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WORLD BANK GROUP

JUDICIAL TRAINING COLLEGE

Module 1

On line tuition manual

A - THE PURPOSE OF THIS MANUAL

In 2014, UNCITRAL published a report called *UNCITRAL Model Law on Cross-border Insolvency: The Judicial Perspective*.[1] The publication had its origins in a request by judges attending the Eighth UNCITRAL/INSOL International/World Bank Multinational Judicial Colloquium in Vancouver in 2009, "*that consideration should be given to providing assistance for Judges with respect to questions arising under the UNCITRAL Model Law on Cross-border Insolvency"*.

In explaining the purposes of the document, the Commission emphasised that the text did "not purport to instruct Judges on how to deal with applications for recognition and relief under the legislation enacting the Model Law" because "such an approach would run counter to principles of judicial independence".

This manual has been prepared as an introduction to the matters that will be addressed in the programme of judicial training that is planned to take place. It is intended to provide some assistance to judges in understanding the dynamics of cases involving insolvency and restructuring under laws relating to insolvency and restructuring, with a view to improving the quality of decision-making in individual countries. The manual is prepared without specific reference to the laws of your jurisdiction. In any case, it is for the individual Judge to decide whether or not to apply any particular suggestions made in this manual.

B - GOALS OF AN EFFECTIVE INSOLVENCY REGIME

Whilst the core function of an insolvency regime is to facilitate the collective satisfaction of liabilities owed by an individual, corporation or other entity which is unable to pay its debts as and when they fall due, the ultimate goal of an effective insolvency regime is to facilitate economic stability and growth.

The World Bank Group (in its 2016 report on 'Principles for Effective Insolvency and Creditor/Debtor Regimes') and UNCITRAL (in its Legislative Guide on Insolvency Law published in 2004) identified a number of specific objectives that an insolvency system

[1] Available at uncitral.org in all six UN languages

must meet in order for a jurisdiction to achieve the broader objectives of economic stability and growth. Those broader objectives include:

Integration with the country's broader legal and commercial systems

An effective insolvency regime should be compatible with the country's existing legal, commercial and social systems and reflective of its values.

Maximisation of the value of assets

Maximising the value of an insolvent entity's assets so as to facilitate higher recoveries by creditors is important. This includes equitable antecedent transaction avoidance provisions for the purpose of limiting the impact of any corporate misconduct prior to insolvency and to ensure that creditors are treated fairly.

Provide for the efficient liquidation of the estate

The liquidation process needs to be fair, transparent, efficient and cost-effective. A regime for the regulation of insolvency practitioners is important to develop the confidence of the financial and commercial communities in the efficacy of the insolvency system.

Strike a careful balance between liquidation and reorganization

In many circumstances greater value may be achieved for all the parties by maintaining the key components of a business than by liquidating its assets piecemeal. Reorganisation of the business may reduce the loss of employment and promote entrepreneurialism. However, reorganisation will often come at an immediate cost to creditors and the system needs to be constructed to avoid abuse by the stakeholders. Accordingly, an effective regime will enable easy conversion of proceedings from one proceeding to another.

Provide for equitable treatment of similarly situated creditors

The concept of *pari passu*, or equal treatment of creditors in the same class, is fundamental to an effective insolvency regime. This also requires domestic and foreign creditors of the same class to be treated equally.

Provide for timely, efficient, and impartial resolution of insolvencies

The negative economic and social impacts of insolvency increase where the process is slow or uncertain. An efficient regime requires clear and comprehensive legislation

and a trained judiciary with sufficient resources to hear and determine matters expeditiously where required. Efficiency should not come at a cost to flexibility or the right of creditors and, where appropriate, the debtor to participate.

Prevent the improper use of the insolvency system

Ease of access to insolvency procedures is important, but must be balanced with the need to ensure those procedures are not abused. Management must not be able to hive down assets to new companies to avoid creditors. Otherwise solvent companies without obvious future liquidity issues should not be able to use insolvency procedures to avoid or defer payment to creditors or to benefit from protections such as moratoriums. Further, companies ought not be able to use the insolvency regime as a means of gaining an advantage over its competitors.

Preserve the insolvency estate to allow equitable distribution to creditors

An insolvency regime needs to protect against the risk of assets being dissipated prior to and upon the commencement of an insolvency procedure in order to maximise the assets available to the creditor pool. This means that insolvency practitioners appointed to a company or individual need statutory powers to take control of assets, obtain information and conduct investigations into the affairs of the debtor prior to their appointment. The ability to stay existing legal proceedings and rules against the commencement of new proceedings are also relevant to this objective.

Recognise existing creditor rights and respect the priority of claims with a predictable and established process

An effective insolvency regime requires effective laws governing the rights of creditors and the priorities as between them. The process of determination of claims needs to be efficient and inexpensive so as to increase returns to creditors. Where a system does not adequately recognise and protect those rights, the availability of credit within the jurisdiction will be diminished.

Establish a framework for cross-border insolvencies, with recognition of foreign proceedings

It is now broadly accepted universally that best practice is a universal approach to cross-border insolvencies. Modern insolvency regimes recognise that many businesses are operating in more than one jurisdiction and that the assets of the

company ought to be available to its creditors regardless of where those creditors are situated. The UNCITRAL Model Law on Cross Border Insolvency has been developed to facilitate recognition of foreign proceedings and co-operation between proceedings in multiple jurisdictions.

C. SOURCES OF INSOLVENCY LAW

The insolvency laws of a state are often found in a number of pieces of primary and secondary legislation. Historically, the form of the debtor, either as a corporate entity, a partnership, cooperative or a private individual determined where the applicable insolvency law was to be found. Modern practice is to encourage the codification of all laws relating to the liquidation and restructuring of commercial entities in one national insolvency act, thereby aiding debtors, creditors and other interested parties while simultaneously reducing uncertainty as to the priority of seemingly conflicting laws. Even where a comprehensive codified law is adopted, national policy may require subsidiary details to be delegated to administrative regulations. This practice facilitates more regular revision and updating where it is unnecessary to amend the primary legislation.

An exception to the single insolvency act is frequently to be found where the debtor is, for example, a bank or other financial institution or a strategically important entity. Such specialist legislation may deal with all aspects of such an insolvency or it may be limited to certain aspects, such as determining the party who may initiate insolvency proceedings and who may be appointed to administer the estate.

Even where the insolvency law is codified, the administration of the estate will require the insolvency practitioner to consider numerous issues that are determined by other laws. For example, the nature and value of the assets will be determined any mixture of land law; tenancy rights, contract law and maybe even family law where the insolvency involves individuals. The claims of creditors will be determined by the laws of contract, security, and maybe retention of title; except to the extent that the insolvency law has specifically varied these rights. One category of creditors whose rights are typically dealt with by extensive legislation are employees and insolvency practitioners must take care not to breach employees' rights unless there is no alternative, in which case the employees will possibly have increased compensation

claims. Furthermore, in certain jurisdictions, government taxing and regulatory claims such as statutory and other at-source deductions and pension contributions have a statutory priority.

Despite encouragement for all aspects relating to insolvency to be included in one enactment, relevant legislative provisions relating to the conduct of directors and officers may also be found in the civil code, commercial code or self-contained legislation[2].

Apart from written legislative provisions, a most valuable source of law is to be found in the judgments handed down in other relevant courts. Depending on the legal system of the state, these may be either binding, subject to the ability of the court to distinguish, or persuasive. The decided cases that are relevant to a judge may be limited to the courts of his or her own jurisdiction or may include jurisdictions with similar legal systems[3]. Within Europe, the European Court of Justice has a supreme role in interpreting matters of EU law and ensuring its equal application across the member states.

D - THE DIFFERENCE BETWEEN SINGLE DEBT ENFORCEMENT PROCEDURES AND COLLECTIVE INSOLVENCY PROCEDURES

Single Debt Enforcement Procedures

These are actions taken by a creditor acting alone to recover, in its entirety, a debt owed to it by the debtor. They include:

1. actions for a judgment debt, damages or other relief by the creditor bringing its own proceeding in court by itself as plaintiff or applicant; and
2. appointment of a receiver or receiver and manager to property that has been given by the debtor as collateral or to which on some other basis, the creditor's debt can attach. This can be done by two primary mechanisms:
    a. the creditor doing so itself, without getting a judgment from the court; or
    b. by application to the court on proper grounds.

[2] Such as the UK's Company Directors Disqualification Act 1986 et seq
[3] Within the British Commonwealth, the decisions of the Privy Council have a unique role in guiding judges.

The important feature here is the creditor is claiming to have the right to enforce its judgment or otherwise attach its debt or claim to property of the debtor and thereby be the sole or primary beneficiary of that property's realisation for the payment of their debt or claim. In this respect, the creditor is seeking to exercise its own contractual or bilateral rights against the debtor.

The absence of any moratorium accompanying its action means there may be a multiplicity of similar actions. The creditor who first completes enforcing their rights will be first to obtain payment from the debtor, with those later in time possibly missing out. Therefore, it encourages a race to the court.

Collective Insolvency Procedure

"Insolvency proceedings" are proceedings that entail the partial or total divestment of the assets of a debtor usually accompanied by the appointment by the court of an official to supervise the proceeding. The procedures include (taking examples from the United Kingdom):

- in the case of a corporate entity, liquidation, administration, or creditor voluntary arrangements; and
- in the case of a natural person, bankruptcy or individual voluntary arrangements.

In some jurisdictions, such as the United States, reorganization or adjustment of debts is permitted with the debtor still in possession under Chapter 11, albeit subject to court supervision.

The proceedings are considered "collective" because they affect all the debtor's creditors in a manner that is intended to be orderly and effective. Creditors within the same class are treated identically, receiving a distribution from the estate that is proportionately equal to that received by others in their class. Collective proceedings are generally subject to the supervision of the court and the insolvency law imposes a moratorium preventing creditors from applying for individual remedies outside the proceeding. A creditor's individual remedies are replaced by an entitlement to participate in the legislatively imposed insolvency proceeding. This avoids a multiplicity of actions and a race to the court.

An aspect of collective proceedings that enhances the prospect of recovery by creditors is that the insolvency law typically provides for the possibility to recover assets that have been put beyond the reach of creditors, such as fraudulent transfers, transactions at an undervalue and preferences.

KEY FEATURES OF AN INSOLVENCY FRAMEWORK

E 1 – STAKEHOLDERS

Insolvency proceedings affect a number of parties and also introduce new players all of whom have roles and responsibilities.

