditor committee formed during the course of the voluntary restructuring negotiations.

Commencement

163. The insolvency law should specify that the application for commencement will automatically commence the proceedings or that the court will be required to promptly determine whether the debtor satisfies the requirements of recommendations 160 or 161 and if so, commence proceedings.

Effects of commencement

164. The insolvency law should specify that:

(a) Provisions of the insolvency law that apply to full reorganization proceedings will also apply to expedited proceedings unless specified as modified or not applicable;

(b) Unless otherwise determined by the court, the effects of commencement should be limited to the debtor, individual creditors and classes of creditors and equity holders whose rights are modified or affected by the plan;

(c) Any creditor committee formed during the course of the voluntary restructuring negotiations should be treated as a creditor committee appointed under the insolvency law; and

(d) A hearing on the confirmation of the plan by the court should be held as expeditiously as possible.

Notice of commencement

165. The insolvency law should specify that notice of the commencement of expedited proceedings is to be given to affected creditors and affected equity holders. The notice should specify:

(a) The amount of each affected creditor's claim according to the debtor;
(b) The time period for submitting a claim in a different amount if the affected creditor disagrees with the debtor's statement of the claim, and the place where the claim can be submitted;
(c) The time and procedure for challenging claims submitted by other parties;
(d) The time and place for the hearing on confirmation of the plan, and for the submission of any objection to confirmation; and
(e) The impact of the plan on equity holders.

Confirmation of the plan

166. The insolvency law should specify that the court will confirm the plan if:
(a) The plan satisfies the substantive requirements for confirmation of a plan in full reorganization proceedings, in so far as those requirements apply to affected creditors and affected equity holders;
(b) The notice given and the information provided to affected creditors and affected equity holders during the voluntary restructuring negotiations was sufficient to enable them to make an informed decision about the plan and any pre-commencement solicitation of acceptances to the plan complied with applicable law;
(c) Unaffected creditors are being paid in the ordinary course of business and the plan does not modify or affect the rights or claims of unaffected creditors without their agreement; and
(d) The financial analysis submitted with the application demonstrates that the plan satisfies all applicable requirements for reorganization.

Effect of a confirmed plan

167. The insolvency law should specify that the effect of a plan confirmed by the court should be limited to the debtor and those creditors and equity holders affected by the plan.

Failure of implementation of a confirmed plan

168. The insolvency law may specify that where there is a substantial breach by the debtor of the terms of the plan or an inability to implement the plan, the court may close the judicial proceedings and parties in interest may exercise their rights at law.

Post-commencement finance
(Part two, chapter II, paras. 94-107 and recommendations 63-68)

To maximise the return for all creditors, whether through liquidation or reorganization, an insolvency representative must have sufficient funds to continue to operate the business during the insolvency proceedings. The estate may have sufficient liquid assets to fund such anticipated expenses, in the form of cash or other assets that will be converted to cash (such as anticipated proceeds of receivables), which may be subject to effective security interests held by the debtor's pre-existing creditors. Where there are insufficient liquid assets or anticipated cash flow, the insolvency representative must seek financing from third parties. Often, these parties are the same suppliers and lenders that extended credit to the insolvent debtor prior to the insolvency proceedings, and typically, they will only be willing to extend the

necessary credit if they receive appropriate assurance (either in the form of a priority claim on, or security rights in, the assets of the estate) that they will be repaid.

In any of these financing arrangements (referred to collectively as "post-commencement finance"), the *Legislative Guide* notes that the economic value of the security rights of pre-existing secured creditors should be appropriately protected, such as by periodic payments or security rights in additional assets in substitution for the assets used by the insolvency representative or encumbered in favour of a new lender.

The *Guide* includes the following recommendations on post-commencement finance.

Purpose of legislative provisions

The purpose of provisions on post-commencement finance is:

(a) To facilitate finance to be obtained for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the assets of the estate;

(b) To ensure appropriate protection for the providers of post-commencement finance; and

(c) To ensure appropriate protection for those parties whose rights may be affected by the provision of post-commencement finance.

Contents of legislative provisions

Attracting and authorizing post-commencement finance

63. The insolvency law should facilitate and provide incentives for post-commencement finance to be obtained by the insolvency representative where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the estate. The insolvency law may require the court to authorize or creditors to consent to the provision of post-commencement finance.

Priority for post-commencement finance

64. The insolvency law should establish the priority that may be accorded to post-commencement finance, ensuring at least the payment of the post-commencement finance provider ahead of ordinary unsecured creditors, including those unsecured creditors with administrative priority.

