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Report of Working Group V (Insolvency Law) on the work of its twenty-sixth session (New York, 13-17 May 2002)

Contents

* The document is late submitted because it reports on the Working Group's session which was held between 13 and 17 May 2002

I. Introduction

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

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

3. To facilitate that further study, the Commission decided to convene an exploratory session of a working group to prepare a feasibility proposal for consideration by the Commission at its thirty-third session.

4. At its thirty-third session in 2000 the Commission noted the recommendation that the Working Group had made in the report of the exploratory session held in Vienna from 6 to 17 December 1999 (A/CN.9/469, para. 140) and gave the Group the mandate to prepare a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including consideration of out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features, including a discussion of the alternative approaches possible and the perceived benefits and detriments of such approaches.

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

with INSOL and the IBA organized the UNCITRAL/INSOL/IBA Global Insolvency Colloquium in Vienna, from 4-6 December 2000.

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

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

8. The Working Group on Insolvency Law commenced the preparation of a legislative guide to insolvency law at its twenty-fourth session (New York, 23 July to 3 August 2001) and continued its work at its twenty-fifth session (Vienna, 3-14 December 2001). The reports of those meetings are contained in documents A/CN.9/504 and A/CN.9/507.

9. The Working Group on Insolvency Law, which was composed of all States members of the Commission, held its twenty-sixth session in New York from 13 to 17 May 2002. The session was attended by representatives of the following States members of the Working Group: Austria, Brazil, Burkina Faso, Canada, China, Colombia, Fiji, France, Germany, India, Iran (Islamic Republic of), Italy, Mexico, Russian Federation, Singapore, Spain, Sudan, Sweden, Thailand and United States of America.

10. The session was attended by observers from the following States: Algeria, Australia, Denmark, Gabon, Iraq, Ireland, Jordan, Malta, New Zealand, Nigeria, Philippines, Portugal, Republic of Korea and Switzerland.

11. The session was also attended by observers from the following international organizations: (a) organizations of the United Nations system: International Labour Organization (ILO), International Monetary Fund (IMF), World Bank; (b) intergovernmental organizations: League of Arab States, European Bank for Reconstruction and Development (EBRD), (c) non-governmental organizations invited by the Commission: American Bar Association (ABA), American Bar Foundation (ABF), Groupe de reflexion sur l'insolvabilité et sa prévention (G.R.I.P.), International Bar Association (IBA), International Federation of Insolvency Professionals (INSOL), International Insolvency Institute, International Law Institute, International Working Group on European Insolvency Law.

12. The Working Group elected the following officers:

Chairman: Mr. Wisit WISITSORA-AT (Thailand);

Rapporteur: Mr. Jorge PINZON-SANCHEZ (Colombia).

13. The Working Group had before it three Notes by the Secretariat: Draft legislative guide on insolvency law A/CN.9/WG.V/WP.61 and Addenda 1 and 2.

14. The Working Group adopted the following agenda:

1. Election of officers.
2. Adoption of the agenda.
3. Preparation of a legislative guide on insolvency law.
4. Other business.
5. Adoption of the report.

II. Deliberations and decisions

15. At the present session, the Working Group on Insolvency Law continued its work on the preparation of a legislative guide on insolvency law, pursuant to the decisions taken by the Commission at its thirty-third (New York, 12 June-7 July 2000)[1] and thirty-fourth sessions (Vienna, 25 June-13 July 2001)[2] and of the Working Group on Insolvency Law at its twenty-fourth and twenty-fifth sessions. The decisions and deliberations of the Working Group with respect to that legislative guide are set forth below.

16. The Secretariat was requested to prepare a revised version of the Guide, based on those deliberations and decisions, to be presented to the twenty-seventh session of the Working Group on Insolvency Law (Vienna, 9-13 December 2002) for review and further discussion.

III. Preparation of a draft legislative guide on insolvency law

A. General Remarks

17. The Working Group suggested that the reorganization procedure needed to be discussed more clearly in the recommendations and that reorganization should be stressed before liquidation. It was also suggested that sections C and D of chapter V should be moved from the chapter on administration of the insolvency proceedings to a subsequent part dealing with resolution of the proceedings. A further suggestion was that the recommendations should be included in the draft Guide both as a

[1] *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17*, A/55/17, paras. 186-192.

[2] *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 18*, A/55/18, paras. 296-308.

separate text or annex, as well as throughout the document following each relevant section of the analytical commentary.

B. Part One. Key objectives

18. As a general remark, it was observed that the recommendations focussed upon the protection of creditors and did not mention the protection of the debtor, which was an equally important aspect of an insolvency regime.

19. As to the form of Part One, support was expressed in favour of including the recommendations in the form of a preamble to state the purposes and objectives of the Guide. That approach would establish the background for the recommendations that would follow the preamble and would also serve as a useful tool of interpretation.

20. A number of suggestions were made as to the content of recommendations (1) to (7). It was suggested that recommendation (1) should focus more clearly on the options of liquidation and reorganization and omit the words following "businesses" in the second line. A proposal to include a reference to the need to give full consideration to the protection of employees in recommendation (1) was not supported.

21. The Working Group generally agreed that recommendation (3) should include the term "equally" rather than "equitably" with respect to similarly situated creditors, while the term "equitably" was more relevant in the context of recommendation (6) and the treatment of different classes of creditors and that that usage should be reflected throughout the draft Guide.

22. General support was expressed in favour of including in recommendation (5) a reference to the periodic provision to creditors by those supervising the insolvency process of information with respect to the debtor's financial situation and the progress of the proceedings.