1. The Debtor

Insolvency proceedings start with a party who is unable to pay its liabilities as they fall due: the debtor. In case of inability to pay debts, both debtors and creditors are usually entitled to apply for insolvency proceedings[4,5]. A debtor can be a natural person or a legal entity.

The role of the debtor differs significantly, depending on the nature of the insolvency proceeding that is opened. Generally speaking, a distinction is drawn between liquidation and reorganisation proceedings. In liquidation proceedings, a debtor usually loses control of its assets (the estate) and an insolvency representative is appointed to liquidate the estate and distribute the proceeds to creditors, in accordance with the ranking of their claims. In some reorganisation proceedings, a debtor can remain 'in possession' (i.e. remain entitled to the management of its assets) while in other jurisdictions an insolvency representative is appointed to manage this process either solely or in conjunction with the debtor[6].

In all insolvency proceedings, the debtor has obligations to its creditors, the court and the insolvency representative including the obligation to cooperate with the court and the insolvency representative; in particular, the debtor has a duty to provide accurate, reliable and complete information[7]. In addition to the debtor, the directors of an

[4]The World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, principle C4
[5] In certain jurisdictions, also the government, usually via the public prosecutor, is entitled to file an insolvency application if public policy demands insolvency.
[6] The World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, principle C6 & UNCITRAL, *Legislative Guide on Insolvency Law*, chap. III, para.10-18 and recommendation 112
[7] UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. III, para 22-27 and recommendation 110.

insolvent company may be personally liable if they fail to take steps to avoid insolvency or to minimise the extent of the insolvency in the period preceding insolvency[8]. The debtor also has certain rights, such as the right to be heard in proceedings, a right of access to information and to retain certain personal property[9].

2. The insolvency representative

Insolvency representatives are appointed individuals or legal entities who are responsible for administrating the estate and thus the insolvency proceedings in respect of an insolvent debtor[10]. The insolvency representative is appointed either solely by the court or in some combination with the creditors[11].

The insolvency representative's duties include taking control of and realising the estate to supervising and implementing a reorganisation plan, possibly in combination with the debtor.[12] The insolvency representative owes an obligation to the general body of creditors to protect and preserve the assets of the estate[13] and may be held personally responsible for any negligent diminution of its value.

The insolvency representative should act with integrity, impartiality and independence[14]. The most efficient insolvency systems provide for the training, examination regulation and supervision of insolvency practitioners, either by the state or as a self-regulating profession. In addition to the possibility to impose sanctions, the insolvency law should provide for the dismissal and replacement of the insolvency practitioner for due cause[15].

The insolvency representative is usually remunerated out of the assets of the estate in priority to payment of creditors' claims.

3. Creditors

Their role in insolvency proceedings differs depending on the nature of the proceeding (liquidation or reorganisation) and the ranking of their claim.

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[8] The World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, principle B2 & UNCITRAL, *Legislative Guide on Insolvency Law*, part IV.
[9] UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. III, paras. 19-21 and recommendations 108-109
[10] UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. III, para. 1.
[11] UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. III, paras 44-47 and recommendation 118.
[12] UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. III, para. 49.
[13] UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. III, para. 50 and recommendation 120
[14] The World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, principle D8
[15] UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. III, paras. 49, 60-65, 73-74 and recommendations 120-123

In liquidation proceedings, the role of the creditors is limited to receiving notifications; filing their claims and participating in meetings of creditors[16]. Unsecured creditors rank *pari passu* and the assets of the estate should therefore are distributed on this basis[17] subject to the applicable rules of priority (e.g. employee claims which are paid in priority).

The law will set out what notifications and reports the creditors are entitled to receive from the insolvency practitioner. Depending on the legal system, creditors file their claims with the court or insolvency representative, often within relatively short periods following notification of the proceedings. There are typically rules for the agreement and admission of creditors claims. Creditors will ultimately receive dividends (if any) in accordance with the priority rules set by applicable law[18]. In reorganisation proceedings, all affected creditors will be entitled to vote on a reorganisation plan[19].

3.1. Secured creditors

These are creditors with a security right *in rem* over one or more of the assets of the debtor. Despite the commencement of the insolvency proceedings, secured creditors may be able to enforce their security interest, or this may be the responsibility of the insolvency representative who will realise the secured assets and remit the balance of the proceeds after costs to the secured creditor. If the value of the security is greater than the creditors claim, the balance goes to the insolvency estate. If the creditors claim exceeds the value of the security, the balance of the claim ranks as unsecured.

However, in an increasing number of reorganisation systems, the rights of the secured creditors to realise its security is restricted while the opportunities to reorganise the debtor's affairs are explored. Such restriction of enforcement of their rights is typically for a certain period of time, a so-called 'stay',[20] but this does not oblige a secured creditor to be bound by a reorganisation without the secured creditor's agreement. During a stay, the secured creditors position should be protected against any reduction in the value of the security. The reorganisation plan may have to provide for the secured creditor to be repaid to the value of the security.

3.2. Creditors' committees

[16] UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. III, para. 84.
[17] The World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, principle C12.3
[18] UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. V, para. 2-50 and recommendations 169-184
[19] UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. III, para. 84.
[20] UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. II, para. 36-40.

Many insolvency systems provide for the possibility to form a creditors' committee. The committee may be restricted to certain creditors, such as India, or of the major creditors, as is typically the case in the UK, or be intended to be a fair representation of the creditor group as a whole, as in several Eastern European countries. Such a committee may assist the administration in cases where creditors have very diverse interests[21]. The functioning of a creditors' committee is subject to local insolvency laws: in some jurisdictions it is merely an advisory body while in other jurisdictions it is a supervisory body with powers to approve actions, authorise compromises and fix remuneration[22].

4. Courts

In most jurisdictions, courts play a vital role in insolvency proceedings from (possibly simultaneously) opening the insolvency file; making the finding of insolvency and commencing the proceedings; appointing the insolvency practitioner and supervising various aspects of the proceedings[23], although in some jurisdictions, these aspects may be relegated to administrative tasks where the court becomes involved only on the application of an interested party. The relevant court is either a specialised court, such as exists in Thailand or the USA or the bankruptcy registrar in England and Wales, or part of a general purpose commercial court[24]. In courts of general jurisdiction, great benefit can be obtained by focusing all insolvency cases on a restricted list of judges enabling them to develop experience and expertise in insolvency matters.

The supervision the court exercises during the proceedings depends on the domestic insolvency law and local practice. For example, the court may be able to over-rule resolutions of creditors where it deems a reorganisation plan to be incapable of completion or contrary to the interests of certain parties while in other jurisdictions, the court must only decide whether the appropriate procedures were followed.

5. Employees claims

Employees are typically afforded some degree of priority payment, usually limited in terms of duration and types of entitlement. In many countries they are in the first level

[21]UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. III, para. 99.
[22]UNCITRAL, *Legislative Guide on Insolvency Law*, part II, chap. III, para. 101-114.
[23]The World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, principle D.1
[24] UNCITRAL, *Legislative Guide on Insolvency Law*, part. II, chap I, para. 54-58.

of payment while in others, they are paid by the state, which stands in their shoes as creditors either as a priority creditor, as in Lithuania, or as an ordinary unsecured claim, as in the UK.

Where the business continues trading in reorganisation proceedings, the law, as in the European Union, may protect workers rights. This can cause substantial problems where it is necessary to reduce the workforce to permit the business to reorganise[25].

6. Owners of the business/shareholders

The owners of the business, or the shareholders in case of a legal entity, rank behind the creditors in respect of their shareholding[26]. In liquidation proceedings this means that shareholders do not receive anything unless all other creditors have been fully repaid, including interest[27]. Some reorganisation plans provide a continued involvement for shareholders, albeit typically on heavily diluted terms[28].

KEY FEATURES OF AN INSOLVENCY FRAMEWORK

E 2. – COMMENCEMENT STANDARD

Introduction

In a world where jurisdictions are encouraged to embrace a "rescue culture" and avoid premature and value destructive liquidation of companies and businesses[29], it is important that the commencement standards for the opening of insolvency proceedings reflect the underlying policy goals and rational behind the insolvency proceedings and insolvency law generally.

Separate or Single Access Systems: Depending on the jurisdiction, a number of different insolvency proceedings may exist separately, each with its own door ("**Separate Access System**"), or there may be one door to an insolvency system that provides a variety of insolvency proceedings within that system ("**Single Access**

[25] The World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, principle C12.4 & *UNCITRAL, Legislative Guide on Insolvency Law*, part II, chap. V, para. 76.
[26] The World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, principle C12.5
[27] The World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, principle C12.5
[28] The World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, principle C12.5
[29] An example of this trend is EU Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU [2016/0359 (COD)].

System"). In jurisdictions with a Separate Access System, it may be possible for the debtor to defend itself against an involuntary filing of insolvency proceedings by creditors aimed at liquidation by filing itself for proceedings aimed at restructuring. The Netherlands is an example of such a Separate Access System.[30] Germany, on the other hand, is an example of a Single Access System.

Eligibility: The World Bank Principles[31] advocate that insolvency proceedings should apply to all enterprises or corporate entities, including state-owned enterprises. The recommendation of the UNCITRAL Legislative Guide on eligibility is even broader[32]. They both agree that exceptions should be limited[33], but in practice certain highly regulated institutions such as banks, insurance companies, utility companies, and stock or commodity brokers tend to have their own insolvency proceedings[34].

Jurisdiction: Courts frequently have to decide whether there is a sufficient connection to a jurisdiction for a debtor to be able to avail itself of the local insolvency proceedings. For example, does the opening of a bank account in that jurisdiction establish the required connection[35] or is it sufficient for the finance documents of the debtor to be governed by the local law of the jurisdiction and name the local courts in the jurisdiction clause? More commonly accepted connections that establish jurisdiction for insolvency proceedings are the so-called "Centre of Main Interest" (or COMI)[36] of a

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[30] In the restructuring of the Brazilian Telecom group Oi SA, this happened in 2016 in respect of two Dutch finance companies in the Oi SA group (Oi Brasil Holdings Coöpertief UA and Portugal Telecom International Finance BV). In response to a Dutch bankruptcy (*faillissement*) filing by creditors, the two Dutch finance companies filed for Dutch suspension of payment proceedings (*surséance van betaling*) which were opened by the Dutch Court. Subsequently, a legal battle erupted in 2017 when the Court-appointed Dutch administrators (*bewindvoerders*), supported by creditors, requested the Dutch Court to convert the suspension of payment proceedings into bankruptcy proceedings. This request was denied in first instance, but on appeal, that decision was overturned and bankruptcy proceedings were opened in respect of the two finance companies. This was confirmed by the Dutch Supreme Court following a further appeal.

