

THE WORLD BANK

# PRINCIPLES FOR EFFECTIVE INSOLVENCY AND CREDITOR/DEBTOR REGIMES



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## Foreword

Well-designed legal and regulatory frameworks with respect to insolvency and creditor/debtor rights (ICR) facilitate the extension of credit and enable private sector development. The availability of credit is a key driver of economic activity, innovation and growth. By providing for the restructuring and preservation of distressed yet viable businesses, and providing, alternatively, for the orderly resolution of distressed, non-viable businesses, insolvency laws offer predictability and enhance investor confidence. Overall, the transparency and efficiency of ICR systems have a direct impact on the allocation of credit risk and risk management in the financial sector, and consequently also influence access to credit and its cost.



The World Bank's Principles for Effective Insolvency and Creditor/Debtor Rights Systems (the Principles) sets out a range of benchmarks, based on international best practice, for evaluating the effectiveness of domestic ICR systems. The Principles offer a framework for analyzing core commercial laws and regulations on topics such as the registration and enforcement of security rights, credit information systems, insolvency procedure, and the roles of relevant judicial decision-makers and supervisory bodies. This analysis has typically been conducted in the context of the Reports on the Observance of Standards and Codes, which form part of the joint International Monetary Fund-World Bank Standards and Codes Initiative. Importantly, the Principles are flexible in that they may be applied across a spectrum of legal systems, irrespective of a country's specific legal heritage, or the origin of its legal and regulatory frameworks in a particular family of legal systems.

The Legal Vice Presidency of the World Bank is very pleased to have played a key role in developing the Principles. In 1999, during the aftermath of the Asian financial crisis, the international community mandated the World Bank to identify internationally-recognized best practices in the design of ICR systems. The Principles were prepared by a task force and working groups comprised of more than 70 international experts, led by the Legal Vice Presidency, and in collaboration with a number of multilateral development banks, international organizations and expert industry bodies. The Principles were subsequently discussed in a series of regional roundtables, involving officials and experts from roughly 75 countries. Since 2001, the Principles have been applied in the World Bank's assessment of country systems and provision of technical assistance. Over time, in light of the World Bank's experience, and as a result of ongoing consultation with client countries, international experts and partner organizations, the Principles have been periodically refined and updated to reflect evolving best practice, and also to account for lessons learned, including from the 2008 global financial crisis. In 2015, the stewardship of the Principles was transferred to the World Bank Group Finance & Markets Global Practice, and the Principles were further updated to address emerging issues in international finance.

The development and revision of the Principles since 2001 has been a collective undertaking. It is my pleasure to thank current and former Legal Vice Presidency staff, including Vijay Tata, Gordon Johnson, Mahesh Uttamchandani, José Garrido, Riz Mokal, Irit Ronen Mevorach, Adolfo Rouillon, Nagavalli Annamalai, José Ignacio Tirado, Pauline Crane, Francesca Daverio and Yesha Yadav, for their hard work in helping to generate, review and revise the Principles over the years. I would also like to thank our various partner organizations, in particular the International Monetary Fund and the United Nations Commission on International Trade Law, for their tremendous efforts, collaboration and support.

A handwritten signature in black ink, appearing to read 'Anne-Marie Leroy', with a small dot at the end.

Anne-Marie Leroy  
Senior Vice President and General Counsel, World Bank Group

## Foreword

Greater access to finance for firms and individuals plays a critical role in promoting inclusive development. If finance is the circulatory system of an economy, credit is the lifeblood that flows through that circulatory system, ensuring that businesses can innovate, develop, and grow. Indeed, businesses that have greater access to finance are more likely to retain and hire employees. The ICR Principles support a sound insolvency and creditor/debtor rights (ICR) framework, which is crucial to promoting access to finance because it provides a predictable, transparent, and efficient framework to resolve debts in the context of business distress or failure. As part of a country's broader credit infrastructure, ICR systems – together with legal and regulatory frameworks for secured transactions over moveable collateral and credit information – reduce information asymmetries and allow lenders to accurately price risk. This results in a greater abundance of credit, available at lower costs. In a world where businesses in 71 percent of countries report access to finance as their biggest constraint to growth and where the global credit gap is in excess of US \$2 trillion, this is crucial for development.



At the same time, access to credit has to be considered in the context of the overwhelming need for macro-financial stability. In the wake of the global financial crisis, the international community has a renewed interest in ensuring that financial systems remain as sound and resilient as possible. In fact, the ICR Principles initially resulted from a request from the international community following the financial crises of the late 1990s. The Financial Stability Board and its predecessor entities recognized the importance of sound ICR systems and included this as one of their 14 “Key Standards for Sound Financial Systems”. The ICR Standard comprises the Principles, together with the UNCITRAL Legislative Guide on Insolvency Law. The Principles also form the basis on which the ICR Report on the Observance of Standards and Codes (ICR ROSC), part of the WB/IMF Standards and Codes Program, is carried out. The ICR ROSC provides countries with a detailed benchmarking of their ICR systems and is often conducted alongside the broader Financial Sector Assessment Program (FSAP). Since the development of the ICR Principles in 2001, 79 ROSCs have been conducted and the Principles have been amended on several occasions, most recently in May 2015. Through our Insolvency and Debt Resolution Technical Assistance program, we have helped over 75 countries, in every region of the world, improve their ICR systems.

I would like to express my sincere thanks to the World Bank Group's ICR Task Force, under the chairmanship of Mahesh Uttamchandani, for their continuing work in ensuring that the ICR Principles evolve in a manner that allows them to respond to the ever-changing world of finance. I would also like to thank our many partners in this endeavor, including UNCITRAL; International Association of Insolvency Regulators; European Bank for Reconstruction and Development; International Association of Restructuring, Insolvency & Bankruptcy Professionals; and the many policy-makers, professionals, and academics who generously donated their time and knowledge to the development and maintenance of the ICR Principles.

A handwritten signature in black ink, appearing to read 'G. Grandolini'.

Gloria Grandolini  
Senior Director, Finance and Markets Global Practice

# INTRODUCTION

Effective creditor/debtor rights and insolvency systems are an important element of financial system stability. The World Bank Group accordingly has been working with partner organizations to develop principles for insolvency and creditor/debtor rights systems. The Principles for Effective Insolvency and Creditor/Debtor Regimes (the Principles) are a distillation of international best practice on design aspects of these systems, emphasizing contextual, integrated solutions and the policy choices involved in developing those solutions.

The Principles were originally developed in 2001 in response to a request from the international community in the wake of the financial crises in emerging markets in the late 90s. At the time, there were no internationally recognized benchmarks or standards to evaluate the effectiveness of domestic creditor/debtor rights and insolvency systems. The World Bank's initiative began in 1999 with the constitution of an ad hoc committee of partner organizations and the assistance of leading international experts who participated in the World Bank's Task Force and Working Groups.<sup>1</sup> The Principles themselves were vetted in a series of five regional conferences, involving officials and experts from some 75 countries, and drafts were placed on the World Bank's website for public comment. The Bank's Board of Directors approved the Principles in 2001 for use in connection with the joint IMF-World Bank program to develop Reports on the Observance of Standards and Codes (ROSC), subject to reviewing the experience and updating the Principles as needed.

From 2001 to 2004, the Principles were used to assess country systems under the ROSC and Financial Sector Assessment Program (FSAP) in some 24 countries in all regions of the world. Assessments using the Principles have been instrumental to the Bank's developmental and operational work and in providing assistance to member countries. These assessments have yielded a wealth of experience and enabled the Bank to test the sufficiency of the Principles as a flexible benchmark in a wide range of country systems. In taking stock of that experience, the Bank has consulted a wide range of interested parties at the national and international level, including officials, civil society, business and financial sectors, investors, professional groups, and others.

In 2003, the World Bank convened the Global Forum on Insolvency Risk Management (FIRM) to discuss the experience with and lessons from the application of the Principles in the assessment program. The forum convened over 200 experts from 31 countries to discuss the lessons from this application and to discuss further

The Principles distill best practice on design aspects of creditor/debtor rights systems, emphasizing contextual, integrated solutions and the policy choices involved in developing those solutions.

The Principles are used in connection with the joint IMF-World Bank program to develop Reports on the Observance of Standards and Codes (ROSC).

The Principles are a flexible benchmark in a wide range of country systems.

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1. The ad hoc committee that served as an advisory panel comprised representatives from the African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank, International Finance Corporation, International Monetary Fund, Organization for Economic Co-operation and Development, United Nations Commission on International Trade Law, INSOL International, and the International Bar Association (Committee J). In addition, over 70 leading experts from countries around the world participated in the Task Force and Working Groups.

The Principles are a collaboration of the World Bank Group with UNCITRAL, IAIR, and INSOL.

Efficient, reliable, and transparent creditor/debtor regimes and insolvency systems are of key importance.