23. In the context of recommendation (6), it was noted that the protection of employees was of particular importance in an insolvency law and that they should be specifically mentioned as a class of creditor requiring particular attention. While that proposal received some support, the Working Group was generally of the view that although protection of employees was an issue of some importance (particularly in terms of meeting international obligations) a reference to one particular class of creditors in recommendation (5) was not desirable and might reflect a policy bias that should not be included in the general objectives. It was observed that as drafted the reference to creditors would include employees with claims and that the issue of protection of employees could be addressed more specifically under the sections on treatment of contracts and distribution.

24. General support was expressed in favour of retaining recommendation (7) to encourage and promote adoption of the Model Law on Cross-Border Insolvency.

25. Suggestions for additional recommendations were that all claims of creditors should be dealt with in a single insolvency proceeding, and that the insolvency law should encourage the search for an amicable agreement and solution to the debtor's financial situation to avoid the need for insolvency proceedings.

C. Part Two. Core provisions

1. Introduction

A. Structure [organization] of the insolvency regime

26. It was suggested in respect of recommendation (8) that more explanation should be included in the Guide and recommendations on the ways in which the different procedures could be arranged in the insolvency regime.

27. A drafting suggestion was that the reference to the ability of the debtor to convert proceedings in recommendation (9) should be amended to refer to the need to include in the insolvency law a facility for conversion of proceedings.

2. Application for and commencement of insolvency proceedings

A. Eligibility and jurisdiction

28. A general remark was that the draft Guide should more clearly indicate whether each recommendation applied to either liquidation and reorganization or to both procedures.

29. It was observed that recommendation (13) was potentially in conflict with article 28 of the Model Law on Cross-Border Insolvency which provided for commencement of insolvency proceedings on the basis of presence of assets. In response, it was suggested that a distinction should be drawn between the draft Guide and the Model Law on the ground that the Model Law referred to commencement of ancillary proceedings based on presence of assets in a situation where main proceedings had been commenced elsewhere, whereas recommendation (13) was referring essentially to commencement of those main proceedings. It was noted however, that since some insolvency laws did provide for commencement on the basis of assets, a more flexible approach should perhaps be adopted in the draft Guide. It was suggested that the recommendations should include a general statement of the principle along the lines of paragraph (c) of the purpose clause, that is that the insolvency law should address the question of which debtors have sufficient connection to a State to be subject to its insolvency laws. An additional recommendation should then be added to the effect that while different approaches might be taken to identifying those connecting factors, as a minimum or as examples, they should include those set forth in recommendation (13) paragraphs (a) and (b).

B. Application and commencement criteria

30. General support was expressed in favour of amending the reference in paragraph (c) of the purpose clause from “inexpensive” to “cost effective”.

31. Concern was expressed with the reference in recommendation (17)(a) to the future inability of the debtor to pay its debts, on the basis of the difficulty of proof of that criterion and the need to establish some element of the imminence of that inability. It was suggested that if the inability to pay was not imminent, the debtor should seek to resolve its position by informal negotiations, not by commencing formal proceedings. It was observed in response that informal negotiations were not

always possible with respect to certain types of financial instruments which required unanimity for amendment of repayment terms.

32. A contrary view was that the recommendation should be included as currently drafted in order to encourage voluntary applications by debtors at an early stage, which the Working Group had agreed should be a key element of the insolvency law. It was suggested in support of that view that if such a provision led to abuse by debtors, that issue should be addressed in terms of the consequences of the application, rather than in terms of the commencement criteria.

33. Concern was also expressed with regard to recommendation (18) on the basis that failure to pay a single debt might lead to application of the presumption without consideration of whether the debt was disputed or whether there might a right of set-off in respect of that debt. To address those concerns it was suggested that the recommendation should include words to the effect that the debt was not subject to a legitimate dispute or an offset in an amount equal or greater than the amount of the debt. That proposal received some support. With respect to the number of creditors, some support was expressed in favour of requiring failure to pay more than one creditor. In response, it was suggested that what was important was not the number but rather the quantity of the debt held by a particular creditor and the relationship between assets and liabilities. It was noted, however, that different approaches with respect to those issues might need to be taken in different countries to reflect varying stages of economic development, prevalence of different types of financial instruments and other similar factors.

34. A further concern was that as presently drafted, recommendation (18) did not make it clear how the debtor could defend itself against such a presumption. In response it was suggested that recommendations (20)(b) and (23) provided protection for the debtor who would have the opportunity to rebut the presumption by showing that it was able to pay its debts, that the debt was subject to a legitimate dispute, that the debt was not mature and other relevant facts and the court would have to assess those facts in considering whether or not to commence insolvency proceedings. It was observed that the purpose of the recommendation was to provide an opportunity to compel the debtor to show that it should not be subject to the insolvency law.

35. After discussion, the Working Group agreed that in order to accommodate the different views expressed, the recommendation should indicate that the insolvency law “might” rather than “should” provide for the inclusion of a presumption, with reference to the different approaches that might be taken with respect to the circumstances that must be established for proceedings to be commenced, in particular the number of creditors or quantity of debt that might be required.

36. Support was expressed in favour of retaining in recommendation (21) the words in square brackets as examples of how notice might be provided and adding references to other means by which notice could be given, such as through relevant electronic registries. Another suggestion which received support was that recommendation (21) should be limited to provision of notice to the public and that recommendation (22) should address provision of notice to creditors, both known and generally. A further suggestion which received support was that the information to be included in the notice to creditors should be set forth in a separate

recommendation which would apply to both the general notification of creditors and notification to known creditors and should be a requirement of the law.