[31] World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (Revised 2011) - Principle C3

[32] UNCITRAL Legislative Guide on Insolvency Law (Part 2 (2004) - Recommendation 8

[33] The World Bank Principle C3 and UNCITRAL Legislative Guide recommendation 9

[34] Following the 2008 Financial Crisis, significant efforts have been made on national and supra-national levels to put a framework in place pursuant to which a collapse (such as that of Lehman Brothers) of financially distressed credit institutions can be avoided and such institutions can be rescued, other than by way of public bail-outs. See Bank Recovery and Resolution Directive (BRRD) – Directive 2014/59/EU (https://ec.europa.eu/info/law/bank-recovery-and-resolution-directive-2014-59-eu_en).

[35] For the opening of US Chapter 11 proceedings this may be considered a sufficient connection. See *Global Ocean Carriers Ltd* 251 B.R. (Bankr. D. Del. 2000), in which case it was sufficient to establish jurisdiction for the opening of US Chapter 11 proceedings for the debtor to hold a few hundred US dollars in a US bank account.

[36] The COMI concept is used in the European Insolvency Regulation (re-cast) (EIR) (http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32015R0848) to determine the jurisdiction for the opening of main insolvency proceedings. See recitals 23, 28, 30 and 31 (which also deal with "forum shopping" by shifting the COMI of the debtor from one jurisdiction to another) and Article 3 EIR. Also UNCITRAL Legislative Guide recommendation 10(a) advocates for the use of COMI. In the EIR there is a rebuttable presumption that the COMI is at the place of registration if the Debtor is a corporate entity or the habitual residence if the debtor is a natural person.

debtor; whether the debtor has a so-called "establishment"[37] in the jurisdiction; or whether the debtor has any meaningful assets in the jurisdiction[38].

Purpose of Commencement Standard: The purpose of commencement provisions in insolvency proceedings is described in the UNCITRAL Legislative Guide[39] as:

- to establish safeguards to protect both debtors and creditors from improper use of the application procedure[40]; and
- to establish requirements for effective notification of commencement of insolvency proceedings.

Objectives of Commencement standard: The objectives of the commencement standard are to identify which debtor is subject to which insolvency proceeding and which stakeholder can apply for the opening of which insolvency proceeding[41].

Types of Commencement Standard

Inability to pay debts test[42]: A debtor may be deemed unable to pay its debts if it meets either the "cash flow or liquidity" test or the "balance sheet" test.[43] The former typically requires a court to be satisfied that the debtor is unable to pay its debts as they fall due[44]. The balance sheet test typically requires a court to be satisfied that the value of

[37] Article 2(11) EIR defines "establishment" as "*any place of operations where a debtor carries out in the 3 –month prior to the request to open insolvency proceedings a non-transitory economic activity with human means and assets*." UNCITRAL Legislative Guide recommendation 12 advocates a similar definition.

[38] Another aspect of jurisdiction is the "competent courts" in respect of which UNCITRAL Legislative Guide recommendation 13

[39] UNCITRAL Legislative Guide (Part 2 (2004) at p. 64.

[40] In practice, there is a risk that creditors use the application of insolvency proceedings as a debt collection mechanism. Debtors, on the other hand, may try to use the application of insolvency proceedings prematurely – following, for example, so-called "bad forum shopping" – to prejudice creditors.

[41] The World Bank Principle C4.1 advocates that "*[both Debtors and creditors should be entitled to apply for insolvency proceedings.*" In addition, jurisdictions may grant other stakeholders, such as for example a government authority, application rights as well. It should be noted, however, that in certain jurisdictions (such as France for example), creditors are not entitled to open restructuring proceedings as this is viewed as inappropriate involvement in the management of the Debtor company.

[42] This test is also referred to as the "general cessation of payments-test" or may be referred to as "overindebtedness" of the debtor (UNCITRAL Legislative Guide (Part 2 (2004)) at pages 45, 46 and 48).

[43] When applying either the cash-flow or balance sheet test, it is also important to assess whether or not the inability to pay is temporary in nature only, while the business is otherwise viable. While Debtors should be allowed to avoid a race by creditors to grab assets, a premature finding of "inability to pay" may also result in Debtors applying for insolvency proceedings too early, in particular in those jurisdiction that impose a mandatory duty on directors to file, failing which they may incur personal liability (both civil and criminal in nature). Filing too early could be value destructive and detrimental to creditors and a disincentive to the creation of a so-called "rescue culture".

[44] A "futurity requirement" in this test may be captured in the words "as they fall due". Under English law these words are interpreted to mean that also debts falling due from time to time in the reasonably near future need to be considered. What qualifies as "reasonably near future" will depend on the circumstances, but especially the nature of the company's business. *BNY Corporate Trustee Services Ltd and others v Eurosail-UK 2007-3BL plc* [2013] UKSC 28, at 37. Other jurisdictions (such as France for example) interpret the cash-flow test differently and may not take account of any future debt or any debt in respect of which the maturity deadline has been extended.

the debtor's assets is less than its liabilities (typically including contingent and prospective liabilities[45]). Creditors are invariably acutely aware whether debts are being paid when due but they do not usually have access to adequate financial information to ascertain if the balance sheet test is met. By far the majority of nations use the cash flow test while some, such as the UK, permit the courts to consider either test. Some laws require more than one debt to be unpaid for the cash flow test.

Prospective/imminent insolvency test[46]: If the inability to pay debts test is used as the commencement standard for the opening of insolvency proceedings, there may exist an additional commencement standard, that is more easily met, that the debtor will be unable to pay its future debts as they full due. Such a test is typically restricted to the debtor's own application and may also be restricted to an application the opening of restructuring proceedings. In jurisdictions such as France, on the basis of one commencement standard (*e.g.* an insolvency test), there is a choice between opening restructuring or liquidation proceedings. The decision depends on a fair appraisal by the Court of the likelihood that a restructuring will be implemented. If the likelihood exists, restructuring proceedings will be opened; if not, liquidation proceedings will be opened.

Alternative tests: A debtor does not have to be insolvent for opening US Chapter 11 reorganisation proceedings, but broadly speaking, the debtor can file a petition to commence Chapter 11 proceedings providing it has property in the US. For an English scheme of arrangement to be used as a restructuring tool to implement and get court sanctioned, a non-UK debtor only has to demonstrate that it is "*a company liable to be wound up under the English Insolvency Act 1986*"[47]. For the opening of French *sauvegarde* proceedings, a debtor does not have to be insolvent (or face a general "cessation of payments") providing it can demonstrate that is has "difficulties that it is unable to overcome"[48]. Such difficulties do not have to be financial, but could also be commercial in nature.

[45] Under English law, Section 123 of the Insolvency Act 1986 deems a company to be "unable to pay its debts" if either the cash flow test is met (paragraph 1(e)) or the balance sheet test is met (paragraph 2). In the balance sheet test contingent and prospective liabilities must be taken into account.

[46] According to the World Bank Principle C4.3 *"[D]ebtors should have easy access to the insolvency system upon showing proof of basic criteria (insolvency or financial difficulty."*

[47] This follows from Section 895(2) of the Companies Act 2006. Pursuant to Section 221 of the Insolvency Act 1986, an unregistered company [i.e. a foreign non-UK company] may be wound up under the Insolvency Act 1986.

[48] Article L. 620-1 of the French Commercial Code.

Standard Related Issues There are a number of related procedural matters[49] that should be considered simultaneously, including the following:

- Is the filing for the opening of insolvency proceedings mandatory or voluntary?[50]
- What (if any) (interim) relief is to be granted following a filing application but prior to a decision on the same?[51]
- Who decides on an application and by when?
- Who (if anyone) is entitled to notice of a filing application and what rights exist to challenge the filing application?[52]
- Who is entitled to notice of the decision and what rights of appeal exist by when by whom?[53]
- What relief is granted following the rendering of the decision to open insolvency proceedings[54]?
- What other orders, such as for the appointment of an insolvency practitioner, need to be made consequent on making such an order?

KEY FEATURES OF AN INSOLVENCY FRAMEWORK

E 3 – EFFECTS OF OPENING AN INSOLVENCY CASE

Insolvency regimes in all major jurisdictions seek to address the consequences of insolvency through a collective process. The underlying premise is that the assets of a debtor should be collected and distributed in a single process. Most regimes also

[49] See also the issues already raised in the introduction to this Module.

[50] The absence of a mandatory duty to file may provide directors with more flexibility to honestly attempt – without unnecessary fear for personal liability – a rescue of the business or enterprise of the Debtor while at the same time the existence of a wrongful trading concept could sufficiently safeguard against inappropriate continuation of a business/enterprise where directors knew or should have known that there was no reasonable prospect anymore that an insolvent liquidation (or other insolvency proceedings) could be avoided.

[51] According to the World Bank Principle C5.1 when an application is filed, but before a decision is rendered thereon by a court, *"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.*"

[52] According to the World Bank Principle C4.4 in case of an application 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."*

[53] See UNCITRAL Legislative Guide recommendations 23 (on "general notice"), 24 (on "notice to creditors") and 25 (on "content of the notice").

[54] World Bank Principles C5.2 and C5.3 advocate for a wide and all-encompassing stay that also affects secured creditors with only limited exceptions for clearly defined enforcement actions. How to deal in this context with Debtors with insufficient assets is another separate issue to consider (see UNCITRAL Legislative Guide recommendation 26).

provide a framework through which the debtor may be restructured. In substance, this collective procedure of corporate insolvency has three essential features[55].

1. Actions by individual creditors against the bankrupt are frozen. The piecemeal seizure of assets by individual creditors through attachment or execution are stayed and replaced by a right to claim for a dividend against the common pool;
2. All assets of the bankrupt belong to the pool which is available to pay creditor claims, subject to certain typical exceptions, such as security rights, set-offs rights with respect to certain assets; and
3. Creditors are paid *pari passu*, i.e. pro rata out of the assets according to their claims, subject to statutory and other priority claims under the relevant insolvency regime.

Fundamental Principle of Collectivity & the "Common-Pool Problem"

All insolvency or bankruptcy regimes, from their introduction through maturity, aim to address the "Common-Pool Problem" or "Tragedy of the Commons" outlined in contemporary economics. The Common-Pool Problem is intuitive; each of the debtor's creditors has an incentive to try to seize the assets of the debtor immediately, even if it prematurely depletes the common pool of assets for creditors as a whole. Although creditors as a group may be better off by working together to distribute the debtor's assets in an orderly fashion, each individual creditor has an incentive to race to grab his share — in modern times, the Common-Pool Problem affects a "race to the court-house" for creditors. Professor Ian F. Fletcher explains that:

At least one fundamental principle [of insolvency or bankruptcy regimes] appears to command universal acceptance (although the exact circumstances and mode of its application can vary). This may be termed 'the principle of collectivity', and amounts to a recognition that insolvency constitutes an example of the so-called 'common pool problem', which arises whenever conditions are such that more than one person has rights over the same, finite fund of resources[56].