The Principles call for an integrated approach to reform, taking into account a wide range of laws and policies in the design of creditor/debtor regimes and insolvency systems.

refinements to the Principles themselves. During 2003 and 2004, the Bank also convened three working group sessions of the Global Judges Forum, involving judges from approximately 70 countries who assisted the Bank in its review of the institutional framework principles and developed more detailed recommendations for strengthening court practices for commercial enforcement and insolvency proceedings. Other regional fora have also provided a means for sharing experience and obtaining feedback in areas addressed by the Principles, including the Forum on Asian Insolvency Reform (FAIR) from 2002 to 2004 (organized by OECD and co-sponsored with the Bank and the Asian Development Bank), and the Forum on Insolvency in Latin America (FILA) in 2004, organized by the Bank.

In the area of the insolvency law framework and creditor/debtor regimes, Bank staff has continued their participation in the UNCITRAL working groups on insolvency law and security interests and have liaised with UNCITRAL staff and experts to ensure consistency between the Bank's Principles and the UNCITRAL Legislative Guide on Insolvency Law. The Bank has also benefited from an ongoing collaboration with the International Association of Insolvency Regulators (IAIR) to survey the regulatory practices of IAIR member countries and develop recommendations for strengthening regulatory capacity and frameworks for insolvency systems. A similar collaboration with INSOL International has provided feedback and input in the areas of director and officer liability and informal workout systems.

Based on the experience gained from the use of the Principles, and following extensive consultations, the publication has been thoroughly reviewed and updated in 2005, 2011 and 2015. The revised Principles contained in this document have benefited from wide consultation and, more importantly, from the practical experience of using them in the context of the Bank's assessment and operational work.

The Principles have been designed as a broad-spectrum assessment tool to assist countries in their efforts to evaluate and improve core aspects of their commercial law systems that are fundamental to a sound investment climate, and to promote commerce and economic growth. Efficient, reliable, and transparent creditor/debtor regimes and insolvency systems are of key importance for the reallocation of productive resources in the corporate sector, for investor confidence, and for forward-looking corporate restructuring. These systems also play a pivotal role in times of crisis to enable a country and stakeholders to promptly respond to and resolve matters of corporate financial distress on systemic scales.

National systems depend on a range of structural, institutional, social, and human foundations to make a modern market economy work. There are as many combinations of these variables as there are countries, though regional similarities have created common customs and legal traditions. The Principles have been designed to be sufficiently flexible to apply as a benchmark to all country systems and to embody several fundamentally important propositions. First, *effective systems respond to national needs and problems*. As such, these systems must be rooted in the country's broader cultural, economic, legal, and social context. Second, *transparency*,



*accountability, and predictability are fundamental to sound credit relationships.* Capital and credit, in their myriad forms, are the lifeblood of modern commerce. Investment and the availability of credit are predicated on both perceptions of risk and the reality of risks. Competition in credit delivery is handicapped by lack of access to accurate information on credit risk and by unpredictable legal mechanisms for debt enforcement, recovery, and restructuring. Third, *legal and institutional mechanisms must align incentives and disincentives across a broad spectrum of market-based systems—commercial, corporate, financial, and social.* This calls for an integrated approach to reform, taking into account a wide range of laws and policies in the design of creditor/debtor regimes and insolvency systems.

The Principles emphasize contextual, integrated solutions and the policy choices involved in developing those solutions. The Principles are a distillation of international best practice in the design of insolvency systems and creditor/debtor regimes. Adapting international best practices to the realities of countries requires an understanding of the market environments in which these systems operate. This is particularly apparent in the context of developing countries, where common challenges include weak or unclear social protection mechanisms, weak financial institutions and capital markets, ineffective corporate governance and uncompetitive businesses, ineffective and weak laws, institutions and regulation, and a shortage of capacity and resources. These obstacles pose enormous challenges to the adoption of systems that address the needs of developing countries while keeping pace with global trends and good practices. The application of the Principles at the country level will be influenced by domestic policy choices and by the comparative strengths (or weaknesses) of applicable laws, institutions and regulations, as well as by capacity and resources.

The Principles highlight the relationship between the cost and flow of credit (including secured credit) and the laws and institutions that recognize and enforce credit agreements (Part A). The Principles also outline key features and policy choices relating to the legal framework for risk management and informal corporate workout systems (Part B), formal commercial insolvency law frameworks (Part C), and the implementation of these systems through sound institutional and regulatory frameworks (Part D).

The Principles have broader application beyond corporate insolvency regimes and creditor rights. The ability of financial institutions to adopt effective credit risk management practices to resolve or liquidate non-performing loans depends on having reliable and predictable legal mechanisms that provide a means for more accurately pricing recovery and enforcement costs. Where non-performing assets or other factors jeopardize the viability of a bank, or where economic conditions create systemic crises, creditor/debtor regimes and insolvency systems are particularly important to enable a country and stakeholders to respond promptly. These conditions raise issues that may require supplemental enhancement measures to address the needs of the crisis.

The application of the Principles at the country level will be influenced by domestic policy choices and by the comparative strengths (or weaknesses) of applicable laws, institutions and regulations, as well as by capacity and resources.

Having reliable and predictable legal mechanisms that provide a means for more accurately pricing recovery and enforcement costs affect the ability of financial institutions to adopt effective credit risk management practices.



Countries must adapt and evolve to maximize their own advantages for commerce and to attract investment by adopting laws and systems that create strong and attractive investment climates.

The Principles are designed to be flexible in their application and do not offer detailed prescriptions for national systems. The Principles embrace practices that have been widely recognized and accepted as good practices internationally. As markets evolve and competition increases globally, countries must adapt and evolve to maximize their own advantages for commerce and to attract investment by adopting laws and systems that create strong and attractive investment climates. Increasingly, businesses have become global in nature and business failures or insolvencies have had international implications, which also bring into context the importance of adopting modern practices that accommodate international business. As legal systems and business and commerce are evolutionary in nature, so too are the Principles, and we anticipate that these will continue to be reviewed going forward to take account of significant changes and developments.

# EXECUTIVE SUMMARY

Following is a brief summary of the key elements in the Principles.

## Credit Environment

- **Compatible credit and enforcement systems.** A regularized system of credit should be supported by mechanisms that provide efficient, transparent, and reliable methods for recovering debt, including the seizure and sale of immovable and movable assets and sale or collection of intangible assets, such as debt owed to the debtor by third parties. An efficient system for enforcing debt claims is crucial to a functioning credit system, especially for unsecured credit. A creditor's ability to take possession of a debtor's property and to sell it to satisfy the debt is the simplest, most effective means of ensuring prompt payment. It is far more effective than the threat of an insolvency proceeding, which often requires a level of proof and a prospect of procedural delay that in all but extreme cases make the threat not credible to debtors as leverage for payment.

While much credit is unsecured and requires an effective enforcement system, an effective system for secured rights is especially important in developing countries. Secured credit plays an important role in industrial countries, notwithstanding the range of sources and types of financing available through both debt and equity markets. In some cases, equity markets can provide cheaper and more attractive financing. But developing countries offer fewer options, and equity markets are typically less mature than debt markets. As a result, most financing is in the form of debt. In markets with fewer options and higher risks, lenders routinely require security to reduce the risk of nonperformance and insolvency.

- **Collateral systems.** One of the pillars of a modern credit-based economy is the ability to own and freely transfer ownership interests in property, and to grant security rights to credit providers as a means of gaining access to credit at more affordable prices. Secured transactions play an enormously important role in a well-functioning market economy. Laws governing secured credit mitigate lenders' risks of default and thereby increase the flow of capital and facilitate low-cost financing. Discrepancies and uncertainties in the legal framework governing security rights are the main reasons for the high costs and unavailability of credit, especially in developing countries.

The legal framework for secured lending should address the fundamental features and elements for the creation, recognition, and enforcement of security rights in all types of assets—movable and immovable, tangible and intangible—

An efficient system for enforcing debt claims is crucial to a functioning credit system, especially for unsecured credit.

In markets with fewer options and higher risks, lenders routinely require security to reduce the risk of nonperformance and insolvency.

Discrepancies and uncertainties in the legal framework governing security rights are the main reasons for the high costs and unavailability of credit, especially in developing countries.

The law should encompass any or all of a debtor's obligations to a creditor, present or future, and debt obligations between all types of persons.

A modern, credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system.

An effective enforcement and supervision mechanism should be in place for resolving disputes, along with proportionate sanctions.

including inventories, receivables, proceeds, and future property and, on a global basis, including both possessory and non-possessory rights. The law should encompass any or all of a debtor's obligations to a creditor, present or future, and debt obligations between all types of persons. In addition, it should allow effective notice and registration rules to be adapted to all types of property, and should provide clear rules of priority on competing claims or interests in the same assets. For security rights and notice to third parties to be effective, they must be capable of being publicized at reasonable costs and easily accessible to stakeholders. A reliable, affordable public registry system is therefore essential to promote optimal conditions for asset-based lending. Where several registries exist, the registration system should be integrated to the maximum extent possible so that all notices recorded under the secured transactions legislation can be easily retrieved.