37. With regard to the opening words of recommendation (23), it was suggested that a distinction should be drawn between denial of an application for commencement and dismissal of proceedings, especially where the commencement criteria functioned as automatic commencement, as referred to for example in recommendation (19)(a). General support was expressed in favour of including two recommendations to deal with denial along the lines of recommendation (23) and a separate recommendation providing for dismissal on the grounds contained in (23)(a) and (b). A proposal that a further ground should be added to reflect the discussion in the Working Group on denial of an application based upon the debt being the subject of a legitimate or bona fide dispute was supported. The Working Group agreed that the text in the second set of square brackets in paragraph (b) was preferable and should be retained, and that a subheading could usefully be added to the recommendation.

3. Treatment of assets on commencement of proceedings

A. Assets to be affected

38. One suggestion of a general nature in respect of the recommendations on assets to be affected by the commencement of insolvency proceedings was that a distinction should be drawn between liquidation and reorganization, as the assets to be affected by the commencement of different types of proceedings may differ. In response, it was observed that that approach might establish an artificial distinction which could potentially be abused by debtors. It was also noted that the difference between liquidation and reorganization was more important in terms of how the assets were affected, rather in the definition of the assets to be included in the estate.

39. With respect to recommendation (24)(a), the Working Group discussed the question of the location of the assets to be subject to the proceedings and whether the recommendation should adopt the universal approach of referring to all assets "wherever situated". Some concern was expressed in relation to both that approach and to the Guide addressing the question of which law should govern the assets, particularly secured assets.

40. After discussion, the Working Group agreed that the concerns expressed could be accommodated by revising the recommendation along the lines "The insolvency law should define the assets to be included in the insolvency estate" which might include assets of the kind referred to paragraphs (a) and (b) of recommendation (24) and clearly indicating whether the law adopted a universal or territorial approach to the assets to be included. Support was also expressed in favour of the proposal that the Guide should clarify how assets possessed by the debtor pursuant to a contract should be treated and include a reference to assets recovered through avoidance actions and potential assets, such as prospective awards from an action for damages.

B. Protection and preservation of the insolvency estate

41. With respect to recommendation (26)(a) some concern was expressed as to the meaning of the word "execution" and it was suggested that the paragraph should

refer to "execution and other enforcement against the assets of the insolvency estate" to clarify the point. It was also suggested that that language could be used in recommendation (28)(b). It was pointed out that recommendation (26)(b) should refer to administration "or" realization of all or part of the debtor's assets, although the need to address realization was questioned. With respect to the words following "…preserve the value of assets" an alternative was suggested along the lines of "in accordance with the objective of the insolvency proceedings" which would accommodate both liquidation and reorganization without specifying the types of actions included in (26)(b).

42. A further concern raised was whether the recommendations as presently drafted would apply to secured creditors. To address that issue it was suggested that the words "including perfection or enforcement of security interests" could be added to recommendation (28)(a). A further suggestion to clarify that point drew attention to the difference between the language of recommendation (28)(c) and article 20 of the Model Law on Cross-Border Insolvency on which the recommendation was based. To clarify the concern, it was suggested that the language of (28)(c) should be amended to "the transfer, encumbrance of other disposal of any assets of the insolvency estate is suspended." In the course of the discussion of recommendation (28)(a) it was observed that in some countries the stay and suspension did not apply to commencement or continuation of actions, but rather to enforcement of the outcome of those actions. It was noted that that approach was reflected in article 20(3) of the Model Law on Cross-Border Insolvency.

43. With regard to recommendation (32) it was suggested that both texts in square brackets in paragraph (a) should be retained.

44. A suggestion was made that recommendation (33) should be redrafted to express the general principle of protection, with the types of protection mentioned in the recommendation to be included as examples of how that protection might be provided.

C. Use and disposition of assets

45. As a matter of drafting, support was expressed in favour of the proposal to omit from paragraph (c) of the purpose clause the references to abandonment or surrender of assets and refer only to treatment of burdensome assets and, using the language of recommendation (38), assets determined to be of no value to the insolvency estate and assets that cannot be realised in a reasonable period of time.

46. A general concern raised related to the definition of "insolvency representative", and whether it would include a debtor in possession. It was noted that that issue could be considered at a later time when the Working Group considered the glossary to the draft Guide.

47. Concern was expressed that the relationship of recommendation (35) to recommendation (24) was not clear and, in particular, whether assets owned by third parties would be considered part of the insolvency estate.

48. With respect to recommendation (36) it was proposed that both texts in square brackets should be retained so that the assets should be both of benefit to, and necessary for, the conduct of the insolvency proceedings. A concern was expressed as to the meaning of "assets subject to security interests" and whether the

reference was limited in the context of recommendation (36) to rights *in rem*. It was observed that the draft recommendations included provisions addressing the protection of secured creditors (recommendations (32) and (33)) and counterparties to contracts with the debtor (recommendation (44)). To ensure the protection of third parties, it was proposed that parallel provisions be included after recommendation (36).

49. Some support was expressed in favour of a proposal that the second sentence of recommendation (39) should require private sales to be subject to supervision by the court or approval of the creditors. In regard to approval of creditors, it was suggested that reference should be made to the section on creditors and the creditor committee. In response to a suggestion that the recommendation should perhaps make a distinction between sales in liquidation and reorganization, it was noted that the purpose of the provision was to address the issue of sales outside the ordinary course of business, whether in liquidation or reorganization. In response to a question of whether or not a creditor could be a buyer, it was noted that it was not generally desirable to place restrictions on who could purchase assets of the debtor, and that what was required were protections of the kind included in recommendation (39). It was further proposed that those protections would also be relevant to recommendation (40).

D. Treatment of contracts

50. As a matter of drafting, concern was expressed as to the precise meaning of the phrase "that have not or not fully been performed by either the debtor and its counterparty" and thus to the scope of section D. It was clarified in response that the section was intended to address contracts that required performance by both parties and not simply the situation where one party had performed its obligations and was awaiting payment by the other party. The Secretariat was requested to reflect that idea more clearly in the draft recommendations.