[55] Philip Wood, Law And Practice Of International Finance, §4-01 Sweet & Maxwell (2008)
[56] Ian F. Fletcher, Insolvency In Private International Law, §1.08 Oxford Press (2005)

The primary objective of an insolvency regime is to avoid this race to the courthouse; over the course of history, the cure of this Common-Pool Problem has been typified by the absolute "collective" nature of insolvency regimes. Professor Max Radin isolates this common characteristic in his observation of the development English and United States Bankruptcy regimes:

Whatever else was present or absent, there was always some method by which all of the creditors were compelled to accept some arrangement or some disposition of their claims against the bankruptcy's property, whether they all agreed to it or not. Everything else is clearly incidental. The bankruptcy might be stripped of all his property and thrown into prison. He might be allowed certain exemptions. He might be relieved of his debts or have them scaled down or postponed. All these are stages of increasing humanity toward an unsuccessful member of the commercial community. He might even be helped to reconstruct and carry on his business, and this, with a view to maintaining an economic unit that involved a great many persons who are not properly creditors. But whatever happens to the debtor, in every case the creditors have been assembled in some formal way, their claims examined and classified, and assigned for satisfaction in definite proportions to an existing or prospective fund[57].

As described by Professor Roy Goode[58] the primary purpose of insolvency is to replace the free-for-all attendant upon the pursuit of individual claims by creditors with a statutory regime in which creditors' rights and remedies are suspended, wholly or in part, and a mechanism is provided for the orderly collection and realization of assets and the rateable distribution of dividends among creditors.

Overtime, the following nearly universal effects of opening an insolvency case have developed, in part to safeguard the collective nature of an insolvency or bankruptcy proceeding and address the Common Pool Problem.

Stay or Moratorium of Proceedings Against The Debtor

Generally, an automatic stay of all proceedings and creditor collection activities against the debtor once the court order is issued accepting the bankruptcy filing. When

[57] Max Radin, The Nature Of Bankruptcy, 89 U.Pa.L.Rev. 1, 3-4 (1940)

[58] Principles Of Corporate Insolvency Law, 2nd Edition, page 5

the stay becomes effective and the scope of the stay (*i.e.*, types of activities stayed, geographical breadth of stay, and entities affected by the stay) varies by jurisdiction. For example, in the United States, the stay is effective immediately upon the filing of a bankruptcy petition without the need for further action by the Bankruptcy Court[59]. Compare this automatic effect with India's insolvency regime. Under the Insolvency and Bankruptcy Code (2016), the National Company Law Tribunal (the adjudicating authority overseeing insolvency cases) has up to fourteen days to admit an application for commencement of corporate resolution process that has been submitted by a debtor - whereupon a "moratorium order" shall be declared[60].

Under most regimes, the stay merely suspends creditor rights pending a court's order to lift the stay as to a creditor or entity, or resolution of the insolvency case. Additionally, the stay generally does not stay actions against non-debtor third parties (though circumstances where the stay may extend to such third-parties may exist under certain regimes (*i.e.*, by court order in the United States)).

Purpose of the Stay

- Reorganization - for the debtor the stay provides a "breathing space" from creditor collections and lawsuits. The stay also ensures protection of the debtor's property, which may be critical to the success of the reorganization.

- Liquidation - for an individual or corporate debtor intending to liquidate (and the liquidator responsible for distributing assets to creditors), the stay provides time necessary for the liquidator to assemble the debtor's assets and assess and organize claims.

- Creditors - for the creditors, the stay solves the "Common-Pool Problem." Under many regimes, the stay freezes all individual creditor collection activities and non-bankruptcy rights and thus maintains the status quo. No creditor can advance a claim over the other; the stay is the first and fundamental shift towards a "collectivized" resolution of the debtor's affairs.

[59] U.S. Bankruptcy Code, 11 U.S.C. § 362.
[60] Sumant Batra, *India*, The Asia-Pacific Restructuring Review (2018)

Effect of Stay on Creditor Rights

Depending on the insolvency policies underlying the insolvency regime in the relevant jurisdiction, the rights and remedies of the creditors would be suspended, wholly or in part, automatically or following the commencement of certain procedure, in order to address the common-pool problem described above through a collective process.

In the United States, the stay does not extinguish a creditor's claim, lien or other security rights that existed prior to the insolvency proceeding[61]. Rather it delays the realization or enforcement of the claim, lien, or other rights, though other provisions in the regime's bankruptcy code or insolvency laws may diminish these rights[62]. For example, under the U.S. Bankruptcy Code, a secured creditor is not permitted to foreclose on its lien without: (i) the bankruptcy court first lifting the stay; or (ii) upon exit from bankruptcy, where the secured creditor's security may survive[63].

Likewise, under English insolvency law, generally, a secured lender may look to his pre-existing security, often with recourse to "self-help" remedies, without being subject to a stay on foreclosure or a requirement to share the proceeds in the liquidation process (except where the debtor has been placed in an administration. As Professor Fletcher explains this general principle:

"The principle of respect for such pre-bankruptcy rights is widely accepted by national laws, even if the nature of such rights and the conditions attaching to their creation are by no means uniform throughout the world. Broadly speaking, however, the precedence enjoyed by proprietary over personal and contractual claims under general law is replicated under the regime of insolvency law, with the consequence that security interests and other rights in rem which have been created prior to the commencement of insolvency remain intact, and are thus permitted to accomplish their intended purpose of insulating the creditor from full exposure to risk of loss in the event of the debtor's default. Hence the fully-secured creditor is enabled to stand outside the collective process of administration of the debtor's unencumbered assets, while the

[61] Pennsylvania Dept. of Public Welfare v. Davenport, 495 U.S. 552, 560 n.3 (1990) "Although the automatic stay protects a debtor from various collection efforts over a specified period, it does not extinguish or discharge any debt."
[62] David G. Epstein, et al. Bankruptcy § 3-1 (1992)
[63] *Dewsnup v. Timm*, 502 U.S. 410, 418 (1992) holding that ordinarily, liens and other secured interests survive bankruptcy.

partially -secured creditor is placed in the position of having to rely on that process only in respect of the unsecured balance of his claim[64]".

Cross-Border Guidelines to Stay

Unless a stay already exists because of a domestic insolvency case concerning the same debtor, if a court recognizes a foreign insolvency case as a main proceeding with respect to the debtor, it should promptly grant a stay or moratorium prohibiting the unauthorized disposition of debtor's assets and restraining actions by creditors to enforce their rights and remedies against the debtor or the debtor's assets[65].

Similarly, under English insolvency law (and a number of other jurisdictions which have taken this approach), the principle of "modified universalism" is generally respected, under which the assets or a debtor shall be collected and distributed on a world-wide basis in a single insolvency proceeding, as modified to permit the courts to evaluate foreign law and foreign courts before deferring to a foreign main insolvency proceedings[66].

Creation of the Bankruptcy Estate

Generally, although the extent and substance of an insolvency estate differs by jurisdiction, the commencement of a bankruptcy case creates an estate. The estate becomes the temporary owner of all of the debtor's assets and property rights, with certain exceptions (for example, in the United States and many other jurisdictions, certain property of an individual debtor is exempted from the estate). Assets that are part of the estate are subject to the exclusive control and protection of the bankruptcy court or the insolvency practitioner appointed by the court (or other court/jurisdictional entity) and is the primary focus of the stay discussed above.

[64] Ian F. Fletcher, Insolvency In Private International Law, §1.10 Oxford Press (2005)

[65] The American Law Institute and the International Insolvency Institute, *Report to ALI* Transnational Insolvency: Global Principles For Cooperation In International Insolvency Cases Principle 17

[66] For further discussion on this topic, please refer to the INSOL publication "Recognition and Enforcement of Cross Border Insolvency".

For example, in the United States, the filing of a bankruptcy petition automatically creates an "estate." Bankruptcy Code Section 541 states that the bankruptcy estate includes, among other property and wherever located:

1. all of the debtor's interests in tangible property;
2. debtor's property in the possession of others;
3. intangible assets;
4. property acquired within 180 days after filing for bankruptcy;
5. proceeds and rents of prepetition property;
6. equitable interests in property;
7. claims and causes of the action of the debtor.

Courts in the U.S. have interpreted the language of § 541 broadly, such that many rights and interests that are not traditionally thought of as assets are included in a debtor's estate (*e.g.,* a debtor's leasehold interest or interest in an executory contract). Additionally, Bankruptcy Code section 541(a) states that the estate is comprised of such property "wherever located." U.S. courts have interpreted this express language to command extraterritorial application of this Bankruptcy Code section. Thus, the "estate" under the U.S. Bankruptcy Code is a global one.

In England and Wales, winding up divests the debtor of its beneficial interest in its property although the legal title remains in the debtor. "The making of a winding up order divests the company of the beneficial ownership of its assets which cease to be applicable for its own benefit. They become instead subject to a statutory scheme for distribution among the creditors and members of the company".[67]" While it is clear that neither creditors nor members have any proprietary interest in the property by reason or as a result of the winding up, on a winding up, the assets cease to be available for profit making purposes but instead have acquired the nature of a fund destined for the payment of debts and distribution among the members.

[67] Mitchell v Carter [1997] BCC 907 at 912

Proscription Against Unauthorized Asset Sales And Unauthorized Payments

Under many insolvency regimes, once insolvency proceedings have commenced, the debtor, debtor's representative, or debtor-in-possession in the case of certain reorganization regimes, is not permitted to make post-petition payments or sell the debtor's assets unless authority is expressly provided under the laws of the regime or prior court approval is obtained. The voidability and return of such unauthorized post-petition transfers and asset sales prevents any one creditor or entity from receiving an unauthorized advantage as against the creditor body as a whole. This functions to preserve the "collective nature" of the insolvency proceeding.

For example, in the United States, a trustee (defined to include a debtor-in-possession) may avoid post-petition transfers of estate property that are not authorized by the bankruptcy court[68]. Likewise, post-petition sale of a debtor's assets (outside the ordinary course of business) is only permissible upon "notice" to parties in interest and after a "hearing" on the merits of the sale[69]. Together, these sections proscribe asset sales outside the ordinary course of business after the insolvency proceedings have commenced, if the bankruptcy court has not first authorised them.