- **Enforcement systems.** A modern, credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. These systems must be designed to work in harmony. Commerce is a system of commercial relationships predicated on express or implied contractual agreements between an enterprise and a wide range of creditors and constituencies. Although commercial transactions have become increasingly complex as more sophisticated techniques are developed for pricing and managing risks, the basic rights governing these relationships and the procedures for enforcing these rights have not changed much. These rights enable parties to rely on contractual agreements, fostering confidence that fuels investment, lending and commerce. Conversely, uncertainty about the enforceability of contractual rights increases the cost of credit to compensate for the increased risk of nonperformance or, in severe cases, leads to credit tightening.

## Risk Management and Informal Workout Systems

- **Credit information systems.** A modern credit-based economy requires access to complete, accurate, and reliable information concerning borrowers' payment histories. This process should take place in a legal environment that provides the framework for the creation and operation of effective credit information systems. Permissible uses of information from credit information systems should be clearly circumscribed, especially regarding information about individuals. Legal controls on the type of information collected and distributed by credit information systems may often be used to advance public policies, including anti-discrimination laws. Privacy concerns should be addressed through notice of the existence of such systems, notice of when information from such systems is used to make adverse decisions, and access by data subjects to stored credit information with the ability to dispute and have corrected inaccurate or incomplete information. An effective enforcement and supervision mechanism should be in place that provides efficient, inexpensive, transparent, and predictable methods

for resolving disputes concerning the operation of credit information systems along with proportionate sanctions that encourage compliance but are not so stringent as to discourage the operation of such systems.

- **Informal corporate workouts.** Corporate workouts should be supported by an environment that encourages participants to restore an enterprise to financial viability. Informal workouts are negotiated in the “shadow of the law.” Accordingly, the enabling environment must include 1) clear laws and procedures that require disclosure of or access to timely and accurate financial information on the distressed enterprise; 2) encourage lending to, investment in, or recapitalization of viable distressed enterprises; 3) support a broad range of restructuring activities, such as debt write-offs, reschedulings, restructurings, and debt-equity conversions; and 4) provide favorable or neutral tax treatment for restructurings.

A country’s financial sector (possibly with help from the central bank or finance ministry) should promote an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure—especially in markets where enterprise insolvency is systemic. An informal process is far more likely to be sustained where there are adequate creditor remedies and insolvency laws.

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## Insolvency Law Systems

- **Commercial insolvency.** Though approaches vary, effective insolvency systems have a number of aims and objectives. Systems should aspire to: (i) integrate with a country’s broader legal and commercial systems; (ii) maximize the value of a firm’s assets and recoveries by creditors; (iii) provide for the efficient liquidation of both nonviable businesses and businesses whose liquidation is likely to produce a greater return to creditors and reorganization of viable businesses; (iv) strike a careful balance between liquidation and reorganization, allowing for easy conversion of proceedings from one proceeding to another; (v) provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors; (vi) provide for timely, efficient, and impartial resolution of insolvencies; (vii) prevent the improper use of the insolvency system; (viii) prevent the premature dismemberment of a debtor’s assets by individual creditors seeking quick judgments; (ix) provide a transparent procedure that contains, and consistently applies, clear risk allocation rules and incentives for gathering and dispensing information; (x) recognize existing creditor rights and respect the priority of claims with a predictable and established process; and (xi) establish a framework for cross-border insolvencies, with recognition of foreign proceedings.

Where an enterprise is not viable, the main thrust of the law should be swift and efficient liquidation to maximize recoveries for the benefit of creditors. Liquidations can include the preservation and sale of the business, as distinct

The rescue of a business should be promoted through formal and informal procedures.

Modern systems generally rely on design features to achieve objectives of appropriate rescue procedures.

The integrity of the insolvency system is the linchpin for its success.

Creditor/debtor rights and insolvency systems are most effective when good practices are adopted in other relevant parts of the legal system, especially the commercial law.

from the legal entity. On the other hand, where an enterprise is viable, meaning that it can be rehabilitated, its assets are often more valuable if retained in a rehabilitated business than if sold in a liquidation. The rescue of a business preserves jobs, provides creditors with a greater return based on higher going concern values of the enterprise, potentially produces a return for owners, and obtains for the country the fruits of the rehabilitated enterprise. The rescue of a business should be promoted through formal and informal procedures. Rehabilitation should permit quick and easy access to the process, protect all those involved, permit the negotiation of a commercial plan, enable a majority of creditors in favor of a plan or other course of action to bind all other creditors (subject to appropriate protections), and provide for supervision to ensure that the process is not subject to abuse. Modern rescue procedures typically address a wide range of commercial expectations in dynamic markets. Though insolvency laws may not be susceptible to fixed formulas, modern systems generally rely on design features to achieve the objectives outlined above.

## Implementation: Institutional and Regulatory Frameworks

- Strong institutions and regulations are crucial to an effective insolvency system. The institutional framework has three main elements: the institutions responsible for insolvency proceedings, the operational system through which cases and decisions are processed, and the requirements needed to preserve the integrity of those institutions—recognizing that the integrity of the insolvency system is the linchpin for its success. A number of fundamental principles influence the design and maintenance of the institutions and participants with authority over insolvency proceedings.

## Overarching Considerations for Promoting Sound Investment Climates

- **Transparency, accountability and corporate governance.** Minimum standards of transparency and corporate governance should be established to foster communication and cooperation. Disclosure of basic information—including financial statements, operating statistics, and detailed cash flows—is recommended for sound risk assessment. Accounting and auditing standards should be compatible with international best practices so that creditors can assess credit risk and monitor a debtor’s financial viability. A predictable, reliable legal framework and judicial process are needed to implement reforms, ensure fair treatment of all parties, and deter unacceptable practices. Corporate law and regulation should guide the conduct of the borrower’s shareholders. A corporation’s board of directors should be responsible, accountable, and independent of management, subject to best practices on corporate governance. The law should be imposed impartially and consistently. Creditor/debtor rights and insolvency systems interact with and are affected by these additional systems,

and are most effective when good practices are adopted in other relevant parts of the legal system, especially the commercial law.

- **Transparency and Corporate Governance.** Transparency and good corporate governance are the cornerstones of a strong lending system and corporate sector. Transparency exists when information is assembled and made readily available to other parties and, when combined with the good behavior of “corporate citizens,” creates an informed and communicative environment conducive to greater cooperation among all parties. Transparency and corporate governance are especially important in emerging markets, which are more sensitive to volatility from external factors. Without transparency, there is a greater likelihood that loan pricing will not reflect underlying risks, leading to higher interest rates and other charges. Transparency and strong corporate governance are needed in both domestic and cross-border transactions and at all phases of investment: at the inception when making a loan, when managing exposure while the loan is outstanding, and especially when a borrower’s financial difficulties become apparent and the lender is seeking to exit the loan. Lenders require confidence in their investment, and confidence can be provided only through ongoing monitoring, whether before or during a restructuring or after a reorganization plan has been implemented.

- From a borrower’s perspective, the continuous evolution in financial markets is evidenced by changes in participants, in financial instruments, and in the complexity of the corporate environment. Besides traditional commercial banks, today’s creditor (including foreign creditors) is as likely to be a lessor, an investment bank, a hedge fund, an institutional investor (such as an insurance company or pension fund), an investor in distressed debt, or a provider of treasury services or capital markets products. In addition, sophisticated financial instruments such as interest rate, currency, and credit derivatives have become more common. Although such instruments are intended to reduce risk, in times of market volatility they may increase a borrower’s risk profile, adding intricate issues of netting and monitoring of settlement risk exposure. Complex financial structures and financing techniques may enable a borrower to leverage in the early stages of a loan. But sensitivity to external factors, such as the interest rate environment in a developing economy, may be magnified by leverage and translate into greater overall risk.

- From a lender’s perspective, once it is apparent that a firm is experiencing financial difficulties and approaching insolvency, a creditor’s primary goal is to maximize the value of the borrower’s assets in order to obtain the highest debt repayment. A lender’s support of an exit plan, whether through reorganization and rehabilitation or through liquidation, depends on the quality of the information flow. To restructure a company’s balance sheet, the lender must be in a position to prudently determine the feasibility of extending final maturity, extending the amortization schedule, deferring interest, refinancing, or converting debt to equity, while alternatively or

Transparency and corporate governance are especially important in emerging markets, which are more sensitive to volatility from external factors.

Sensitivity to external factors, such as the interest rate environment in a developing economy, may be magnified by leverage and translate into greater overall risk.