51. Support was expressed in favour of using mandatory language in recommendation (42) and including as a further category (c) the fact of insolvency of the debtor or its weakened financial position. Recalling the discussion in the context of protection of the estate that many countries provided for the stay to apply to the counterparty to a contract with the debtor in order to prevent the contract being terminated, support was also expressed in favour of ensuring that that was clearly stated in the recommendations to ensure that the contract remained in place to allow the insolvency representative time to consider the possibility of continuation.

52. With respect to recommendations (43) and (45) it was noted that (43) contained a condition for continuation whereas (45) made the right of rejection unconditional. It was proposed that (45) should be limited to contracts that were burdensome to the insolvency estate.

53. Wide concern was expressed on the inclusion of recommendation (46)(b) on the basis that it appeared to give an advantage to parties who did not perform their contractual obligations and had the potential to place an insolvent debtor in a stronger position than a party that continued to perform its obligations. In response, it was observed that paragraph (b) may have some application in certain cases, particularly in the case of reorganization, where the contract in question may be

crucial. After discussion, the Working Group agreed that the issue required further consideration and placed paragraph (b) in square brackets.

54. In the context of recommendation (50), it was noted that although reference was made to the time period within which the insolvency representative should act to continue or reject a contract, no provision was included for the counterparty to request the insolvency representative to take prompt action. That proposal was supported.

55. Different views were expressed as to the need for provisions on assignment of contracts. One view expressed was that the question of assignment should be left to the general law of contract and should not be addressed in the insolvency law. A contrary view was that special rules were required to address assignment in the insolvency context, particularly in those jurisdictions where assignment was not permitted against the disagreement of the counterparty. It was noted that a policy justification for such provisions was the retention of the value of a contract for the benefit of the insolvency estate (and subsequently creditors), provided that the counterparty's position was not disadvantaged or its position made worse as a result of the assignment. For those purposes, either Variant A or B was acceptable. A further view was that Variant A, recommendation (53) might be too difficult to satisfy and that all that was required were recommendations (51) and (52) of Variant A. After discussion, the Working Group agreed that the recommendations should reflect both views that assignment could be left to general contract law and that special provisions could be included in the insolvency law. The Secretariat was requested to prepare the necessary revisions.

56. As to recommendation (54), it was suggested that specific mention should be made of financial transactions (addressed in detail in section F), as well as contracts involving intellectual property where it was desirable that the contract be able to be continued.

E. Avoidance actions

57. With respect to the Purpose clause, it was suggested that paragraph (a) should not so much refer to preservation of the assets, as to reconstruction or reconstitution of the assets. The use of the phrase "fair treatment" was queried in light of the earlier discussion on the key objectives and the use of equal and equitable treatment. Suggestions for additions to the purpose clause included a paragraph to the effect that a purpose of the provisions was to ensure legal certainty for third parties as to the actions that might be avoidable, and a paragraph concerning the treatment of payments made prior to commencement that were in the ordinary course of business. Different views were expressed on the need to address post-commencement transactions in the section on avoidance, but the Working Group agreed generally that the issue should be addressed in the Guide, such as in recommendations (35) and (57)(d) or in the section on treatment of contracts.

58. A change to the title of the section to "Avoidance proceedings" was also proposed.

59. It was observed with respect to paragraph (b) that the phrase "involving the debtor" might be too narrow, as there may be transactions involving the debtor's property to which the debtor was not a party.

60. A drafting suggestion in respect of recommendation (56) was to replace "retrospectively" with "retroactively".

61. A number of views were expressed on recommendation (57). A preliminary remark was that the reference to "commence proceedings" in the chapeau might not be sufficient to cover other ways in which avoidance might arise, such as by way of defence to an action concerning particular assets brought by someone other than the insolvency representative. Additional suggestions were that paragraph (a) should refer, in addition to the transfer of assets, to the incurring of liabilities, and to transactions which left the debtor with few assets or in financial difficulties.

62. One concern with respect to paragraph (a) was that the reference to fraud might not be sufficient to describe the types of transactions that should be covered in the recommendation, and that what was required were examples of transactions and some objective indicators as to the types of transactions covered. A related concern was that the requirement of actual intent might prove difficult to satisfy and that a reference to situations where the third party had reason to suspect the fraudulent nature of the transaction might be of assistance. It was also suggested that the requirement of fraud might be too narrow and too specific and it was proposed that supplementary requirements such as transactions made in bad faith might be relevant. Another suggestion was that the word fraud be deleted and the section focus on the objective characteristics of the transactions sought to be avoided.

63. In respect of recommendation (61), it was proposed that it include the transactions referred to in recommendation (57)(a).

64. With respect to determination of the suspect period in recommendation (58), it was suggested that reference should be made to (62) and the need to have longer periods for the transactions addressed in recommendation (57)(a) generally, not just those involving related parties.

65. Support was expressed for the view that recommendation (65) was not required in the section on avoidance.

66. With respect to footnote 15, it was noted that the notion of control of the debtor and a reference to a legal entity, not just natural persons, should also be included.

67. It was suggested that a reference to the exercise of avoidance powers could usefully be added to recommendation (78).

68. It was observed that section E did not address the treatment in the insolvency proceedings of a transferee to a contract that was avoided where the transferee failed to disgorge or return the assets to the estate. It was noted that some insolvency laws provided that a claim by such a transferee would not be admitted.

F. Netting and set-off and G. Financial contracts

69. The Working Group based its consideration of those topics on the following text which had been revised by the Secretariat.

"F. Netting and set-off [A/CN.9/WG.V/WP.58, paras. 116-123]

(66) In general, netting and close-out arrangements should be legally protected and should, to the greatest extent possible, not be [unwound] [undone].