Security for post-commencement finance

65. The insolvency law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower priority security interest on an already encumbered asset of the estate.

66. The law[1] should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation 67.

67. The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having

[1] This rule may be in a law other than the insolvency law, in which case the insolvency law should note the existence of the provision.

priority over pre-existing security interests provided specified conditions are satisfied, including:

(a) The existing secured creditor was given the opportunity to be heard by the court;

(b) The debtor can prove that it cannot obtain the finance in any other way; and

(c) The interests of the existing secured creditor will be protected.

Effect of conversion on post-commencement finance

68. The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the reorganization should continue to be recognized in the liquidation.

Institutional infrastructure

(Part one, chapter III, paras. 1-8)

The *Legislative Guide* notes that an insolvency law is a part of an overall commercial legal system and is heavily reliant for its proper application not only on a well-developed commercial legal system, but also on a well-developed institutional framework for administration of the law. The choices made in developing or reforming an insolvency law will therefore need to be closely linked to the capacities of existing institutions. The insolvency system will only be effective if the courts and officials responsible for its implementation have the necessary capacity to provide the most efficient, timely and fair outcome to those for whose benefit an insolvency regime exists. If that institutional capacity does not already exist, it is highly desirable that reform of the insolvency law be accompanied by institutional reform, where the costs of establishing and maintaining the necessary institutional framework are weighed against the benefits of providing a system that is efficient, effective and in which the public has confidence. Although it is noted that a detailed discussion of the means by which this institutional capacity can be developed or enhanced is beyond the scope of the *Guide*, a number of general observations are nevertheless included in the *Guide*.

The *Guide* observes that in designing the insolvency law it may be appropriate to consider the extent to which courts will be required to supervise the proceedings and whether or not their role can be limited with respect to different parts of the proceedings or balanced by the role of other participants, such as the creditors and the insolvency representative. To reduce the functions to be performed the court under an insolvency law, but at the same time provide the necessary the checks and balances, an insolvency law can assign specific functions to other participants, such as the insolvency representative and creditors, or to some other authority, such as an insolvency or corporate regulator. An insolvency law may provide that the insolvency representative, for example, is authorized to make decisions on a number of issues, such as verification and admission of claims, the need for post-commencement funding, surrender of encumbered assets of no value to the estate, sale of major assets, commencement of avoidance actions, and treatment of contracts, without the court being required to intervene, except in the case of a dispute concerning one of these matters. The use of this approach depends upon the availability of a body of suitably qualified professionals to serve as insolvency representatives.

The court's capacity to handle the sometimes complex commercial issues involved in insolvency cases is often not only a question of knowledge and experience of specific law and business practices, but also a question of that knowledge and experience being current and regularly updated. To address the issue of judicial capacity, a special focus on the education and ongoing training of court personnel, not only of judges but also of clerks and other court administrators, will assist in supporting an insolvency regime that has the ability to respond effectively and efficiently to its insolvency caseload.

A further consideration related to the court's capacity to supervise insolvency cases is the balance in the insolvency law between mandatory and discretionary components. While mandatory elements, such as automatic commencement or automatic application of the stay, may provide a high degree of certainty and predictability for the debtor and creditors, as well as limiting the matters requiring consideration by the courts, it may also lead to rigidity if there are too many of these types of elements. A discretionary approach allows the court to weigh facts and circumstances, taking into account precedent, community interests, and the interests of persons affected by the decision and market conditions. Nevertheless, that approach may also impose a burden on the court where it does not have the knowledge or experience required to weigh these considerations or the resources to respond in a timely manner. Where an insolvency law requires the exercise of discretion by a decision-maker, such as a court, it is preferable that adequate guidance as to the proper exercise of that discretion also be included, particularly where economic or commercial issues are involved.

Implementing an insolvency system depends not only on the court, but also on the professionals involved in insolvency proceedings, whether they are insolvency representatives, legal advisers, accountants, valuation specialists or other professional advisers. The adoption of professional standards and training may assist in developing capacity. It may be appropriate to assess which insolvency functions are truly public in nature and therefore should be performed in the public sector in order to ensure the level of trust and confidence required to make the insolvency system effective, and those functions that can be performed by creating adequate incentives for private-sector participants in insolvency proceedings, such as the function of insolvency representative.