Values must be established on both a going-concern and liquidation basis to confirm the best route to recovering the investment.



Transparency increases confidence in decision making and so encourages the use of out-of-court restructuring options.

concurrently encouraging the sale of non-core assets and closing unprofitable operations. The enterprise's indicative value should be determined to assess the practicality of its sale, divestiture, or sale of controlling equity interest. Values must be established on both a going-concern and liquidation basis to confirm the best route to recovering the investment. And asset disposal plans, whether for liquidity replenishment or debt reduction, need to be substantiated through valuations of encumbered or unencumbered assets, taking into account where the assets are located and the ease and cost of access. All these efforts and the maximization of value depend on and are enhanced by transparency.

Transparency increases confidence in decision making and so encourages the use of out-of-court restructuring options. Such options are preferable because they often provide higher returns to lenders than straight liquidation through the legal process—and also because they avoid the costs, complexities and uncertainties of the legal process. In many developing countries it is hard to obtain reliable data for a thorough risk assessment. Indeed, it may be too costly to obtain the quantity and quality of information required in industrial countries. Still, efforts should be made to increase transparency.

The inability to predict downside risk can cripple markets having the effect of impinging on other risks in the country, causing lender reluctance even toward untroubled borrowers.

- **Predictability.** Investment in emerging markets is discouraged by the lack of well-defined and predictable risk allocation rules and by the inconsistent application of written laws. Moreover, during systemic crises, investors often demand uncertainty risk premiums too onerous to permit markets to clear. Some investors may avoid emerging markets entirely despite expected returns that far outweigh known risks. Rational lenders will demand risk premiums to compensate for systemic uncertainty in making, managing, and collecting investments in emerging markets. The likelihood that creditors will have to rely on risk allocation rules increases when the fundamental factors supporting investment deteriorate. That is because risk allocation rules set minimum standards that have considerable application in limiting downside uncertainty but usually do not enhance returns in non-distressed markets (particularly for fixed-income investors). During actual or perceived systemic crises, lenders tend to concentrate on reducing risk and risk premiums soar. At these times the inability to predict downside risk can cripple markets. The effect can impinge on other risks in the country, causing lender reluctance even toward untroubled borrowers.

Many creditors simply are not willing (or do not have the mandate) to try to improve returns if the enforcement process has an unpredictable outcome.

Lenders in emerging markets demand compensation for a number of procedural uncertainties. First, information on local rules and enforcement is often asymmetrically known. There is a widespread perception among lenders that local stakeholders can manipulate procedures to their advantage and often benefit from fraud and favoritism. Second, the absence or perceived ineffectiveness of corporate governance raises concerns about the diversion of capital, the undermining of security interests, or waste. Third, the extent to which non-insolvency laws recognize



contractual rights can be unpredictable, leaving foreign creditors in the sorry state of not having bought what they thought they bought. Fourth, the enforcement of creditor rights may be disproportionately demanding of time and money. Many creditors simply are not willing (or do not have the mandate) to try to improve returns if the enforcement process has an unpredictable outcome. In the end, a procedure unfriendly to investors but consistently applied may be preferred by lenders to uncertainty, because it provides a framework for managing risk through price adjustment.

Moreover, emerging markets appear to be particularly susceptible to rapid changes in the direction and magnitude of capital flows. The withdrawal of funds can overwhelm fundamental factors supporting valuation, and (as in the summer of 1998) creditors may race to sell assets to preserve value and reduce leverage. As secondary market liquidity disappears and leverage is unwound, valuation falls further in a self-reinforcing spiral. In industrial countries there is usually a class of creditor willing to make speculative investments in distressed assets and provide a floor to valuation. In theory such creditors also exist in emerging markets. But in practice, dedicated distressed players are scarce and tend to have neither the funds nor the inclination to replace capital withdrawn by more ordinary creditors. Non-dedicated creditors often fail to redirect capital and make up the investment deficit, partly because the learning curve in emerging markets is so steep, but also because of uncertainty about risk allocation rules. The result? Markets fail because there are no buyers for the price at which sellers not forced to liquidate simply hold and hope. If risk allocation rules were more certain, both dedicated and non-dedicated emerging market creditors would feel more comfortable injecting fresh capital in times of stress. In addition, sellers would feel more comfortable that they were not leaving money on the table by selling.

Relative to industrial countries, developing countries typically have weaker legal, institutional, and regulatory safeguards to give lenders (domestic and foreign) confidence that investments can be monitored or creditors' rights will be enforced, particularly for debt collection. In general, a borrower's operational, financial, and investment activities are not transparent to creditors. Substantial uncertainty exists regarding the substance and practical application of contract law, insolvency law, and corporate governance rules. And creditors perceive that they lack sufficient information and control over the process used to enforce obligations and collect debts. The lack of transparency and certainty erodes confidence among foreign creditors and undermines their willingness to extend credit.

In the absence of sufficient and predictable laws and procedures, creditors tend to extend funds only in return for unnecessarily high-risk premiums. In times of crisis they may withdraw financial support altogether. Countries would benefit substantially if creditor/debtor rights and insolvency systems were clarified and applied in a consistent and fully disclosed manner.

If risk allocation rules were more certain, both dedicated and non-dedicated emerging market creditors would feel more comfortable injecting fresh capital in times of stress.

Lack of transparency and certainty erodes confidence among foreign creditors and undermines their willingness to extend credit.

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## PART A. CREDITOR/DEBTOR RIGHTS

### A1 Key Elements

A modern credit-based economy should facilitate broad access to credit at affordable rates through the widest possible range of credit products (secured and unsecured) inspired by a complete, integrated and harmonized commercial law system designed to promote:

- reliable and affordable means for protecting credit and minimizing the risks of non-performance and default;
- transparency of credit instruments and a fair treatment of the rights of creditors and debtors, including appropriate protection for natural persons with respect to consumer debts and assets<sup>1</sup>;
- reliable procedures that enable credit providers and investors to more effectively assess, manage and resolve default risks and to promptly respond to a state of financial distress of an enterprise borrower;
- affordable, transparent and reasonably predictable mechanisms to enforce unsecured and secured credit claims by means of individual action (e.g., enforcement and execution) or through collective action and proceedings (e.g., insolvency);
- a consistent policy governing credit access, property rights, credit protection, credit risk management and recovery, and insolvency through laws and regulations that are compatible procedurally and substantively.

### A2 Security (Immovable Property)

One of the pillars of a credit economy is the ability to own and freely transfer ownership in land and land-use rights, and to grant a security right (such as a mortgage, charge or hypothec) to credit providers with respect to such rights as a means of gaining access to credit at more affordable prices. The typical hallmarks of such system include the following features:

- Clearly defined rules and procedures for granting, by agreement or operation of law, security rights in all types of immovable assets;
- Security rights related to any or all of a debtor's obligations to a creditor, present or future, and between all types of persons;
- Clear rules of ownership and priority governing hierarchy of competing claims or rights in the same assets, eliminating or reducing priorities over security rights as much as possible;
- Methods of notice, including a system of registry, which will sufficiently publicize the existence of security rights to creditors, purchasers, and the public generally at the lowest possible cost.

### A3 Security (Movable Property)

A credit economy should broadly support all manner of modern forms of lending and credit transactions and structures, with respect to utilizing movable assets as a means of providing credit protection to reduce the costs of credit. A mature secured transactions system enables parties to grant a security right in movable property, with the primary features that include:

- Clearly defined rules for the creation, enforceability and effectiveness against third parties of security rights over movable assets;
- Clear rules for security agreements, and security rights arising by operation of law, if any;
- Allowance of security rights in all types of movable assets, whether tangible or intangible (for instance, equipment, inventory, goods in transit, attachments, accounts receivable, bank accounts, securities, intellectual property, agricultural products, commodities, and their proceeds, offspring and mutations), present, after-acquired or future assets (including goods to be manufactured or

- acquired); wherever located and taken as collateral as specific assets, categories of assets, or the totality of movable assets of the grantor; and based on both possessory and non-possessory rights;
- Security rights related to any or all of a debtor's obligations to a creditor, present or future, and between all types of person;
- Methods of notice (especially, through a system of registration) that will sufficiently publicize the possibility that there may be security rights to creditors, purchasers, and the public generally at the lowest possible cost;
- Clear rules of priority governing hierarchy of competing claims or rights in the same assets, eliminating or reducing priorities over security rights as much as possible; and
- Specific rules for acquisition finance developed on the basis of the general rules applicable to security rights or based on the recognition of the ownership rights of sellers in reservation of title sales and of lessors in financial leases; including methods of notice that will sufficiently publicize such rights.