(a) A right of set-off existing under general law and exercised before the commencement of insolvency proceedings should be excluded from the application of provisions on avoidance;
(b) After commencement of insolvency proceedings, the insolvency law should permit creditors and the insolvency estate to exercise a right of set-off permitted under general law and should exclude the exercise of that right of set-off from the application of provisions on stay and suspension of actions against the debtor and treatment of contracts.

"G. Financial contracts*

(67) Notwithstanding other provisions of general law or the insolvency law:

(a) upon application for commencement of an insolvency proceeding against a debtor, any creditor of the debtor that is a party to a financial contract involving the debtor may terminate that contract;
(b) upon an application for commencement of insolvency proceedings against a debtor, any creditor of the debtor that is a party to a financial contract involving the debtor may [apply security][exercise their security] and exercise rights of setoff under that financial contract; and
(c) transactions under a financial contract and related security arrangements should not be subject to provisions on stay and suspension of action against the debtor and should not be subject to avoidance provisions unless they constitute actual fraud.

"* The definition from the United Nations Convention on Assignment of Receivables in International Trade, 2001, Art. 5(k) provides: "Financial contract" means any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets, irrespective of whether or not they were effected on an exchange, and any combination of the transactions mentioned above [*underlining indicates new text*]."

70. There was general agreement in the Working Group that those issues should be addressed in the Guide and that the Guide should stress the importance of the types of contracts to be covered and the complexity of the arrangements involved.

71. As to the scope of the financial contracts to be covered, it was suggested that the definition in footnote 16 was too broad and should be more narrowly focussed to cover only those transactions which formed part of a broader framework contract.

72. Some concern was expressed as to whether the right of set-off described was limited in its application to financial contracts or was of more general application. After discussion, the Working Group agreed that set-off in the context of those

recommendations would be limited to financial contracts and that the Guide would address the issue of set-off more generally in another section. It was proposed that the recommendation should, in the context of financial contracts, generally protect a pre-commencement right of set-off and permit post-commencement set-off where the mutual claims arose under the same framework agreement.

73. With respect to recommendation (67) it was noted that there was a need for an exception for financial framework agreements only where two conditions were satisfied: (a) where post-commencement set-off was not permitted for mutual financial obligations; or (2) where the insolvency law gave the insolvency representative the ability to override contract termination provisions.

74. It was suggested that the provisions required careful consideration to ensure that they were clearly explained and that countries would not adopt provisions that would interfere with the operation of arrangements such as SWIFT and the IATA clearing house, taking into account special systems rules on insolvency and unwinding of transactions.

4. Participants and institutions

A. The debtor

75. With respect to paragraph (a) of the purpose clause, it was noted that the text in square brackets referred to the obligations of third parties. Considerable support was expressed in favour of addressing the obligations of third parties in the draft Guide. While those obligations might include an obligation to deliver books and records belonging to or relating to the debtor and to surrender property of the debtor in the possession of the third party, it was noted that the obligations of third parties might differ from the corresponding obligations of the debtor. For example, it was suggested that the provision of information might need to be more specifically defined by reference to its relevance to the proceedings.

76. It was observed that given the importance of participation of the debtor in reorganization proceedings, “may” should be replaced by “should” in recommendation (70). That proposal was supported. It was also proposed that some distinction may need to be made between liquidation and reorganization, as the latter procedure required a more active participation, and the provision of information was more important to the success of the procedure.

77. With respect to recommendation (71), support was expressed in favour of adding a number of additional obligations. Those included an obligation of the debtor not to leave its habitual residence; to provide information on any ongoing court or administrative proceedings, including enforcement proceedings; to surrender property and business records; and to provide information on transactions occurring during the suspect period. With respect to the surrender of property, it was suggested that that obligation would need to be cross-referenced to recommendation (24) and limited to property that comprised the insolvency estate, whether domestic or foreign. With respect to foreign property, the suggestion was made that a reference to the Model Law on Cross-Border Insolvency and the appointment of a foreign representative might be appropriate. Both of those proposals were supported. It was also suggested that some consideration should be given to the

relationship between recommendations (71) and (73) and to indicating where the different obligations would be relevant to the types of procedures included in (73).

78. Wide support was expressed in favour of including an additional recommendation that made reference to recommendation (25) and the debtor's right to retain personal property needed for daily survival.

79. The Working Group agreed that the duty of confidentiality in recommendation (72) should extend to information in the control of the debtor but belonging to a third party and to information relating to trade secrets irrespective of whether that information belonged to the debtor or a third party.

80. Some support was expressed in favour of deleting recommendation (73)(c) on the basis that it described a particularly specialised type of procedure which relied on a well-developed court structure. The view was expressed that it was not an option that should be recommended without considerable explanation and background information. In response, however, it was agreed that since recommendation (73) merely set forth different options, all three paragraphs should be retained. It was noted, however, that some reference might be made to different levels of supervision that could be provided in such an approach, and to the protections that operated in conjunction with that approach.

81. Support was expressed in favour of retaining recommendation (74) and for an addition to the effect that the insolvency law should also provide for actions taken in violation of the obligations to be invalid. It was also suggested that the recommendation should apply to both individual and corporate debtors.

B. The insolvency representative

82. Some support was expressed in favour of giving more prominence in recommendation (76) to appointment of the insolvency representative by creditors. In response to suggestions that that approach might lead to compromise of the insolvency representative's independence, the attention of the Working Group was drawn to the protections already included in recommendations (77), (79) and (80)(d). A contrary view was the Guide already adequately addressed the interests of creditors and the recommendation should be retained as drafted.