Priorities

(Part two, chapter V, paras. 51-79 and recommendations 185-193)

The *Legislative Guide* recognizes that there are many diverse and competing interests in insolvency proceedings. For the most part, creditors are creditors by virtue of having entered into a legal and contractual relationship with the debtor prior to the insolvency. There are creditors, however, who have not entered into such an arrangement with the debtor, such as taxing authorities (who will often be involved in insolvency proceedings) and tort claimants (whose participation generally will be less common). Insolvency laws generally rank creditors for the purposes of distribution of the proceeds of the estate in liquidation by reference to their claims, and establishing a clear and predictable ranking system for distribution can help to ensure that creditors are certain of their rights at the time of entering into commercial arrangements with the debtor and, in the case of secured credit, facilitate its provision.

The *Guide* also recognizes, however, that in addition to rankings based upon commercial and legal relationships between the debtor and its creditors, distribution policies also very often reflect choices that recognize important public interests (such as the protection of employment), the desirability of ensuring the orderly and effective conduct of the insolvency proceedings (providing priority for the remuneration of insolvency professionals and the expenses of the insolvency administration), and promoting the continuation of the business and its reorganization (by providing a priority for post-commencement finance). To the extent that these broader public interests compete with private interests, they may lead to a distortion of normal commercial incentives. Where public interests are given priority, and equality of treatment based upon the ranking of claims is not observed, it is desirable that the policy reasons for establishing that priority be clearly stated in the insolvency law. In the absence of equality of treatment, this approach will at least provide an element of transparency and predictability in the area of claims, distribution and the establishment of creditor classes under a reorganization plan.

The *Guide* discusses the priority accorded to different types of claims in some detail, including, for example, claims of secured creditors, administrative costs and expenses,

employee and tax claims, owners and equity holders and persons related to the debtor ("related persons").

The *Guide* includes the following recommendations on priority.

Purpose of legislative provisions

The purpose of provisions on priority and distribution is:

(a) To establish the order in which claims should be satisfied from the estate;

(b) To ensure that similarly ranked creditors are satisfied proportionately out of the assets of the estate; and

(c) To specify limited circumstances in which priority in distribution is permitted.

Content of legislative provisions

Classes and treatment of creditors affected by commencement of insolvency proceedings

185. The insolvency law should specify the classes of creditors that will be affected by the commencement of insolvency proceedings and the treatment of those classes in terms of priority and distribution.

Establishing an order for satisfaction of claims (paras. 5 and 52)

186. The insolvency law should establish the order in which claims are to be satisfied from the estate.

Priority claims (paras. 53, 67-71)

187. The insolvency law should minimize the priorities accorded to unsecured claims. The law should set out clearly the classes of claims, if any, that will be entitled to be satisfied in priority in insolvency proceedings.

Secured claims (paras. 62-65)

188. The insolvency law should specify that secured claims should be satisfied from the encumbered asset in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the insolvency law. To the extent that the value of the encumbered asset is insufficient to satisfy the secured creditor's claim, the secured creditor may participate as an ordinary unsecured creditor.

Ranking of claims other than secured claims (paras. 66-79)

189. The insolvency law should specify that claims other than secured claims, are ranked in the following order:

(a) Administrative costs and expenses;
(b) Claims with priority;
(c) Ordinary unsecured claims;
(d) Deferred claims or claims subordinated under the law.

190. The insolvency law should specify that in the event there is a surplus after all claims have been satisfied in full, the surplus is to be returned to the debtor.

Creditor participation
(Part two, chapter III, paras. 75-115 and recommendations 126-136)

Creditors have a significant interest in the debtor's business once insolvency proceedings are commenced. As a general proposition, many insolvency laws provide that these interests are safeguarded by the appointment of an insolvency representative. For a number of different reasons, many insolvency laws facilitate direct creditor involvement in the proceedings. As the party with the primary economic stake in the outcome of the proceedings, creditors may lose confidence in proceedings where key decisions are made without consulting them by individuals who may be perceived by creditors as having limited experience or expertise in the debtor's type of business or a lack of independence, depending upon the manner in which the representative is appointed. Creditors are often in a good position to provide advice and assistance with respect to the debtor's business and to monitor the actions of the insolvency representative, providing a check against possible abuse of insolvency proceedings and excessive administrative costs, as well as a means for processing and distributing information. The desirability of facilitating high levels of creditor participation must be balanced against the need to ensure the creditor representation mechanism remains efficient and cost-effective and avoids creditors involving themselves in matters that will not impact on their interests (although often it may be difficult to draw a clear distinction between those matters that do have such an impact and those that do not).

The *Guide* discusses various ways in which creditor participation in insolvency proceedings might be facilitated and how the different options could be implemented. The *Guide* includes the following recommendation on creditor participation and their rights and obligations.