#### **A4 Registry for Property and Security Rights over Immovable Assets**

- There should be an efficient, transparent, and cost-effective registration system with regard to property rights and security rights in the grantor's immovable assets.
- The registry should register property rights over land; land use rights; mortgages or hypothecs; charges or encumbrances over land, and it may also register permanent fixtures and attachments to the land. Land registries may be established by jurisdiction, region, or locale where the property is situated; ideally, they should provide for integrated, computerized search features.
- Mortgages, hypothecs and other charges or encumbrances over immovable assets should be registered in order to be effective vis-à-vis third parties.
- The registration system should be easily accessible, and inexpensive with respect to recording requirements and searches of the registry, and it should be secure.

#### **A5 Registry for Security Rights over Movable Assets**

- There should be an efficient, transparent and inexpensive means of providing notice of the possible existence of security rights in regard to the grantor's movable assets, with registration in most cases being the principal and strongly preferred method, with limited exceptions. The registration system should be easily accessible and inexpensive with respect to recording requirements and searches of the registry, and should be secure.
- Registration of notices should be possible before or after the creation of the security right.
- Registration of notices should be done upon the inclusion of the required information in the registry forms.
- The registry should record and integrate the notices of security rights, rendering them searchable on the basis of the grantor's name, and, in some cases, the serial number of assets.
- Ideally the registry system should be centralized and computerized.
- Special registries are beneficial in the case of certain kinds of highly mobile assets, such as aircraft and vessels.
- Security rights over intellectual property can be registered at the general security rights' registry, or at a special intellectual property registry, if any.
- Special registries for securities and rights over securities may also be established.
- Special registries should be coordinated, when necessary, with the general registry for security rights over movable assets.

<b>A6</b>	<b>Enforcement of Unsecured Debt</b> <ul style="list-style-type: none"><li>▪ A functional credit system should be supported by mechanisms and procedures that provide for efficient, transparent, and reliable methods for satisfying creditors' rights by means of court proceedings or non-judicial dispute resolution procedures. To the extent possible, a country's legal system should provide for abbreviated procedures for debt collection and execution<sup>2</sup>.</li><li>▪ The proceeds should be distributed according to the priority rules of the applicable substantive law.</li></ul>
<b>A7</b>	<b>Enforcement of Security Rights over Immovable Assets</b> <ul style="list-style-type: none"><li>▪ Enforcement systems should provide efficient, cost-effective, transparent and reliable methods (including both judicial and non-judicial) for enforcing a security right over immovable assets.</li><li>▪ Enforcement proceedings should provide for prompt realization of the rights obtained in secured assets, designed to enable recovery in a commercially reasonable manner.</li><li>▪ The proceeds should be distributed according to the priority rules of the applicable substantive law.</li></ul>
<b>A8</b>	<b>Enforcement of Security Rights over Movable Assets</b> <ul style="list-style-type: none"><li>▪ There should be efficient, cost-effective, transparent and reliable methods (including both judicial and non-judicial) for enforcing security rights over movable assets.</li><li>▪ Enforcement proceedings should provide for recovery of possession of the encumbered asset, the possibility of proposing the acquisition of the asset by the secured creditor in total or partial satisfaction of the secured debt, and the prompt realization of the value of the encumbered asset, in good faith and in a commercially reasonable manner.</li><li>▪ The proceeds should be distributed according to the priority rules of the applicable substantive law.</li></ul>

**PART B. RISK MANAGEMENT AND CORPORATE WORKOUT****B1 Credit Information Systems**

A modern credit-based economy requires access to complete, accurate, and reliable information concerning borrowers' payment histories. Key features of a credit information system should address the following:

- B1.1 Legal framework.** The legal environment should not impede but ideally should provide the framework for the creation and operation of effective credit information systems. Libel laws and similar laws have the potential to constrain good-faith reporting by credit information systems. While the accuracy of information reported is an important value, credit information systems should be afforded legal protection sufficient to encourage their activities without eliminating incentives to maintain high levels of accuracy.
- B1.2 Operations.** Permissible uses of information from credit information systems should be clearly circumscribed, especially regarding information about individuals. Measures should be employed to safeguard information contained in the credit information system. Incentives should exist to maintain the integrity of the database. The legal system should create incentives for credit information services in order to collect and maintain a broad range of information on a significant part of the population.
- B1.3 Public policy.** Legal controls on the type of information collected and distributed by credit information systems can be used to advance public policies. Legal controls on the type of information collected and distributed by credit information systems may be used to combat certain types of societal discrimination, such as discrimination based on race, gender, national origin, marital status, political affiliation, or union membership. There may be public policy reasons for restricting the ability of credit information services to report negative information beyond a certain period of time, such as five or seven years.
- B1.4 Privacy.** Subjects of information in credit information systems should be made aware of the existence of such systems and be able to access information about themselves. In particular, they should be notified when information from such systems is used to make adverse decisions about them. They should be able to dispute inaccurate or incomplete information and mechanisms should exist to have such disputes investigated and have errors corrected.
- B1.5 Enforcement/Supervision.** One benefit of the establishment of a credit information system is to permit regulators to assess an institution's risk exposure, thus giving the institution the tools and incentives to assess that exposure itself. Enforcement systems should provide efficient, inexpensive, transparent, and predictable methods for resolving disputes concerning the operation of credit information systems. Both nonjudicial and judicial enforcement methods should be considered. Sanctions for violations of laws regulating credit information systems should be sufficiently stringent to encourage compliance but not so stringent as to discourage the operation of such systems.

**B2 Directors' Obligations in the Period Approaching Insolvency**

Laws governing directors' obligations in the period approaching insolvency should promote responsible corporate behavior while fostering reasonable risk taking and encouraging business reorganization. The law should provide appropriate remedies for breach of directors' obligations, which may be enforced after insolvency proceedings have commenced.<sup>3</sup>



- B2.1 The obligation.** The law should require that when they know or ought reasonably to know that insolvency of the enterprise is imminent or unavoidable, directors should have due regard to the interests of creditors and other stakeholders, and should take reasonable steps either to avoid insolvency, or where insolvency is unavoidable, to minimize its extent.
- B2.2 Persons owing the obligation.** The law should specify the persons owing the obligation, which may include any person formally appointed as a director and any other person exercising factual control and performing the functions of a director<sup>4</sup>.
- B2.3 Liability and Remedies.** Where creditors suffer loss or damage due to a director's breach of their obligations, the law should impose liability subject to possible defenses (including that the director took reasonable steps to avoid or minimize the extent of insolvency). The extent of any liability should not exceed the loss or damage suffered by creditors as a result of the breach. The law should specify that the remedies for liability found by the court to arise from a breach of the obligations should include payment in full to the insolvency estate of any damages assessed by the court. The insolvency representative should have primary standing to pursue a cause of action for breach<sup>5</sup>.
- B2.4 Funding of actions.** The law should provide for the costs of an action against a director to be paid as administrative expenses.

### **B3 Enabling Legislative Framework**

Corporate workouts and restructurings should be supported by an enabling environment, one that encourages participants to engage in consensual arrangements designed to restore an enterprise to financial viability. An environment that enables debt and enterprise restructuring includes laws and procedures that:

- B3.1** Require disclosure of or ensure access to timely, reliable, and accurate financial information on the distressed enterprise;
- B3.2** Encourage lending to, investment in, or recapitalization of viable financially distressed enterprises;
- B3.3** Flexibly accommodate a broad range of restructuring activities, involving asset sales, discounted debt sales, debt write-offs, debt reschedulings, debt and enterprise restructurings, and exchange offerings (debt-to-debt and debt-to-equity exchanges);
- B3.4** Provide favorable or neutral tax treatment with respect to losses or write-offs that are necessary to achieve a debt restructuring based on the real market value of the assets subject to the transaction;
- B3.5** Address regulatory impediments that may affect enterprise reorganizations; and
- B3.6** Give creditors reliable recourse to enforcement, as outlined in Section A, and to liquidation and/or reorganization proceedings, as outlined in Section C.