Similarly, under English law, any disposition of the debtor's property and any transfer of shares of the debtor made after the commencement of the winding up is void unless the court orders otherwise[70]. Hence, any post-petition transfer of the property of the debtor will require the court's sanction. For completeness, it should be noted that the English law insolvency regime also allows certain pre-bankruptcy preferences to be avoided in order to recapture assets transferred by the debtor in the suspect period prior to the commencement of formal insolvency proceedings.

Cross-Border Guidelines to Asset Sales. Where there are parallel insolvency proceedings and assets will be sold, courts, insolvency administrators, the debtor, and other parties should cooperate in order to obtain the maximum aggregate value for the assets of the debtor as a whole, across national borders. Each of the courts involved

[68] Bankruptcy Code 11 U.S.C. § 549
[69] U.S. Bankruptcy Code section (§ 363) in conjunction with 11 U.S.C. § 549
[70] Section 127 of the Insolvency Act 1986

should approve sales that will produce the highest overall price for the debtor's assets. [71].

KEY FEATURES OF AN INSOLVENCY FRAMEWORK

E 4 – REORGANIZATION OR LIQUIDATION

Consideration of Key Objectives & Policies Relevant in this Context

The World Bank's *Principles for Effective Insolvency and Creditor/Debt or Regimes*, "Key Objectives and Policies" are especially relevant to assessing how the legal system can properly provide for either reorganization or liquidation:

- 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;
- Provide for the reorganization of viable businesses;
- Strike a careful balance between liquidation and reorganization, allowing for easy conversion of proceedings from one procedure to another.[72]

The benefit of a flexible approach for selecting between liquidation and reorganization

Reorganization[73] and liquidation types of proceedings are common to the majority of insolvency laws[74]. However, the traditional distinction between these two types of

[71] Transnational Insolvencies, at Global Principle 29; see also id. at Global Principle 17 (nations should institute a "moratorium prohibiting the unauthorized disposition of debtor's assets

[72] The World Bank, *Principles for Effective Insolvency and Creditor/Debt or Regimes* (the "**Principles**"), Part C § C1 at 20, 2015 (revised); *see also* United Nations Commission on International Trade Law (UNCITRAL), *Legislative Guide on Insolvency Law* Part One § I-B at 10-14, "Establishing the Key Objectives."

[73] The Legislative Guide notes that not all debtors that experience serious financial difficulty in a competitive marketplace should necessarily be liquidated; a debtor with a viable, potentially profitable business should be permitted to reorganize where it can be demonstrated that there is greater value (and therefore greater benefit for creditors in the long term) in keeping together the essential business and other component parts of the debtor. In these instances, reorganization proceedings are designed to give a debtor time or "breathing space" in which to recover from its temporary liquidity difficulties or more permanent overindebtedness and, where necessary, provide it with an opportunity to restructure its debt and its relations with creditors. Simply stated, the Legislative Guide uses the term "reorganization" in a broad sense to refer to the type of proceeding whose ultimate purpose is to allow the debtor to overcome its financial difficulties and resume normal commercial operations (although in some cases such rehabilitation may include a reduction in the debtor's scope of the business or its sale as a going concern to another company). *See* Legislative Guide, Part One § II-C-1 ¶ 24 at 27.

[74] A "liquidation" type proceeding is regulated by the insolvency law and generally provides for a public authority (typically, although not necessarily, a judicial court acting through a person appointed as liquidator) to displace management and take charge of the debtor's assets, with a view to terminating the commercial activity of the debtor, generally requiring the sale of assets for cash to occur in a piecemeal manner as quickly as possible and

proceedings can be somewhat artificial and can create unnecessary polarization and inflexibility.[75]

For these reasons, it is desirable that an insolvency law provide more than a choice between a single, narrowly defined reorganization and strictly traditional liquidation. Since the concept of reorganization can accommodate a variety of arrangements, it is desirable that an insolvency law adopt an approach that is not prescriptive and supports a variety of arrangements that will achieve results that provide greater value to creditors than if the debtor's assets were liquidated piecemeal.[76]

Some insolvency systems provide, in effect, that the party applying for the insolvency proceedings will have the initial choice between liquidation and reorganization. When liquidation proceedings are initiated by creditors, the law will often provide a mechanism that enables the debtor to request conversion into reorganization proceedings where feasible. [77] Conversely, creditors' standing to request conversion should be protected as a check against a debtor's potential abuses.

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distributing same proportionately to creditors. Some insolvency laws permit liquidation to involve the sale of the business in productive units or as a going concern (under other insolvency laws, a going-concern sale is only permissible in "reorganization")]. *See* Legislative Guide, Part One § II-C-2 ¶ 33 at 30.

[75] The Legislative Guide notes that a strict separation of regimes of liquidation and reorganization does not accommodate, for example, cases not easily situated at either such pole -- those cases where a flexible approach to the debtor's financial situation is likely to achieve the best result for both the debtor and the creditors in terms of maximizing the value of the insolvency estate. For example, the term "reorganization" is sometimes used to refer to a particular way of ensuring preservation and possible enhancement of the value of the insolvency estate in the context of liquidation proceedings, such as where the law provides for liquidation to be carried out through a "going-concern sale," – that is, by transferring the business to another entity as a going concern. In that situation, the term "reorganization" merely points to a technique other than traditional liquidation (*i.e.* straightforward, piecemeal sale or realization of the assets) being used in order to obtain as much value as possible from the insolvency estate. To achieve such a going-concern sale, the insolvency law may need to include an element of flexibility not generally available in laws that define liquidation as a sale of assets as soon as possible and allow the business to be continued only for that purpose. Some laws, for example, actually provide the power for the insolvency representative to effect a more advantageous sale or realization of the debtor's assets than would be affected in liquidation. Similarly, reorganization may require the sale of significant parts of the debtor's business or contemplate an eventual liquidation or sale of the business to a new company and the dissolution of the existing debtor. *See* Legislative Guide, Part One § II-C-1 ¶ 20 at 26.

[76] *See* Legislative Guide, Part One § II-C-1 ¶ 21 at 26-27. In discussing the core provisions of an effective and efficient insolvency regime, the Legislative Guide focuses upon reorganization proceedings on the one hand and liquidation proceedings on the other. However, the adoption of this approach is not intended to indicate a preference for particular types of proceeding or a preference for the manner in which the different proceedings should be integrated into an insolvency law. Rather, the Guide seeks to compare and contrast the core elements of the different types of proceeding and to promote an approach that focuses upon maximizing the result for the parties involved in an insolvency rather than upon strictly defined types of proceeding. This may be achieved by designing an insolvency law that incorporates the traditional formal elements in a way that promotes maximum flexibility. *See* Legislative Guide, Part One § II-C-1 ¶ 22 at 27.

[77] *See* Legislative Guide, Part One § I-D-2 ¶ 23 at 18. When the debtor applies for reorganization proceedings, whether on its own motion or as a consequence of an application for liquidation by a creditor, the application for reorganization should logically be decided first. With a view to protecting creditors, however, some insolvency laws provide a mechanism enabling reorganization to be converted into liquidation upon a determination, either at an early stage of the proceedings or later, that reorganization is not likely to, or cannot, succeed. Another mechanism for protection of creditors may consist of setting forth the maximum period for which reorganization against the will of the creditors could be continued. *See id*.

How a debtor is governed in the post-application period usually is a consequence of the choice between liquidation and reorganization. This is because liquidation procedures should provide for the immediate replacement of its management by an insolvency representative with authority to control and otherwise administer the estate in the interest of creditors. In creditor-initiated filings, where circumstances warrant, an interim administrator with limited functions could be appointed to monitor the business and protect creditor interests.[78]

Conversely, the World Bank notes in the *Principles* that there are three preferred approaches to post-application governance of a debtor in reorganization proceedings:

- Exclusive control of the proceeding is entrusted to an independent insolvency representative; or
- Governance responsibilities remain invested in management; or
- An impartial and independent insolvency representative or supervisor undertakes supervision of management.[79]

Striking a balance between liquidation (offering greater speed) & reorganization (potentially greater value and societal good) while protecting against abuse

The insolvency law should include the possibility of reorganization of the debtor as an alternative to liquidation.[80] An insolvency law accordingly needs to balance the advantages of speedier debt collection through liquidation (often the preference of secured and priority creditors) against preserving the going-concern value of the debtor's business through reorganization (often the preference of unsecured trade creditors, the debtor, and other constituencies such as employees).[81]

A common standard is to permit reorganization only where creditors would receive more in reorganization than in liquidation, unless they agree otherwise. This test is predicated on a recognition that greater value may be preserved and realized by keeping the essential components of an enterprise together, rather than breaking up and disposing of them in fragments.[82]

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[78] *See* Principles, Part C § C6.1 at 22.
[79] *See* Principles, Part C § C6.2 at 22. 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. *See id*.
[80] *See* Legislative Guide, Part One § I-B-3 ¶ 6 at 11.
[81] *See* Legislative Guide, Part One § I-B-3 ¶ 6 at 11.
[82] *See* Legislative Guide, Part One § I-B-3 ¶ 6 at 11.