Purpose of legislative provisions

The purpose of provisions on participation of creditors in insolvency proceedings is:
(a) To facilitate participation of creditors in insolvency proceedings;
(b) To provide a mechanism for the appointment of a creditor committee or other creditor representative where to do so would facilitate the participation of creditors in the insolvency proceedings;
(c) To ensure the right of creditors to access information on the insolvency proceedings; and
(d) To specify the functions and responsibilities of the creditor committee or other representative.

Contents of legislative provisions

Confidentiality (paras. 28,52 and 115)

111. The insolvency law should specify protections for information provided by the debtor or concerning the debtor that is commercially sensitive or confidential.

Participation by creditors (paras. 75-87)

126. The insolvency law should specify that creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and identify what that participation may involve in terms of the functions that may be performed.

Voting by creditors (paras. 96-98)

127. The insolvency law should specify the matters on which a vote of creditors is required and establish the relevant eligibility and voting requirements. In particular, the insolvency law should require creditors to vote on approval or rejection of a reorganization plan.

Convening meetings of creditors (paras. 91-94)

128. The insolvency law may require a first meeting of creditors to be convened within a specified period of time after commencement to discuss matters specified in the insolvency law. The insolvency law may also permit the court, the insolvency representative or creditors holding a specific percentage of the total value of unsecured claims to request the convening of any other meeting of creditors and specify the circumstances in which such a meeting may be convened. The insolvency law should specify the party responsible for giving notice of such a meeting to creditors.

Creditor representation (paras. 88-90)

129. The insolvency law should facilitate the active participation of creditors in insolvency proceedings such as through a creditor committee, a special representative or other mechanism for representation. The insolvency law should specify whether a committee or other representation is required in all insolvency proceedings. Where the interests and categories of creditors involved in insolvency proceedings are diverse and participation will not be facilitated by the appointment of a single committee or representative, the insolvency law may provide for the appointment of different creditor committees or representatives.

130. Where the insolvency law permits a creditor committee or representative to be appointed, the relationship between the creditors and the creditor committee or representative should be clearly specified. The insolvency law should specify how the costs of the creditor committee would be paid.

Creditors that may be appointed to a creditor committee (paras. 101-106)

131. The insolvency law should specify the creditors that are eligible to be appointed to a committee. Creditors who may not be appointed to a creditor committee would include related persons and others who for any reason might not be impartial. The insolvency law should specify whether or not a creditor's claim must be admitted before the creditor is entitled to be appointed to a committee.

Mechanism for appointment to a creditor committee (paras. 107-109)

132. The insolvency law should establish a mechanism for appointment of a creditor committee. Different approaches may include selection of the creditor committee by creditors or appointment by the court or other administrative body.

Rights and functions of a creditor committee (paras. 110-112)

133. The insolvency law should specify the rights and functions of the creditor committee in insolvency proceedings, which may include:

(a) Providing advice and assistance to the insolvency representative or the debtor-in-possession;
(b) Participating in development of the reorganization plan;
(c) Receiving notice of and being consulted on matters in which their class has an interest, including the sale of assets outside the ordinary course of business;
(d) The right to hear the insolvency representative at any time; and
(e) The right to be heard in the proceedings.

Employment and remuneration of professionals by a creditor committee (para. 112)

134. The insolvency law should permit a creditor committee, subject to approval by the court, to select, employ and remunerate professionals that may be needed to assist the creditor committee to perform its functions. The insolvency law should specify how the costs and remuneration of those professionals would be paid.

Liability of members of a creditor committee (para. 113)

135. The insolvency law should specify that members of a creditor committee are exempt from liability for their actions in their capacity as members of the committee unless they are found to have acted fraudulently or to be guilty of wilful misconduct.

Removal and replacement of members of a creditor committee (para. 114)

136. The insolvency law should specify the grounds for removal of members of a creditor committee and provide for their replacement.

Right to be heard and to request review (paras. 117-120)

137. The insolvency law should specify that a party in interest has a right to be heard on any issue in the insolvency proceedings that affects its rights, obligations or interests. For example, a party in interest should be entitled:

(a) To object to any act that requires court approval;
(b) To request review by the court of any act for which court approval was not required or not requested; and
(c) To request any relief available to it in insolvency proceedings.

Right of Appeal (para. 121)

138. The insolvency law should specify that a party in interest may appeal from any order of the court in the insolvency proceedings that affects its rights, obligations or interests.