<b>B4</b>	<b>Informal Workout Procedures</b> <p><b>B4.1</b> An informal workout process may work better if it enables creditors and debtors to use informal techniques, such as voluntary negotiation or mediation or informal dispute resolution. While a reliable method for timely resolution of inter-creditor differences is important, the financial supervisor should play a facilitating role consistent with its regulatory duties as opposed to actively participating in the resolution of inter-creditor differences.</p> <p><b>B4.2</b> Where the informal procedure relies on a formal reorganization, the formal proceeding should be able to quickly process the informal, pre-negotiated agreement.</p> <p><b>B4.3</b> In the context of a systemic crisis, or where levels of corporate insolvency have reached systemic levels, informal rules and procedures may need to be supplemented by interim framework enhancement measures in order to address the special needs and circumstances encountered with a view to encouraging restructuring. Such interim measures are typically designed to cover the crisis and resolution period without undermining the conventional proceedings and systems.</p>
<b>B5</b>	<b>Regulation of Workout and Risk Management Practices</b> <p><b>B5.1</b> A country's financial sector (possibly with the informal endorsement and assistance of the central bank, finance ministry, or bankers' association) should promote the development of a code of conduct on a voluntary, consensual procedure for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure, especially in markets where corporate insolvency has reached systemic levels.</p> <p><b>B5.2</b> In addition, good risk-management practices should be encouraged by regulators of financial institutions and supported by norms that facilitate effective internal procedures and practices supporting the prompt and efficient recovery and resolution of nonperforming loans and distressed assets.</p>

## PART C. LEGAL FRAMEWORK FOR INSOLVENCY

### C1 Key Objectives and Policies

Though country approaches vary, effective insolvency systems should aim to:

- Integrate with a country's broader legal and commercial systems;
- Maximize the value of a firm's assets and recoveries by creditors;
- Provide for the efficient liquidation of both nonviable businesses and those where liquidation is likely to produce a greater return to creditors and the reorganization of viable businesses;
- Strike a careful balance between liquidation and reorganization, allowing for easy conversion of proceedings from one procedure to another;
- Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors;
- Provide for timely, efficient, and impartial resolution of insolvencies;
- Prevent the improper use of the insolvency system;
- Prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments;
- Provide a transparent procedure that contains, and consistently applies, clear risk allocation rules and incentives for gathering and dispensing information;
- Recognize existing creditor rights and respect the priority of claims with a predictable and established process; and
- Establish a framework for cross-border insolvencies, with recognition of foreign proceedings.

### C2 Due Process: Notification and Information

Effectively protecting the rights of parties with an interest in a proceeding requires that such parties have a right to be heard on and to receive proper notice of matters that affect their rights, and that such parties be afforded access to information relevant to protecting their rights or interests and to efficiently resolving disputes. To achieve these objectives, the insolvency system should:

- C2.1** Afford timely and proper notice to interested parties in a proceeding concerning matters that affect their rights. In insolvency proceedings, there should be procedures for appellate review that support timely, efficient, and impartial resolution of disputed matters. As a general rule, appeals do not stay insolvency proceedings, although the court may have power to do so in specific cases.
- C2.2** Require the debtor to disclose relevant information pertaining to its business and financial affairs in detail sufficient to enable the court, creditors, and affected parties to reasonably evaluate the prospects for reorganization. The system should also provide for independent comment on and analysis of that information. Provision should be made for the possible examination of directors, officers and other persons with knowledge of the debtor's financial position and business affairs, who may be compelled to give information to the court, the insolvency representative, and the creditor's committee.
- C2.3** Provide for the retention of professional experts to investigate, evaluate, or develop information that is essential to key decision-making. Professional experts should act with integrity, impartiality, and independence.

**Commencement**

<b>C3</b>	<b>Eligibility</b> The insolvency proceeding should apply to all enterprises or corporate entities, including state-owned enterprises. <sup>6</sup> Exceptions should be limited, clearly defined, and should be dealt with through a separate law or through special provisions in the insolvency law.
<b>C4</b>	<b>Applicability and Accessibility</b> <b>C4.1</b> Access to the system should be efficient and cost-effective. Both debtors and creditors should be entitled to apply for insolvency proceedings. <b>C4.2</b> Commencement criteria and presumptions about insolvency should be clearly defined in the law. The preferred test to commence an insolvency proceeding should be the debtor's inability to pay debts as they mature, although insolvency may also exist where the debtor's liabilities exceed the value of its assets, provided that the values of assets and liabilities are measured on the basis of fair-market values. <sup>7</sup> <b>C4.3</b> Debtors should have easy access to the insolvency system upon showing proof of basic criteria (insolvency or financial difficulty). <b>C4.4</b> Where the application for commencement of a proceeding is made by a creditor, the debtor should be entitled to prompt notice of the application, an opportunity to defend against the application, and a prompt decision by the court on the commencement of the case or the dismissal of the creditor's application.

**C5 Provisional Measures and Effects of Commencement**

- C5.1** When an application has been filed, but before the court has rendered a decision, provisional relief or measures should be granted when necessary to protect the debtor's assets and the interests of stakeholders, subject to affording appropriate notice to affected parties.
- C5.2** The commencement of insolvency proceedings should prohibit the unauthorized disposition of the debtor's assets and suspend actions by creditors to enforce their rights or remedies against the debtor or the debtor's assets. The injunctive relief (stay) should be as wide and all-encompassing as possible, extending to an interest in assets used, occupied, or in the possession of the debtor.
- C5.3** A stay of actions by secured creditors also should be imposed in liquidation proceedings to enable higher recovery of assets by sale of the entire business or its productive units, and in reorganization proceedings where the collateral is needed for the reorganization. The stay should be of limited, specified duration, strike a proper balance between creditor protection and insolvency proceeding objectives, and provide for relief from the stay by application to the court based on clearly established grounds when the insolvency proceeding objectives or the protection of the secured creditor's interests in its collateral are not achieved. Exceptions to the general rule on a stay of enforcement actions should be limited and clearly defined.

**Governance****C6 Management**

- C6.1** In liquidation proceedings, management should be replaced by an insolvency representative with authority to administer the estate in the interest of creditors. Control of the estate should be surrendered immediately to the insolvency representative. In creditor-initiated filings, where circumstances warrant, an interim administrator with limited functions should be appointed to monitor the business to ensure that creditor interests are protected.
- C6.2** There are typically three preferred approaches in reorganization proceedings:
- Exclusive control of the proceeding is entrusted to an independent insolvency representative; or
  - Governance responsibilities remain invested in management; or
  - Supervision of management is undertaken by an impartial and independent insolvency representative or supervisor.
    - Under the second and third approaches, complete administrative power should be shifted to the insolvency representative if management proves incompetent or negligent or has engaged in fraud or other misbehavior.

<b>C7</b>	<b>Creditors and the Creditors' Committee</b>
	<p><b>C7.1</b> The role, rights, and governance of creditors in proceedings should be clearly defined. Creditor interests should be safeguarded by appropriate means that enable creditors to effectively monitor and participate in insolvency proceedings to ensure fairness and integrity, including by creation of a creditors' committee as a preferred mechanism, especially in cases involving numerous creditors.</p> <p><b>C7.2</b> Where a committee is established, its duties and functions, and the rules for the committee's membership, quorum and voting, and the conduct of meetings should all be specified by the law. The committee should be consulted on non-routine matters in the case and have the ability to be heard on key decisions in the proceeding. The committee should have the right to request relevant and necessary information from the debtor. It should serve as a conduit for processing and distributing that information to other creditors and for organizing creditors to decide on critical issues. In reorganization proceedings, creditors should be entitled to participate in the selection of the insolvency representative.</p>
<b>Administration</b>	
<b>C8</b>	<b>Collection, Preservation, Administration and Disposition of Assets</b>
	<p><b>C8.1</b> The insolvency estate should include all of the debtor's assets, including encumbered assets and assets obtained after the commencement of the case. Assets excluded from the insolvency estate should be strictly limited and clearly defined by the law.</p> <p><b>C8.2</b> After the commencement of the insolvency proceedings, the court or the insolvency representative should be allowed to take prompt measures to preserve and protect the insolvency estate and the debtor's business. The system for administering the insolvency estate should be flexible and transparent and enable disposal of assets efficiently and at the maximum values reasonably attainable. Where necessary, the system should allow assets to be sold free and clear of security interests, charges, or other encumbrances, subject to preserving the priority of interests in the proceeds from the assets disposed.</p> <p><b>C8.3</b> The rights and interests of a third-party owner of assets should be protected where its assets are used during the insolvency proceedings by the insolvency representative and/or the debtor in possession.</p>
<b>C9</b>	<b>Stabilizing and Sustaining Business Operations</b>
	<p><b>C9.1</b> The business should be permitted to operate in the ordinary course. Transactions that are not part of the debtor's ordinary course of business activities should be subject to court review.</p> <p><b>C9.2</b> Subject to appropriate safeguards, the business should have access to commercially sound forms of financing, including on terms that afford a repayment priority under exceptional circumstances, to enable the debtor to meet its ongoing business needs.</p>

**C10 Treatment of Contractual Obligations<sup>9</sup>**

**C10.1** To achieve the objectives of insolvency proceedings, the system should allow interference with the performance of contracts where both parties have not fully performed their obligations. Interference may imply continuation, rejection, or assignment of contracts.

**C10.2** To gain the benefit of contracts that have value, the insolvency representative should have the option of performing and assuming the obligations under those contracts. Contract provisions that provide for termination of a contract upon either an application for commencement or the commencement of insolvency proceedings should be unenforceable subject to special exceptions.

**C10.3** Where the contract constitutes a net burden to the estate, the insolvency representative should be entitled to reject or cancel the contract, subject to any consequences that may arise from rejection.