An insolvency system—regardless of its precise structure—should contain mechanisms that protect the due process rights of all parties in interest to an insolvency case, who should be afforded easy access to the proceeding[83], as well as to information relevant to protecting their rights or interests. To this end, the *Principles* state that an insolvency system should require the debtor to disclose relevant information pertaining to its business and financial affairs in sufficient detail to enable the court, creditors, and affected parties to reasonably evaluate the prospects for reorganization.[84] The insolvency system should also provide for the retention of professional experts to investigate, evaluate, or develop information that is essential to key decision-making (such as whether an insolvent business is actually "viable") and that these experts should act with integrity, impartiality, and independence. Due process and access to quality information are especially important to the integrity of the law's conversion mechanism.[85]

Insolvency systems are bifurcated ("two systems") or unitary in procedural approach

An insolvency law will need to consider the structure of the procedure that leads to the choice of reorganization or liquidation proceedings. Approaches differ widely. Bifurcated insolvency laws provide for *two distinct proceedings*, each setting forth its own access and commencement requirements, with different possibilities for conversion between the two proceedings.[86] Other laws provide for *unitary, flexible insolvency proceedings with a single commencement requirement* alternatively resulting in either reorganization or liquidation, depending on the circumstances of the case.[87]

Bifurcated insolvency systems, which require a decision to be made between the different types of proceeding at the time of commencement of an insolvency case, have certain disadvantages as such systems create an undesirable degree of polarization between reorganization and liquidation and can result in delay, increased

[83] *See* Principles, Part C § C14.1 at 26.
[84] *See* Principles, Part C § C2 at 20.
[85] *See* Principles, Part C § C2 at 20.
[86] *See* Legislative Guide, Part One § I-D-2 ¶ 21 at 17. The laws that treat reorganization and liquidation proceedings as distinct from one another do so on the basis of different social and commercial policy considerations. However, a significant number of issues are common to both reorganization and liquidation, resulting in considerable overlaps and linkages between them, in terms of both procedural steps and substantive issues. *See id*.
[87] *See* Legislative Guide, Part One § I-D-2 ¶ 21 at 17.

expense and inefficiency, especially, for example, where the failure of reorganization requires a new and separate application to be made for the ensuing liquidation.[88]

Difficulties of determining at the very outset whether the debtor should be liquidated rather than reorganized have led some States to revise their insolvency laws by replacing separate proceedings with "unitary" proceedings. Under the "unitary" approach there is an initial period (an "observation period", which in existing examples of unitary laws last up to three months) during which no presumption is made as to whether the business will be eventually reorganized or liquidated. The choice between reorganization and liquidation proceedings only occurs once the financial situation of the debtor has been assessed and a determination made as to whether reorganization is actually possible.[89]

The basic advantages offered by this approach are its procedural simplicity, its flexibility and possible cost efficiency. Simple unitary proceedings may encourage early recourse to the proceedings by debtors facing financial difficulties, thus enhancing the chances of successful reorganization. A disadvantage of the approach, however, is that the delay that occurs between the decision to commence and the ultimate decision as to which proceedings should be followed, and the negative consequences for the debtor's business and asset value that flow from that delay especially as the vast majority of cases are destined to be liquidated in any event. However, given that the insolvency law is arranged in terms of reorganization and liquidation, it should be structured to ensure that, once a debtor is in the system, it cannot exit without a final determination of its future.[90]

The procedural mechanism of conversion enhances the flexibility of a legal system, especially bifurcated systems

One key reason why procedural flexibility in the insolvency regime is desirable is the important variable of a debtor's financial viability. A determination of whether the business of the insolvent debtor is viable should determine, at least in theory, which type of proceeding will be utilized. As a matter of practice, however, at the time of commencement of either reorganization or liquidation, it is often difficult to make a final

[88] *See* Legislative Guide, Part One § I-D-2 ¶ 22 at 18.
[89] *See* Legislative Guide, Part One § I-D-2 ¶ 25 at 19.
[90] *See* Legislative Guide, Part One § I-D-2 ¶ 25 at 19.

evaluation as to the viability of the business.[91] An insolvency law therefore should also provide for conversion between the two types of proceeding, with a view to allowing conversion when appropriate circumstances become apparent, to ensure that the most appropriate procedure to resolve the debtor's financial difficulty is utilized.[92] The procedural mechanism of conversion also can assist in preventing abuses of insolvency proceedings, such as a non-viable debtor commencing a reorganization proceeding as a means of delaying an inevitable liquidation, or creditors commencing liquidation proceedings as leverage in a simple debt collection dispute.[93]

[91] *See* Legislative Guide, Part One § I-D-2 ¶ 22 at 18. As a general principle, although usually presented as separate, liquidation and reorganization proceedings are normally carried out sequentially; that is, liquidation proceedings will only run their course if reorganization is unlikely to be successful or if reorganization efforts have failed. *See* Legislative Guide, Part One § I-D-2 ¶ 24 at 18.

[92] *See* Legislative Guide, Part One § I-B-3 ¶ 6 at 11. In some insolvency systems, the general presumption is that a business should be reorganized and liquidation proceedings may be commenced only when all attempts to reorganize the entity have failed. In insolvency systems providing for conversion, a request for reorganization to be converted into liquidation may be made by the debtor, the creditors or the insolvency representative, depending upon the provisions of the law. These circumstances may include where the debtor is unable to pay post-petition debts as they fall due; where the reorganization plan is not approved by creditors or the court; where the debtor fails to fulfill its obligations under an approved plan; or where the debtor attempts to defraud creditors. While it is often possible for reorganization proceedings to be converted to liquidation proceedings, most insolvency systems do not allow reconversion to reorganization once conversion of reorganization to liquidation has already occurred. *See* Legislative Guide, Part One § I-D-2 ¶ 24 at 18.

[93] *See* Legislative Guide, Part One § I-D-2 ¶ 22 at 18.

KEY FEATURES OF AN INSOLVENCY FRAMEWORK

E 5 – REORGANISATION

Globalization has added layers of complexity to reorganization processes as, additional to the legal and financial issues, cultural matters play an important role in cross border reorganizations, which also encounter multiple jurisdiction judiciaries with different cultural approaches towards insolvency and reorganization. The World Bank conducts an annual scoring of countries for "Doing Business" and one of the key indicators measured is *Resolving Insolvency*. It is a valuable analysis of a country's ability to rehabilitate debtors in an insolvency looking at key indices including the percentage of secured debt recovered and duration of proceedings. The World Bank also assesses a country's 'Reorganization Proceedings Index', which includes key factors such as the creditors' right to vote on a proposed reorganization, the rights for dissenting creditors to receive as much as they would in a liquidation and whether the reorganization plan provides for equality and voting by classes.

A reorganization process may include pre-insolvency and hybrid restructuring proceedings that allow a company to restructure outside of traditional insolvency proceedings. A judiciary needs to rely on a framework that is grounded in three main principles: -

- Maximizing value for stakeholders;
- Fair processes and procedures; and
- Promoting transparency in process, procedures and information

The Model Law on Cross-Border Insolvency addresses these values in its key objectives: -

- Cooperation between the courts and other competent authorities of this State and foreign States involved in cases of cross-border insolvency;
- Greater legal certainty for trade and investment;
- Fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested persons, including the debtor;
- Protection and maximization of the value of the debtor's assets; and
- Facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

The judiciary must consider the debtor's attempt to restructure through these three lenses and understand where the 'levers' are for the judiciary to control this framework and promote 'maximizing value in a fair and transparent basis'.

Maximizing value in reorganisation

This can take many shapes from simply maximizing the return to secured creditors to also preserving employment and pension funds for workers.

The debtor needs to demonstrate its focus on maximizing value by showing how a restructuring will allow it to be both:

(i) viable in the short-term (i.e., using a formal proceeding to return to day-to-day viability on cash flows); and subsequently

(ii) viable in the long-term (i.e., profitability and ability to operate as a going-concern that meets its obligations to stakeholders).

The debtor's ability to meets its obligations in the short-term and long-term contribute to the value equation and provide the evidence to the courts and stakeholders that the reorganization should maximize the value for all parties.

Fundamentally, the goal of any reorganization is to provide a debtor with time to address this 'return to viability'. This can be achieved in many ways such as debt-for-equity conversions, sale of assets/divisions or change in overall capital structure. Providing sufficient reliable evidence to support this return to viability is a key part of the framework that justifies the court supporting a reorganisation.

Reorganization must promote the concept of fairness

Reorganization requires hard decisions and actions, and often these decisions and actions impact the value available for certain groups of stakeholders. This decision making process needs to be overseen by a process that is fair. The judiciary's role is not to dictate the actual process as to how a debtor restructures its business: that is the task of the debtor's stakeholders (i.e., management, creditors, and any court appointed office holder). However, the judiciary must create a framework that not only affords the debtor the time to 'return to viability', but at the same time provide a forum for creditors to examine the plan, understand the impact on their position and allows them to be heard if they have concerns. Fairness in process also requires a fair

procedure for the debtor to reorganise its affairs, which may involve applying the inherent jurisdiction of the courts to provide interim relief such as a broad stay of proceedings and debtor-in-possession financing.

Any application of the concept of fairness needs to be fair to all stakeholders and where stakeholders that may consider any decision unfair sit in the waterfall of current and future value. It is commonplace for a party who has little expectation of any receipt from liquidation to advocate any reorganisation irrespective of the likelihood of success.

Promoting transparency

An effective insolvency framework also promotes transparency of process, current position, access, documents, financial information and any other information that may support a debtor's reorganization and the decision making process of its stakeholders. The more transparent a reorganization process is the more the principles of maximizing value and fairness will be enhanced. A debtor typically suffers reduced trust and credibility with its stakeholders and access to credible information will support the engagement needed.

How does a judiciary implement this framework?

The courts must create levers and controls they can implement to support the above three principles. A judiciary can support the following: -

- Have the management of the company supervised or controlled by an insolvency practitioner that can take control of the company during the course of reorganization proceedings. Such a practitioner must be independent and accountable to the courts and the stakeholders.
- There needs to be stay of proceedings to enable the debtor and its advisors to formulate a reorganization plan. This time may be specified by the insolvency law and may be able to be extended if the debtor has the support of the insolvency practitioner and principal creditors. Any stay should have time limits.
- There must be reporting requirements and ability for creditors to access information and ask questions. The insolvency practitioner must have the authority to obtain information and address questions of interested parties.

- For complex reorganizations, creditor committees may assist the judiciary to balance the stakeholders' rights.
- Judicial systems need to develop expertise in insolvency courts and insolvency practitioners with the training and experience to handle the increasingly complex reorganization plans with the sensitivity required to preserve and maximize the value of the ongoing concern.

Examples of modern judicial reorganization tools

Chapter 11 of the Bankruptcy Code of the United States of America - enables debtors in distress to come to an arrangement with their creditors in an expeditious manner by separating the business past problems from its future prospects[94]. The Code is extra territorial in its application by the Bankruptcy Court.[95] However, the debtor seeking protection must reside, or be domiciled, or operate a business or own a property in the Unites States of America. The Code grants a debtor automatic relief upon filing[96].

Scheme of arrangements[97] The purpose of a scheme of arrangement is to allow a company or a group to reach an agreement for a consensual restructuring with 75% of each class of its creditors[98]. Any agreement reached and sanctioned by 75% of each class of creditors binds all the other agreements even though they have not voted for it. The procedure involves two stages. The company files a court application for meetings of creditors and members to vote on the proposed compromise[99]. Where the application is granted, the company calls the meetings and thereafter obtains a court sanction for the proposed scheme if 75% of the creditors in each class are in agreement. The use of schemes of arrangements is particularly attractive because they are not considered insolvency proceedings, thereby giving a distressed company the opportunity of avoiding the stigma normally associated with bankruptcy.