83. With regard to recommendation (77), some support was expressed for the view that a conflict of interest should disqualify an insolvency representative from acting. A contrary view was that although conflicts of interest should be disclosed, the issue of disqualification should ultimately be determined by the court. An additional suggestion was that the recommendation should include a requirement that the insolvency representative be independent of other interests. It was proposed that those requirements concerning conflict of interest and independence should extend to persons employed by the insolvency representative.

84. It was proposed that the obligations of the insolvency representative in recommendation (78) should be cross-referenced to the recommendations concerning the debtor, and corresponding obligations for the insolvency representative to take action be included, such as to take possession of books and records. Further proposals which received some support were that the chapeau should include a reference to the general obligations to maximize the value and protect the security of the estate; that the paragraphs should be reorganized to reflect

a hierarchy of importance ((i) for example, should be included more prominently); that paragraph (b) should provide for the insolvency representative to conduct an examination of the debtor (whether under oath or some equivalent procedure); that paragraph (g) should clarify the parties to whom the information should be provided; that the insolvency representative should be required to provide regular reports to creditors on the progress of the proceedings; that the insolvency representative could exercise rights for the benefit of the estate in respect of court proceedings underway but to which the stay and suspension applied; and that (j) could provide for the creditors committee also to refer matters to the insolvency representative.

85. With respect to recommendation (79) some support was expressed in favour of including more detail in terms of liability arising from recommendations (77) and (78).

86. Some concern was expressed as to the meaning of "circumstances" in recommendation (80).

87. With respect to recommendation (84) it was suggested that the terms of the right of review described by reference to footnote 14 were too broad and required further consideration.

88. A general issue as to the treatment of assetless estates was discussed. The Working Group agreed that those estates should be addressed in the Guide, particularly because an estate could be assetless as a result of transactions which would be subject to avoidance, and the failure to administer such estates might encourage behaviour that the insolvency law otherwise sought to address. It was proposed that the Guide should recommend the need to address such estates and indicate the need for a mechanism for administration to be established, whether through a public agency or some other approach. That mechanism would also address appointment and remuneration of the insolvency representative. A related suggestion was that that issue could also be addressed in respect of some cases under the commencement section.

C. Creditors

89. With respect to section 1, in respect of which no recommendations were yet included in the Guide, it was proposed that the different classes of claims should be addressed, in particular, the need for the insolvency law to clearly identify classes and their treatment. It was noted in response that such a section would have to be closely linked to the section on distribution.

90. Some concern was expressed in relation to the structure of the recommendations, as (89) to (96) clearly related to the committee and should be included under that heading.

91. With regard to the functions of the creditor assembly, support was expressed in favour of including the substance of footnote 19 in the recommendation. A further function could relate to verification of claims. Concern was expressed that the recommendations did not clearly address issues such as the relationship between the assembly and the committee, including whether a committee was always required; the distribution of powers between the two bodies; whether the assembly or the committee should be required to exercise the powers and functions listed; sharing of

the listed powers and functions with the insolvency representative; a mechanism for convening meetings of the assembly; and resolution of conflicts between the assembly and the committee. It was also observed that some countries used mechanisms for representation of creditors other than the assembly or the committee, which might be reflected in the commentary.

92. It was observed that recommendation (87), although establishing an acceptable principle, was less fundamental than the parallel right of the debtor in recommendation (69). It was suggested that the recommendation should indicate the matters in respect of which the creditors should have a right to be heard. It was also suggested that the recommendation should clarify the individual nature of the right.

93. With respect to recommendation (90) support was expressed for reversing the order of the two sentences and clarifying the language of the first sentence with respect to the limitation on the participation of secured creditors to the extent that they were secured. It was also observed that different approaches might be taken to the participation of secured creditors in liquidation and reorganization, particularly where the secured creditors claim was to be restructured and in that situation no limitation should be imposed on its participation.

D. Institutional framework

94. General support was expressed in favour of addressing in the draft Guide issues related to the institutional framework required for implementation of the insolvency law. Some concerns were raised, however, as to the manner in which relevant issues would be treated and the level of detail to be included. It was suggested that while discussion should be included in the commentary, no recommendations should perhaps be included in the technical recommendations on the content of the insolvency law. In preparing the commentary, it was proposed that the Secretariat could have regard to the work of other international institutions, in particular the World Bank and International Monetary Fund. Suggestions as to some of the issues that could be included in the commentary included distribution and balance of responsibility between the participants; case management; supervision of both the insolvency proceedings and the participants in those proceedings, including professionals; disciplinary issues; education and training; and issues of cost-effectiveness and economic functionality. It was proposed that the need for specific recommendations could be further considered when a specific text had been prepared for the Working Group.

5. Management of proceedings

95. As a general remark, it was suggested that chapter V should only include sections A-C, as D and E properly related to resolution of the insolvency proceedings.

A. Treatment of creditor claims

96. It was observed that since paragraph (e) of the Purpose clause included only some examples of different types of claims, but was not exhaustive, it should either be extended to refer to all other claims or all examples be deleted, leaving only a reference to the treatment of particular claims.

97. With respect to recommendation (99), it was suggested that some reference should be made, as a general principle, to the need to establish a mechanism for admission and treatment of claims and for creditors to file claims (or to establish a procedure by which undisputed claims could be automatically admitted) in order for them to participate in insolvency proceedings, as well as to the treatment of claims in reorganization and post-commencement claims. With regard to the establishment of some alternative mechanism for the admission of undisputed claims, support was expressed in favour of the principle, particularly in those circumstances where it would be appropriate to avoid the often complex and lengthy procedures associated with filing and verification of claims. However, in response to the suggestion that the accounting records of the debtor could form a sufficient basis for such admission, it was pointed out that the books and records of an insolvent debtor may not be a good source of uncontested information and some other criteria should be found. It was also suggested that footnote 20 was too categorical; in particular it was observed that the claims of tax authorities were often affected by insolvency law, with those claims being limited or subject to some other constraint. It was agreed that the footnote required revision.