**C10.4** Exceptions to the general rule of contract treatment in insolvency proceedings should be limited, clearly defined, and allowed only for compelling commercial, public, or social interests, such as in the following cases:

- Upholding general setoff rights, subject to rules of avoidance;
- Upholding (subject to a possible short stay for a defined period) termination, netting and close-out provisions contained in clearly defined types of financial contracts, where undue delay of such actions would, because of the type of counterparty or transaction, create risks to financial market stability<sup>9</sup>;
- Preventing the continuation and assignment of contracts for irreplaceable and personal services where the law would not require acceptance of performance by another party; and
- Establishing special rules for treating employment contracts and collective bargaining agreements.

**C11 Avoidable Transactions**

**C11.1** After the commencement of an insolvency proceeding, transactions by the debtor that are not consistent with the debtor's ordinary course of business or engaged in as part of an approved administration should be avoided (cancelled), with narrow exceptions protecting parties who lacked notice.

**C11.2** Certain transactions prior to the application for or the date of commencement of the insolvency proceeding should be avoidable (cancelable), including fraudulent and preferential transfers made when the enterprise was insolvent or that rendered the enterprise insolvent.

**C11.3** The suspect period, during which payments are presumed to be preferential and may be set aside, should be reasonably short in respect to general creditors to avoid disrupting normal commercial and credit relations, but the period may be longer in the case of gifts or where the person receiving the transfer is closely related to the debtor or its owners.



### **Claims and Claims Resolution Procedures**

#### **C12 Treatment of Stakeholder Rights and Priorities**

**C12.1** The rights of creditors and the priorities of claims established prior to insolvency proceedings under commercial or other applicable laws should be upheld in an insolvency proceeding to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationships. Deviations from this general rule should occur only where necessary to promote other compelling policies, such as the policy supporting reorganization, or to maximize the insolvency estate's value. Rules of priority should enable creditors to manage credit efficiently, consistent with the following additional principles:

**C12.2** The priority of secured creditors in their collateral should be upheld and, absent the secured creditor's consent, its interest in the collateral should not be subordinated to other priorities granted in the course of the insolvency proceeding. Distributions to secured creditors should be made as promptly as possible.

**C12.3** Following distributions to secured creditors from their collateral and the payment of claims related to the costs and expenses of administration, proceeds available for distribution should be distributed *pari passu* to the remaining general unsecured creditors,<sup>10</sup> unless there are compelling reasons to justify giving priority status to a particular class of claims. Public interests generally should not be given precedence over private rights. The number of priority classes should be kept to a minimum.

**C12.4** Workers are a vital part of an enterprise, and careful consideration should be given to balancing the rights of employees with those of other creditors.

**C12.5** In liquidation, equity interests or the owners of the business are not entitled to a distribution of the proceeds of assets until the creditors have been fully repaid. The same rule should apply in reorganization, although limited exceptions may be made under carefully stated circumstances that respect rules of fairness entitling equity interests to retain a stake in the enterprise.

#### **C13 Claims Resolution Procedures**

Procedures for notifying creditors and permitting them to file claims should be cost effective, efficient, and timely. While there must be a rigorous system of examining claims to ensure validity and resolve disputes, the delays inherent in resolving disputed claims should not be permitted to delay insolvency proceedings.

**C14 Reorganization Proceedings**

**C14.1** The system should:

- Promote quick and easy access to the proceeding;
- Assure timely and efficient administration of the proceeding; afford sufficient protection for all those involved in the proceeding;
- Provide a structure that encourages fair negotiation of a commercial plan; and
- Provide for approval of the plan by an appropriate majority of creditors.

**Key features and principles of a modern reorganization proceeding include the following:**

**C14.2 Plan Formulation and Consideration.** There should be a flexible approach for developing the plan consistent with fundamental requirements designed to promote fairness and prevent commercial abuse.

**C14.3 Plan Voting and Approval.** For voting purposes, classes of creditors may be provided with voting rights weighted according to the amount of a creditor's claim. Claims and voting rights of insiders should be subject to special scrutiny and treated in a manner that will ensure fairness. Plan approval should be based on clear criteria aimed at achieving fairness among similar creditors, recognition of relative priorities, and majority acceptance, while offering opposing creditors or classes a dividend equal to or greater than they would likely receive in a liquidation proceeding. Where court confirmation is required, the court should normally defer to the decision of the creditors based on a majority vote. Failure to approve a plan within the stated time period, or any extended periods, is typically grounds for placing the debtor into a liquidation proceeding.

**C14.4 Plan Implementation and Amendment.** Effective implementation of the plan should be independently supervised. A plan should be capable of amendment (by vote of the creditors) if it is in the interests of the creditors. Where a debtor fails or is incapable of implementing the plan, this should be grounds for terminating the plan and liquidating the insolvency estate.

**C14.5 Discharge and Binding Effects.** The system should provide for plan effects to be binding with respect to forgiveness and to cancellation or alteration of debts. The effect of approval of the plan by a majority vote should bind all creditors, including dissenting minorities.

**C14.6 Plan revocation and closure.** Where approval of the plan has been procured by fraud, the plan should be reconsidered or set aside. Upon consummation and completion of the plan, provision should be made to swiftly close the proceedings and enable the enterprise to carry on its business under normal conditions and governance.

**C15 International Considerations**

Insolvency proceedings may have international aspects, and a country's legal system should establish clear rules pertaining to jurisdiction, recognition of foreign judgments, cooperation among courts in different countries, and choice of law. Key factors to effective handling of cross-border matters typically include:

- A clear and speedy process for obtaining recognition of foreign insolvency proceedings;
- Relief to be granted upon recognition of foreign insolvency proceedings;
- Foreign insolvency representatives to have access to courts and other relevant authorities;
- Courts and insolvency representatives to cooperate in international insolvency proceedings; and
- Non-discrimination between foreign and domestic creditors.

**C16 Insolvency of Domestic Enterprise Groups**

**C16.1 Procedural Coordination.** The system should specify that the administration of insolvency proceedings with respect to two or more enterprise group members may be coordinated for procedural purposes. The scope and extent of the procedural coordination should be specified by the court.

**C16.2 Post-commencement Finance.** The system should permit an enterprise group member subject to insolvency proceedings to provide or facilitate post-commencement finance or other kind of financial assistance to other enterprises in the group which are also subject to insolvency proceedings. The system should specify the priority accorded to such post-commencement finance.

**C16.3 Substantive Consolidation.** The insolvency system should respect the separate legal identity of each of the enterprise group members. When substantive consolidation is contemplated, it should be restricted to circumstances where:

- Assets or liabilities of the enterprise group members are intermingled to such an extent that the ownership of assets and responsibility for liabilities cannot be identified without disproportionate expense or delay; or
- The enterprise group members are engaged in a fraudulent scheme or activity with no legitimate business purpose.

The court should be able to exclude specific claims and assets from an order of consolidation. In the event of substantive consolidation, the system should contemplate an adequate treatment of secured transactions, priorities, creditor meetings, and avoidance actions. The system should specify that a substantive consolidation order would cause the assets and liabilities of the consolidated enterprises to be treated as if they were part of a single estate; extinguish debts and claims as amongst the relevant enterprises; and cause claims against the relevant enterprises to be treated as if they were against a single insolvency estate.

**C16.4. Avoidance actions.**<sup>11</sup> The system should authorize the court considering whether to set aside a transaction that took place among enterprise group members, or between any of them and a related person, to take into account the specific circumstances of the transaction.

**C16.5 Insolvency Representative.** The system should permit a single or the same insolvency representative to be appointed with respect to two or more enterprise group members, and should include provisions addressing situations involving conflicts of interest. Where there are different insolvency representatives for different enterprise group members, the system should allow insolvency representatives to communicate directly and to cooperate to the maximum extent possible.

**C16.6 Reorganization Plans.** The system should permit coordinated reorganization plans to be proposed in insolvency proceedings with respect to two or more enterprise group members. The system should allow enterprise group members not subject to insolvency proceedings to voluntarily participate in a reorganization plan of other group members subject to insolvency proceedings.

**C17 Insolvency of International Enterprise Groups<sup>12</sup>**

- C17.1. Access to court and Recognition of Proceedings.** In the context of the insolvency of enterprise group members, the system should provide foreign representatives and creditors with access to the court, and for the recognition of foreign insolvency proceedings, if necessary.
- C17.2. Cooperation involving courts.** The system should allow the national court to cooperate to the maximum possible extent with foreign courts or foreign representatives, either directly or through the local insolvency representative. The system should permit the national court to communicate directly with, or to request information or assistance directly from, foreign courts or representatives.
- C17.3. Cooperation involving insolvency representatives.** The system should allow insolvency representatives appointed to administer proceedings with respect to an enterprise group member to communicate directly and to cooperate to the maximum extent possible with foreign courts and with foreign insolvency representatives in order to facilitate coordination of the proceedings.
- C17.4. Appointment of the insolvency representative.** The system should allow, in specific circumstances, for the appointment of a single or the same insolvency representative for enterprise group members in different States. In such cases, the system should include measures addressing situations involving conflicts of interest.
- C17.5. Cross-border insolvency agreements.** The system should permit insolvency representatives and other parties in interest to enter into cross-border insolvency agreements involving two or more enterprise group members in different States in order to facilitate coordination of the proceedings. The system should allow the courts to approve or implement such agreements.