[94] Tom Theunisse, 'Introduction of the Pre Pack Regulation in The Netherlands and the Benefits of Pre Packaged Administration: A comparison of Restructuring Through Different Bankruptcy Regulations' Masters Thesis 2014
[95] In re Global Ocean Carriers Ltd 251 BR 31 United States Bankruptcy Court
[96] S. 301 and S.1121 of the Bankruptcy Code
[97] S. 895 – 901 of the English Companies Act, 2006 and Lucas Kortmann & Micheal Veder, 'The Uneasy Case for Schemes of Arrangement Under English Law in Relation to Non UK Companies in Financial Distress: Pushing the Envelope?' (2015) 3 NIBeJ 13
[98] S. 899 of the Companies Act, 2006.
[99] S. 896 of the Companies Act.

The English Courts have held in[100] that while s. 895 (2) of the Companies Act and S. 220 and 221 of the Insolvency Act grant them jurisdiction over such applications by foreign companies, the Court could only exercise discretion to grant the relief sought upon being satisfied that: (a) that the company has sufficient close connection with England in the form of, though not necessarily, assets within the jurisdiction; (b) that there is reasonable possibility of benefit to creditors; and (c) one or more persons interested in the distribution of assets are persons over whom English Courts can exercise jurisdiction[101].

Administration - A company or any of its directors can apply to court for an Administration Order under the UK Enterprise Act[102]. This allows a company to reorganize by obtaining court protection from its creditors as it proposes an arrangement with the creditors. However, the company can only effect the appointment on its own after giving secured lenders notice of its intention to do so.[103] When placed in to administration, the company's affairs are placed under the care of an administrator whose powers include taking possession of any company property, sell property, borrow, establish subsidiaries etc[104]. Further, an administrator has the power to do anything necessary or expedient for the management of the affairs, business and property of the company.[105] The administrator is required to hold a meeting within ten weeks of his appointment of all creditors of the company to present and discuss his proposals.[106] Further, the proposals upon being presented, may be rejected, varied or revised by the general body of creditors, or even subjected to further meetings and discussions.[107] Where the proposals have been approved, he is required to manage the affairs of that business in accordance with those proposals[108].

Prepack administration There instances where expedience does not allow the summoning of creditor meetings to approve an administrator's proposal. Consequently, the ingenuity of English legal system has coined a new relief called a

[100] Re Magyar Telecom BV[100] and Re Rodenstock GmbH (2012) BCC 459
[101] See Re Rodenstock GmbH case – Supra; and Lucas Kortmann and Micheal Veder, 'the Uneasy case for Schemes of Arrangements under English Law in Relation to non UK companies in Financial Distress: Pushing the Envelope?' (2015) NIBLej 13
[102] S. 10 of the Enterprise Act
[103] S. 22 of the Enterprise Act
[104] S. 60 of the Enterprise Act and Schedule 1 of the Insolvency Act 1986
[105] S. 59 of the Enterprise Act
[106] S. 51 (2) (b) of Enterprise Act.
[107] S. 53, 54, 55 and 56 of the Enterprise Act.
[108] S. 68 of the Enterprise Act

pre-packed administration to address such situations. Through pre-packaged sales (or prepacks, as they are known) insolvent debtors may, prior to the commencement of any insolvency proceedings, negotiate the sale of their business and assets to a pre aligned entity by an administrator shortly after his appointment[109]. The assets to be sold may include the shares a parent company holds in an operating company, thereby making prepack administration an important tool in the reorganisation of groups of companies. There is no restriction on the purchasing entity including the directors of the distressed company. Although the Insolvency Act of 1986 (as amended by the Enterprise Act) does not provide for pre pack sales, landmark decisions[110] recognized that there are instanced where a quick and swift disposal of the company's assets by an administrator may be the best way of saving value of those assets[111]. In effect, the court recognized that strict enforcement of the legal requirement for administrators to call a meeting of creditors to present his proposals, including any proposal to sale the assets, for approval may be prejudicial to the creditor's interests. Consequently, the court ruled that an administrator had powers to sell the assets of a distressed company before calling a creditors meeting to present his proposals for the company, if such an action was satisfied his commercial judgement.[112]. The court further held that the sale the administrator did not need court authorization in exercise of these powers**.** The sale could be conducted without any marketing if doing so defeats the tenements of commercial judgement. Nonetheless, the administrator is still required to provide creditors with documented explanation and justification for his actions. It is therefore a critical requirement that the administrator satisfactory demonstrates that the action was the only viable option of retaining value of the company. Consequently, the option is useful in the disposing of a distressed company's business as a going concern as it provides a swift and efficient means of effectuating a sale of business without attracting the considerable costs normally associated with a full blown administration thereby ensuring more returns for creditors[113].

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[109] Statement of Insolvency Practice (SIP) 16. Also see Alastair Goldrein, ' Unwrapping English Pre Packaged Administrations: A Guide to Pre Packs', Pratt's Journal of Bankruptcy Law: Vol 7 No. 5 July/August 2011

[110] 2004] EWHC 932

[111] T & D Industries Plc[111] and Transbus International Ltd**.** Also see Re Hellas Telecommunications (Luxembourg) (2010) BCC 295

[112] Under s. 17 (2) of the Insolvency Act This powers was reiterated by the Court in the Transbus International Ltd case even after wide ranging reforms to the Insolvency Act that were introduced by the Enterprise Act.

[113] Alastair Goldrein, op.cit

KEY FEATURES OF AN INSOLVENCY FRAMEWORK

E 6 – LIQUIDATION

Liquidation is still the predominant form of insolvency regime for businesses that are not economically viable.

Goal and function of liquidation

Liquidation (or "winding up") refers to the process of winding up the debtor's affairs, realising the assets and, in as far as possible, paying the liabilities of the debtor[114].

The principal features and objectives of liquidation are:

- the appointment of an insolvency practitioner to administer the affairs of the insolvent debtor;
- the timely, efficient and impartial resolution of the debtor's affairs, realization of its assets (for maximum value) and distribution of the proceeds to the creditors;
- the equitable treatment of creditors (as modified by social policy influenced priorities and the rights and priorities of secured creditors); and
- from a policy perspective, to remove insolvent businesses from the market and to "facilitate the orderly reallocation of economic resources from businesses which are not viable to more efficient and profitable activities".[115]

Liquidation is a collective enforcement regime where the control of an economically unviable debtor is placed in the hands of an independent insolvency practitioner, the Court or regulatory body[116] for the benefit of the debtor and its stakeholders (including its employees, creditors and shareholders). Liquidation provides for the efficient closure and transfer of the assets of a failed business, enhances certainty in the market and promotes economic stability and growth.

The World Bank Principles[117] state:

[114] While liquidation may also be implemented in respect of a solvent company (e.g. by its shareholders or the Court), this summary focuses on *insolvent* liquidation

[115] Homepage for the UNCITRAL Legislative Guide on Insolvency Law at http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html

[116] The World Bank Principles in article D1.2 state: "Insolvency proceedings should be overseen and impartially disposed of by an independent court. Nonjudicial institutions playing judicial roles in insolvency proceedings should be subject to the same principles and standards applied to the judiciary."

[117] World Bank. 2015. Principles for effective insolvency and creditor - debtor rights systems. Washington, D.C.: World Bank Group. (www.worldbank.org/insolvency) Article C6.1

"In liquidation proceedings, management should be replaced by an insolvency practitioner with authority to administer the estate in the interest of creditors. Control of the estate should be surrendered immediately to the insolvency practitioner."

The objective of liquidation is to sell and dispose of the assets of a debtor to realize a pool of funds for distribution to creditors.[118] This generally means converting the assets of a debtor into cash but it does not necessarily mean a piecemeal sale of the business: converting the assets into cash can also be achieved by a sale of the business as a whole to a third party.[119] In any case, the insolvency practitioner must seek to maximize the return to creditors.

Role and powers of the insolvency practitioner

Usually, it is up to the insolvency practitioner to decide the means of selling the assets although some jurisdictions restrict the means of sale:

- the sale of the assets and property may require a court order;
- It may require the approval of a creditors committee.[120]
- In many civil law countries, assets are required to be sold by way of public auction although In practice the value realized by public auction is not necessarily the maximum value

Liquidation sales are often described as "fire sales" and bids reflect the distressed nature of the sale. If the insolvency practitioner decides to sell assets by other means, or sell the business as a whole, he may need to deliver proof of the value or in some countries obtain court approval.[121]

There is little utility in providing for a liquidation regime if the insolvency practitioner cannot ascertain the whereabouts of the debtor's assets. For that reason, most regimes provide the insolvency practitioner with the power to gather information[122] and to compel the delivery up of the debtor's books, records and property. Courts often

[118] UNCITRAL Legislative Guide on Insolvency Law, Parts One and Two (2004), par. 12 (w).
[119] Nicolaes W.A. Tollenaar, Het pre-insolventieakkoord, grondslagen en raamwerk, Summary in English, par. 12.2.
[120] In a creditors' voluntary liquidation (UK) the Liquidation Committee plays an important role (see Insolvency Act 1986 s. 101.
[121] UNCITRAL Legislative Guide on Insolvency Law, Parts One and Two (2004), par. 80.
[122] For example: section 235 of the Insolvency Act 1986 (UK) provides that officers, employers, administrators or administrative receivers of the company have a duty to provide the liquidator with such information as may reasonably be required. The Dutch Bankruptcy Code has a similar rule and adds a sanction of imprisonment.

have a broad discretion to conduct examinations, or to facilitate examinations by the insolvency practitioner, in order for the insolvency practitioner to efficiently perform his role.

Efficiency

In order for a liquidation to be effective, it is essential that debtor's assets be realized as efficiently as possible. The timing of the sale may impact the value achieved. If the sale of the business as a whole, or substantially the whole, is intended, the insolvency practitioner will need to act expeditiously before the value of the business is affected and the holding costs reduce the net amount available to creditors. If there is no risk of deterioration in value, for example if the assets comprise real estate, it may be prudent to await better market circumstances. If the insolvency practitioner needs court approval for a sale, the court should be approached for that relief as early as is practicable.

The costs and expenses of the liquidation are generally paid out of the estate. In most cases, the insolvency practitioner's fees are afforded priority over all other claims and therefore effectively reduce the amounts available for distribution to creditors. For a liquidation to be efficient, it is therefore important to keep the costs of the liquidation as low as possible.