98. As a general remark it was noted that the section on treatment of creditor claims did not address the treatment of under-secured claims, or the question of whether interest would accrue on claims following commencement.

99. Support was expressed in favour of introducing into recommendation (100) the notion of the equal treatment of similarly situated creditors as contained in recommendation (3). A related suggestion was that the minimisation of formalities and easing of restrictions as to the language in which claims might be made, issues that were addressed in the Model Law on Cross-Border Insolvency, should also be reflected in the draft Guide.

100. With respect to recommendation (101)(b), it was noted that where the claim was not filed until late in the proceedings, the creditor would be required to accept that it could not participate in distributions already made.

101. It was observed that the consequences referred to in recommendation (102) differed between countries and the inclusion in the Guide of some comparative information would therefore be useful.

102. With respect to recommendation (103), it was suggested that provision should be made for situations where parties to a contract had agreed to the time at which conversion of the claim would occur.

103. It was observed that the drafting of recommendations (105) and (107) departed from the general formulation of "The insolvency law should …" and should be revised accordingly. With respect to recommendation (105), it was also suggested that the types of review being proposed should be clarified, whether by the court or some other tribunal, and that the insolvency representative could be allowed to take a decision, in the process of verifying the claim, on the question of set-off.

104. Preference was expressed in favour of the second text in square brackets in recommendation (108)(b).

105. Some concerns were expressed with respect to recommendation (109). It was suggested that the mere fact of a relationship between the claimant and the debtor would not be sufficient in all cases to justify special treatment of a claim. In some cases such claims would be absolutely transparent and in others they might be suspicious. It was noted that some mechanism might be required to address those related party claims that were suspicious or deserved particular attention, and that the draft Guide should make it clear that such treatment was not to be accorded as a matter of course, but would be available in a limited range of situations. It was observed, however, that the treatment of claims described in (109) did not relate to the admission or rejection of a claim, but to the treatment it might be accorded either at the time of admission or at some later time when it became apparent that the related party had caused harm to the estate. It was suggested that the Working Group should take account of the inter-relationship between various recommendations, especially where a number of different approaches were included such as in recommendation (109). For example, where creditors were to play a role in selection of the insolvency representative, related party creditors should not be entitled to participate. A question was raised as to whether (109) was to apply to claims generally and whether any distinction should be made between liquidation and reorganization. After discussion , a suggestion was made to redraft (109) to include paragraph (a) in the chapeau, as well as some reference to the types of situations in which the recommendation might be applicable, along the following lines: "The insolvency law should specify that claims of related parties should be subject to scrutiny and where justified by reference, for example, to undercapitalization of the debtor or self-dealing, then [insert paragraphs (b) and (d)]." That proposal received some support.

B. Post-commencement finance

106. The Working Group generally agreed that the revised provisions reflected the discussion at its twenty-fifth session. Support was expressed for retaining the reference to unreasonable harm in recommendation (114)(a). As a point of clarification, the relevance of the words included in parentheses at the end of recommendation (115) was questioned and it was suggested that the application of the recommendation to a priority given to an unsecured provider of post-commencement finance be made clear. A further suggestion related to the need to link the recommendations with new finance that might be provided under a reorganization plan.

6. Reorganization - additional issues

A. The reorganization plan

107. As a general observation, it was noted that the recommendations concerning the plan did not address the question of interest on claims and how it might be treated.

108. It was suggested that paragraph (a) of the Purpose clause was somewhat vague, and that reference should be made to "the business that was subject to the insolvency law", rather than to "troubled businesses".

109. With respect to recommendation (125), it was suggested that the phrase "but no later than the end of a specified time period" should be replaced by "within a

specified time period". The importance of time periods as a mechanism to end the stay on creditor actions if no plan was presented within the period was stressed. Support was expressed in favour of the time period for submission being fixed by the insolvency law rather than by the court.

110. The reference to the need to identify the party "responsible for preparation of the plan" was felt to be in inappropriate and "identify the parties capable of preparing" was proposed. It was suggested that the recommendation might also address the issue of to whom the proposal for a plan could be made, since it was not always necessary that a plan addressing all creditors be prepared.

111. It was observed that the word "acceptable" in recommendation (127)(b) did not indicate how the question of acceptability was to be addressed and should therefore be deleted.

112. A number of suggestions were made with respect to recommendation (128). These included that paragraph (a) should require some detail to be provided as to the classes of creditors and treatment of their claims, the terms and conditions of the plan, identification of those who would be responsible for the management of the entity into the future, guarantees to be provided by the debtor, whether the assets would be transferred back to the debtor for implementation of the plan, and supervision of the implementation of the plan. It was observed that the reference in (128)(b) to "employment" contracts was different to the terminology used elsewhere in the Guide and should be aligned with that terminology.

113. With respect to recommendation (129), it was suggested that the party responsible for drafting the statement should be identified and information as to how and when it would be provided to creditors should be included. The need for clarification as to whether the statement was an explanatory or disclosure statement was noted. It was suggested in that regard that the information to be included was of the kind that might be required for investment purposes in some jurisdictions and it might therefore be more in the nature of a disclosure statement. Words along the lines of "and that the debtor will have cash flow to pay mature debts" were proposed for addition to the end of paragraph (d).