Treatment of corporate groups
(Part two, chapter V, paras. 82-92)

It is common practice for commercial ventures to operate through groups of companies and for each company in the group to have a separate legal personality. Where a company in a group structure becomes insolvent, treatment of that company as a separate legal personality raises a number of issues that are generally complex and may often be difficult to address. In certain situations, such as where the business activity of a company has been directed or controlled by a related company, the treatment of the group companies as separate legal personalities may operate unfairly. That treatment, for example, may prevent access to the funds of one company for the payment of the debts or liabilities of a related debtor company (except where the debtor company is a shareholder or creditor of the related company), notwithstanding the close relationship between the companies and the fact that the related company may have taken part in the management of the debtor or acted like a director of the debtor and caused it to incur debts and liabilities. Furthermore, where the debtor company belongs to a group of companies, it may be difficult to untangle the specific circumstances of any particular case to determine which group company particular creditors dealt with or to establish the financial dealings between group companies.

Three issues of specific concern in insolvency proceedings involving one of a group of companies are:

(a) The responsibility of any other company in the group for the external debts of the insolvent company (being all debts owed by the insolvent company except for those owed to related group companies, i.e. "intra-group debts");

(b) The treatment of intra-group debts (claims against the debtor company by related group companies); and

(c) Commencement of insolvency proceedings by a group company against a related group company.

Reflecting the complexity of this topic, the discussion included in the *Guide* is intended only as a brief introduction to some of these issues, and no recommendations are made.

Since completion of the *Guide*, UNCITRAL has received a proposal to undertake further work on the treatment of corporate groups in insolvency, building upon the issues identified in the *Guide*. That proposal was discussed in some detail at an International Insolvency Colloquium held in Vienna in November 2005. The report of the colloquium notes that, on the basis of the discussion at the colloquium, it may be concluded that corporate groups are an increasingly important vehicle for world trade and that the problems being encountered with respect to insolvency of one or more members of corporate groups, both domestically and in an international context, would support further work being undertaken by the Commission. That work might take the form of a text that would provide possible legislative guidance to States wishing to address issues specific to the treatment of corporate groups in both domestic and cross-border insolvency.

The UNCITRAL Secretariat has recommended to the Commission, for consideration at its forthcoming annual session in July 2006, that the topic should be referred to a working group for consideration. A meeting of that working group is tentatively scheduled for December 2006.

Cross-border insolvency
(Annex III)

The *Guide* identifies a key objective of an insolvency law as being the establishment of a framework for cross-border insolvency "to promote coordination between jurisdictions and facilitate the provision of assistance in the administration of insolvency proceedings originating in a foreign country." While not specifically addressing cross-border issues, the *Guide* recommends:

> 5. The insolvency law should include a modern, harmonized and fair framework to address effectively instances of cross-border insolvency. Enactment of the UNCITRAL Model Law on Cross-Border Insolvency is recommended.

The UNCITRAL Model Law and its Guide to Enactment are included as Annex III to the *Guide.*

Since completion of the *Guide*, UNCITRAL has received a proposal to undertake further work in the area of cross-border insolvency, specifically with regard to the negotiation, use and approval of cross-border protocols to facilitate coordination of cross-border insolvency cases as envisaged by article 27(d) of the UNCITRAL Model Law. That topic was also discussed at the colloquium in November 2006. The report of the colloquium notes that, on the basis of the discussion, it could be concluded that existing legal and judicial experience with respect to the negotiation, use and content of protocols could usefully be made available in some form to the international legal community. The availability of that experience would build upon, complement and provide further impetus for the enactment of the legislative framework provided by the Model Law, facilitating implementation of the coordination and cooperation authorized by articles 25-27 and the development and use of protocols. Issues to

be addressed in that work could include: facilitating and guiding communications among courts (e.g. notice to parties, participation by parties and disclosure of substantive issues to parties) and standards for the substance of a protocol (e.g. control and protection of assets, coordinating disposition of assets, post-commencement finance, priority of claims, filing and classification of claims, distribution to creditors and effecting reorganization). Examples of protocols that had been negotiated could also be made more widely available.

The UNCITRAL Secretariat has recommended to the Commission, for consideration at its forthcoming annual session in July 2006, that the topic of cross-border protocols could be put on the agenda of a working group, but the initial work of compiling practical experience with respect to negotiating and using cross-border insolvency protocols could be developed through consultation with judges and insolvency practitioners, with the possibility of a preliminary progress report on that work being presented to the Commission for further consideration at its session in 2007.