Role and powers of creditors

Where an insolvency practitioner is appointed, the powers of the controllers of the debtor cease. The appointment of an insolvency practitioner is particularly important in order to protect and preserve the value of assets of the debtor.[123] Protection of the assets is necessary, not only from enforcement actions by creditors but in liquidation also from the directors or management of the debtor. For this reason, during liquidation proceedings, transactions involving assets of the company will generally be void, unless approved by the insolvency practitioner. Many regimes will also provide for a stay or moratorium on enforcement action or litigation by creditors against the company or its property (other than with the express consent of the Court). In liquidation, the contractual or legal claims of creditors against the insolvent company are converted into a right to prove (or to make a claim) in the liquidation of the debtor.

[123] UNCITRAL Legislative Guide on Insolvency Law, Parts One and Two (2004), recommendation 39(c).

In common and civil law regimes, the insolvency practitioner adjudicates upon the claims lodged by creditors and distributes the estate in accordance with the admitted adjudicated claims.

The inevitable consequence of insolvency is that the debtor will have insufficient assets to meet its liabilities in full. The equitable treatment of creditors is a fundamental tenet of liquidation, with the proceeds of sale of the debtor's assets distributed equitably and rateably amongst creditors holding similar legal rights. Pre-insolvency rights and priorities are preserved, in as far as possible, with secured creditors generally entitled to priority over the claims of unsecured creditors. Most regimes also provide for certain statutory or social policy influenced priorities - for example, priority for the costs of the liquidation, for employee creditors and, in certain jurisdictions, for tax authorities. The claims of equity interests/owners are generally subordinated to all other claims.[124]

A further aspect of the equitable treatment of creditors is that transactions entered into by the debtor prior to liquidation (during a prescribed "look-back" or "hardening period") which have the effect of giving a creditor a preference or advantage over other (unsecured) creditors of the same class, or sales or transfers of a debtor's assets at an undervalue, or transfers to defeat creditors, can be avoided in liquidation.

After liquidation

Upon the conclusion of the liquidation process, once all assets have been realized creditors' claims adjudicated and proceeds distributed to creditors, the legal entity is generally dissolved. This achieves another objective of liquidation: removing a non-viable business from the economy. Given that they rank last in the payment waterfall, after unsecured creditors, equity holders will not receive a distribution from an insolvent company's estate unless there is sufficient to pay all creditors in full together with any statutory interest.

[124] See, for example, Article C12.5 of the World Bank Principles which provides:
"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."

KEY FEATURES OF AN INSOLVENCY FRAMEWORK

E 7 – OUT OF COURT RESTRUCTURING

Out of court restructuring (workouts) is an important tool for restructuring a distressed debtor. While there is no legal definition, generally speaking, a work out is a process where a debtor experiencing or which will imminently experience financial difficulties negotiates relief in the form of contractual amendments or waivers from creditors without any judicial intervention. Workouts need not involve all creditors but may be limited to resetting financial covenants, re-scheduling payment obligations, converting accrued interest into repayable principal, or converting debt into equity. In general terms, modern global workouts focus preserve the debtor entity rather than requiring its liquidation or lengthy and expensive in-court procedures.

Similar mechanisms have been developed to address systemic problems in the banking sector and are usually led by international banks and financiers. In some jurisdictions, the central banks of the countries promote workouts by offering banks provisioning and loan classification holidays if a workout is successfully negotiated and implemented. These non-judicial, workout mechanisms have been in place for many years with respect to sovereign debt and various principles from those sovereign workouts are now being employed in private law workouts.[125]

Importance of Workouts

Both the World Bank Principles and the UNCITRAL Legislative Guide consider workouts as important and an integral part of a creditor-debtor regulatory system. Workouts can help preserve the business value of the debtor enterprise and interests of the creditors and other stakeholders. Both these sources also consider work outs to be more likely to succeed where there are adequate creditor remedies and insolvency laws as, absent such negotiations, the debtor or the creditors can trigger the formal insolvency law process, leading to potential detriment to both debtor and creditors in terms of time, cost and ultimate outcome. A regime for work out can either supplement the insolvency regime or can act as a distinct regime after which the formal

[125] *See, e.g.,* Lex Rieffel, Restructuring Sovereign Debt: The Case For *Ad Hoc* Machinery (The Brookings Institute Press 2003: Washington, D.C.) at 56-131 (discussing the so-called "Paris Club" and the "London Club" under which banks of engaged in negotiated workouts); *see also* Edwin Borchard, State Insolvency and Foreign Bondholders (Yale University Press 1951) (discussing in two volumes various sovereign workouts from 1822-1944).

insolvency follows. As such, a growing number of jurisdictions are implementing “pre-insolvency” laws or preventative regimes that permit a borrower to provide notice of a need to work out certain financial debts for a fixed time during which the debtor will endeavour to negotiate a resolution to its financial obligations.

Necessary Pre-conditions

The UNCITRAL Legislative Guide considers the following as pre-conditions for effective workouts:

- Significant amount of debt owed to banks and financial institutions;
- Present or imminent inability of the debtor to service the debt;
- Acceptance by both the debtor and the creditors that a work out will be preferable to formal insolvency proceedings and will bring greater benefit to all parties;
- Use of sophisticated refinancing, security and other tools to restructure the debts;
- The sanction that if the negotiation cannot be started or starts but breaks down, a debtor can resort to swift and effective formal insolvency law tools;
- The debtor does not need relief from trade debts or other reliefs of formal insolvency such as the automatic stay and the business is otherwise be viable; and
- Favourable or neutral tax treatment for both debtor and creditors

Processes Involved

A work out by its nature provides flexibility to the participants in the manner it is conducted. However, usually a work out involves the following steps

- Commencing the process: A work out does not need to commence only when the financial difficulties of the debtor can be demonstrated. Creditors and the debtor can voluntarily come together to commence the process at any time the process is considered necessary and in most cases, the largest financial creditors or a steering committee of the creditors take the lead from the creditors’ side in the negotiations. Availability of effective and swift creditor remedies or insolvency proceedings can encourage commencement of the process.
- A ‘standstill’: For business operations and restructuring negotiations to continue smoothly, it is important that the creditors agree to suspend any enforcement actions. This is achieved by a ‘standstill’ agreement. In regimes that have formalised “pre-insolvency” negotiations, these standstill periods may be invoked

by filing a notice with a court to commence a period of negotiation with specific financial creditors who are then subject to a moratorium. In some jurisdictions (e.g., Spain) the commencement of a pre-insolvency proceeding is public, while in others (e.g., France) the commencement of a pre-insolvency negotiation period is confidential and expressly cannot be disclosed or made public.

- Engaging advisors: it is important for the debtor and creditors to engage legal, accounting and restructuring advisors to ensure provision of reliable information and development of a viable restructuring plan for the debtor. The debtor typically pays for the creditors' advisors and this can be a point of negotiation between parties.
- Ensuring adequate cash flow and liquidity for the debtor: Continued access to established lines of credit or additional financing is important for a stressed debtor to continue its business operations. Creditors therefore agree not to withdraw existing lines of credit.
- Creditors agree that 'new money' will be accorded super-priority status and the existing creditors will subordinate their claims. Most insolvency regimes contemplate such super-priority financing during formal insolvency proceedings or an elevation of "emergency" or "rescue" financing to a first priority status.
- The creditors require access to complete and accurate information on the business: proper evaluation of a restructuring plan cannot be made without such information. The debtor therefore agrees to provide all such information to the independent experts. In this regard, there is often non-disclosure or confidentially agreements agreed to ensure that information remains confidential.
- Where the debtor is a publically-listed entity with securities traded on regulated exchanges, creditors may have to agree to not trade in any of the debtors' securities during this negotiation period. As a result, creditors will often insist on a "cleansing" period in which the material terms of the negotiations are publically disclosed to the market so that all holders of the securities are made aware of the debtor's position and so that creditors who were involved in negotiations can once again trade the securities without breaching securities laws.
- Negotiation among creditors: Different security positions and characteristics of credit may lead to conflict among the creditors in the negotiation. Such a conflict also makes it difficult to agree on a 'standstill' unless a better outcome can be

demonstrated in the negotiation. Aggregation of debt by main creditors or a supporting regulatory regime may be the solution to this problem. For example, the laws of some jurisdictions provide for certain qualifying workouts to be binding on all relevant creditors, if a specified majority of them have approved it.

To facilitate workouts and orderly negotiations of restructuring, many organisations have developed non-binding principles and in some jurisdictions, the central banks have issued guidelines binding banks subscribing to the system. The 'London approach' developed by the Bank of London, is the origin of guidance that urges the banks to adopt a supportive approach towards a workout. This was the basis on which INSOL International developed the *Statement of Principles for a Global Approach to Multi-Creditor Workouts II*[126], which is endorsed by The World Bank and referred to in The Legislative Guide[127].

Pros and cons of workouts

The important advantages of the informal out of court workout are: -

- the flexibility in restructuring. 'Tailor-made' solutions can be agreed leading to better outcomes for the creditors and other stakeholders.
- limited or little involvement of the courts means that the parties can proceed at their own pace in the negotiations.
- confidentiality of the restructuring process
- no compulsory foreign currency conversions into local currency
- continued management control of the business
- no stays on enforcements, set-offs or contract cancellations,
- no termination of leases or contracts on account of insolvency and
- low overall cost of restructuring.

In addition, as noted above, in some jurisdictions, the central bank of the relevant country may also provide the banks forbearance on provision for bad loans and extra time for classification of loan as non-performing.

[126] Latest version was issued in April 2017. Available at insol.org.
[127] UNCITRAL Legislative Guide, p. 26.

At the same time, workouts are not free from disadvantages. Most important of those is

- the need for unanimity among creditors because unlike formal insolvency proceedings, workouts do not provide a cram down mechanism that binds recalcitrant creditors. The result is that these creditors hold out for payment in full which may tip the debtor over to formal insolvency, leading to overall value destruction.
- workouts almost always rely on co-operation from the shareholders and management for effective implementation especially where the restructuring plan involves transfer of substantial assets or debt-equity conversion. Where shareholders have an unrealistic expectation of the outcome or are unwilling to support the plan agreed by the management, the entire plan can fail.
- In short, the complexity of modern capital structures and the potential for conflict and dissent can cause great difficulty in many modern day corporate workouts.
- absence of avoidance powers to enhance the value of the estate,
- no protection of directors' liability who, depending on the insolvency regime, may be required to file for formal insolvency,
- the risk of lender liability on basis of shadow directors or abusive credit while implementing the restructuring plan,
- reduced title protection for the purchaser in the absence of court approval, and difficulty in obtaining cross-border recognition of the restructuring plan.

Where an informal workout is incapable of completion, it is possible for a pre-insolvency negotiated workout where a significant majority of creditors have agreed to compromises to be followed by a formal court process that imposes a negotiated resolution on dissenting creditors.