## PART D. IMPLEMENTATION: INSTITUTIONAL AND REGULATORY FRAMEWORKS

*Institutional Considerations*

<b>D1</b>	<p><b>Role of Courts</b></p> <p><b>D1.1 Independence, Impartiality and Effectiveness.</b> The system should guarantee the independence of the judiciary. Judicial decisions should be impartial. Courts should act in a competent manner and effectively.</p> <p><b>D1.2 Role of Courts in Insolvency Proceedings.</b> Insolvency proceedings should be overseen and impartially disposed of by an independent court and assigned, where practical, to judges with specialized insolvency expertise. Nonjudicial institutions playing judicial roles in insolvency proceedings should be subject to the same principles and standards applied to the judiciary.</p> <p><b>D1.3 Jurisdiction of the Insolvency Court.</b> The court's jurisdiction should be defined and clear with respect to insolvency proceedings and matters arising in the conduct of these proceedings.</p> <p><b>D1.4 Exercise of Judgment by the Court in Insolvency Proceedings.</b> The court should have sufficient supervisory powers to efficiently render decisions in proceedings in line with the legislation without inappropriately assuming a governance or business management role for the debtor, which would typically be assigned to management or an insolvency representative.</p> <p><b>D1.5 Role of Courts in Commercial Enforcement Proceedings.</b> The general court system must include components that effectively enforce the rights of both secured and unsecured creditors outside of insolvency proceedings. If possible, these components should be staffed by specialists in commercial matters. Alternatively, specialized administrative agencies with that expertise may be established.</p>
<b>D2</b>	<p><b>Judicial Selection, Qualification, Training and Performance</b></p> <p><b>D2.1 Judicial Selection and Appointment.</b> Adequate and objective criteria should govern the process for selection and appointment of judges.</p> <p><b>D2.2 Judicial Training.</b> Judicial education and training should be provided to judges.</p> <p><b>D2.3 Judicial Performance.</b> Procedures should be adopted to ensure the competence of the judiciary and efficiency in the performance of court proceedings. These procedures serve as a basis for evaluating court efficiency and for improving the administration of the process.</p>
<b>D3</b>	<p><b>Court Organization</b></p> <p>The court should be organized so that all interested parties—including the attorneys, the insolvency representative, the debtor, the creditors, the public, and the media—are dealt with fairly, in a timely manner, objectively, and as part of an efficient, transparent system. Implicit in that structure are firm and recognized lines of authority, clear allocation of tasks and responsibilities, and orderly operations in the courtroom and case management.</p>
<b>D4</b>	<p><b>Transparency and Accountability</b></p> <p>An insolvency and creditor rights system should be based upon transparency and accountability. Rules should ensure ready access to relevant court records, court hearings, debtor and financial data, and other public information.</p>

<b>D5</b>	<p><b>Judicial Decision Making and Enforcement of Orders</b></p> <p><b>D5.1 Judicial Decision Making.</b> Judicial decision making should encourage consensual resolution among parties where possible, and should otherwise undertake timely adjudication of issues with a view to reinforcing predictability in the system through consistent application of the law.</p> <p><b>D5.2 Enforcement of Orders.</b> The court must have clear authority and effective methods of enforcing its judgments.</p> <p><b>D5.3 Creating a Body of Jurisprudence.</b> A body of jurisprudence should be developed by means of consistent publication of important and novel judicial decisions, especially by higher courts, using publication methods that are both conventional and electronic (where possible).</p>
<b>D6</b>	<p><b>Integrity of the System</b></p> <p><b>D6.1 Integrity of the court.</b> The system should guarantee security of tenure and adequate remuneration of judges, personal security for judicial officers, and the security of court buildings. Court operations and decisions should be based on firm rules and regulations to avoid corruption and undue influence.</p> <p><b>D6.2 Conflict of interest and bias.</b> The court must be free of conflicts of interest, bias, and lapses in judicial ethics, objectivity, and impartiality.</p> <p><b>D6.3 Integrity of participants.</b> Persons involved in a proceeding must be subject to rules and court orders designed to prevent fraud, other illegal activity, and abuse of the insolvency and creditor rights system. In addition, the court must be vested with appropriate powers to enforce its orders and address matters of improper or illegal activity by parties or persons appearing before the court with respect to court proceedings.</p>
<b>D7</b>	<p><b>Role of Regulatory or Supervisory Bodies</b></p> <p>The bodies responsible for regulating or supervising insolvency representatives should:</p> <ul style="list-style-type: none"> <li>▪ Be independent of individual representatives;</li> <li>▪ Set standards that reflect the requirements of the legislation and public expectations of fairness, impartiality, transparency, and accountability; and</li> <li>▪ Have appropriate powers and resources to enable them to discharge their functions, duties, and responsibilities effectively.</li> </ul>
<b>D8</b>	<p><b>Competence and Integrity of Insolvency Representatives</b></p> <p>The system should ensure that:</p> <ul style="list-style-type: none"> <li>▪ Criteria as to who may be an insolvency representative should be objective, clearly established, and publicly available;</li> <li>▪ Insolvency representatives be competent to undertake the work to which they are appointed and to exercise the powers given to them;</li> <li>▪ Insolvency representatives act with integrity, impartiality, and independence; and</li> <li>▪ Insolvency representatives, where acting as managers, be held to director and officer standards of accountability, and be subject to removal for incompetence, negligence, fraud, or other wrongful conduct.<sup>13</sup></li> </ul>

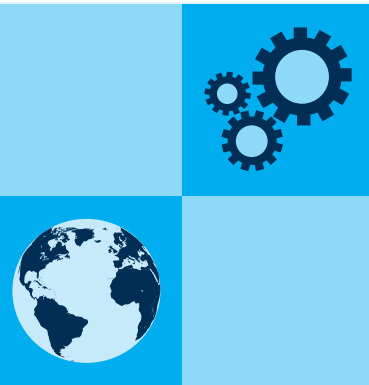
## ENDNOTES

1. See Principle A6 footnote.
2. Enforcement under this principle aims primarily at the treatment with respect to proceedings to recover against corporate debtors. Where enforcement proceedings involve individuals, reasonable and clearly defined exemptions may need to be adopted to allow individuals to retain household goods and those assets indispensable to the debtor's profession or job as well as the subsistence of the debtor and his/her family.
3. This principle addresses only accountabilities of directors in the period when they know or ought reasonably to have known that the enterprise imminently or unavoidably faces insolvency. General principles for corporate governance and officer and director liability to their shareholders are dealt with under the OECD Principles for Corporate Governance.
4. Persons owing the obligation are referred to in this principle as "directors".
5. The liability to compensate creditors for damage caused due to the breach of the obligation does not preclude imposing other remedies in addition to the payment of compensation, for example the disqualification of a director from being a director. It also does not preclude holding directors accountable for fraudulent activities including through taking criminal actions against directors.
6. Ideally, the insolvency process should apply to SOEs, or alternatively, exceptions of SOEs should be clearly defined and based upon compelling state policy.
7. A single or dual approach may be adopted, although where only a single test is adopted it should be based on the liquidity approach for determining insolvency – that is, the debtor's inability to pay due debts.
8. Treatment of contracts typically also includes leases.
9. The identification of relevant types of financial contracts should be determined in advance in accordance with existing international instruments (see below). The operation of termination, netting, and close-out provisions would not preclude the application of a short stay for a defined period under the national law governing bank resolution, or of a similar stay that the national insolvency law may provide, particularly to accomplish the orderly transfer of the contracts to a solvent counterparty. Such stay should be subject to appropriate safeguards. Early termination rights would be suspended, provided that the substantive obligations of the debtor under the relevant contracts continue to be performed in full. The relevant provisions of national law should be reviewed generally for consistency with existing international instruments, including specifically the European Union Bank Recovery and Resolution Directive, the European



Union Directive on Financial Collateral Arrangements, the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, and the UNIDROIT Principles on The Operation of Close-out Netting Provisions.

10. Subject to any intercreditor agreements and contractual subordination provisions or where equitable subordination of a creditors claim may be appropriate.
11. See Principle C11.
12. See Principle C15. See also Principle C16.
13. See Principle B2.



For further information on the ICR Principles, the ICR ROSC or the World Bank Group Insolvency & Debt Resolution Technical Assistance Program, please contact:

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