114. Some clarifications with respect to recommendations (131) and (132) were proposed to more clearly reflect that (131) addressed approval by creditors of a particular class and (132) the issue of approval in the context of all classes of creditors. In recommendation (131) it was implicit that if the required majority of a particular class voted in favour of the plan, that class would be regarded as supporting the plan. In (132), where the required majority was not achieved, the class would be regarded as not approving the plan and would be addressed as dissenting creditors. It was observed that the second criterion concerning lower ranking claims had previously been discussed by the Working Group and some agreement reached to exclude that criterion. All that was required was the criterion included in (133)(b) and (135)(b). Further suggestions with respect to (131) were that the last sentence was not required, that the sentence concerning the combination of amount of claims and number of creditors was too restrictive, and that the reference to voting in person could be expanded to include voting by proxy. It was also noted that some clarification could be provided as to which creditors should be required to vote on approval of the plan. In respect of (132), concern was expressed as to the meaning of the words in square brackets at the end and whether, for

example, four classes of junior classes could bind two classes of more senior creditors.

115. As a general remark with regard to approval of the plan, it was noted that the recommendations as drafted made reference only to approval by the creditors, not by the debtor. If the debtor was not required to participate in the approval process, it was questioned whether the debtor might not be able, as an interested party, to challenge the plan. In that event, paragraphs (a) and (c) of recommendation (135) might be relevant. Some support was expressed in favour of clarifying the meaning of "interested parties".

116. With respect to the issue of confirmation, it was suggested that an additional recommendation might be included concerning the issue of confirmation more generally. That recommendation could then be followed by recommendation (133) redrafted as a positive statement as to when the court should confirm. To the extent that the criteria were not met, the plan could not be confirmed. With regard to paragraph (b), it was observed that the requirement that the court should not confirm in cases where creditors did not receive as much under the plan as in liquidation was inappropriate as it did not take account of commercial realities. It was suggested that where the requirements of the recommendations concerning notice, preparation of the plan and explanatory statement and voting, as well as paragraphs (a) and (c) of (133) had been satisfied, the court should not be able to refuse to confirm. Although the amount to be received might be a factor to be considered by the court, it was pointed out that there were many situations where creditors might agree to receive less under the plan because there were advantages, for example, in receiving an early payment or in the continuing operation of the business of the debtor. In response it was observed that paragraph (b) was intended only as a protection for those creditors who did not vote to approve the plan. A suggestion to address those issues was to add words to the effect of "absent consent of the affected creditors and considering the costs and delays of liquidation" to paragraph (b).

117. Some concern was expressed with regard to the relationship between recommendations (133) and (135). It was suggested that since (135) was capable of applying both to challenges to the approval of the plan and to appeal against the court's decision to confirm a plan, the draft Guide should clearly distinguish the two. It was also suggested that given the requirements for majorities in (131) and (132) and the binding nature of the plan under recommendation (134), it was difficult to understand firstly, how (135) would operate and secondly, the identity of interested parties. Several drafting suggestions to resolve some of those difficulties were made and the Secretariat requested to prepare revised text for consideration at a future meeting.

118. Support was expressed for the view that the reference to discharge in recommendation (134) created some uncertainty as to the time at which discharge might be effective, and might more appropriately be included in recommendations (138) and (139), or amended to indicate that discharge would be effective only after the plan was performed. Some preference was expressed in favour of retaining the reference to commencement of proceedings in the square-bracketed text. It was suggested that the recommendations on the effect of approval of the plan should also address proceedings that had been stayed on commencement of insolvency, recovery by the debtor of management of the entity, and that the use of the terms shareholders, equity holders and owners be clarified.

119. Some concern was expressed with regard to the mechanism for approval of an amendment to a plan under recommendation (136), although it was noted in response that it might not prove too difficult in practice to obtain the agreement of creditors. It was also noted that some insolvency laws imposed a materiality threshold for amendments that required approval of creditors and, if the amended plan were to be more favourable to creditors, no approval was required. It was agreed that more guidance might be required as to mechanisms for approval of amendments.

120. With respect to recommendation (137), it was observed that some insolvency laws did not provide for supervision of implementation of the plan by the court, but enabled creditors to appoint a supervisor, an option which might be reflected in the Guide.

121. As a point of drafting, it was suggested that recommendation (138)(a) should indicate whether termination related to the reorganization proceedings or implementation of the plan. Where reorganization proceedings were converted to liquidation, support was expressed in favour of protecting payments made pursuant to the plan from avoidance in the subsequent liquidation. A further suggestion with respect to recommendation (138)(b) was that conversion to liquidation should be mandatory. It was observed that since there were a number of reasons for which the proceedings might be converted to liquidation, these should all be included in a single provision, such as recommendation (10).

B. Expedited reorganization proceedings

122. The Working Group discussed the topic of expedited reorganization proceedings on the basis of A/CN.9/WG.V/WP.61/Add.1. Wide support was expressed in favour of including such proceedings in the draft Guide and discussing their advantages and benefits. It was recalled that such proceedings had been discussed at the previous session of the Working Group, and reference was made to the explanatory material set forth in A/CN.9/507 (paras. 244-246).

123. Some concerns were expressed, however, as to the scope of the proposal contained in A/CN.9/WG.V/WP.61/Add.1, particularly with respect to the types of creditors that would be involved in such a procedure and its effects on those creditors of the debtor whose interests might not be affected by the plan being proposed; the relationship of such a procedure to both informal negotiations and formal insolvency proceedings; and the effects of commencement of such proceedings, in particular application of the stay.

124. To address those concerns, it was proposed, firstly, that the explanatory material included in A/CN.9/507 be redrafted to form a purpose clause to introduce the recommendations set forth in A/CN.9/WG.V/WP.61/Add.1, and secondly, that the drafting of the recommendations be revised to take account of the Working Group's concerns. That proposal was widely supported.

125. For lack of time the Working Group was not able to consider Chapter V, section C on distribution following liquidation of assets, section D on discharge and section E on closing and reopening of proceedings.

IV. Other issues

1. Intersection of the work of Working Group V (Insolvency law) and Working Group VI (Security interests)

126. The Working Group had before it document A/CN.9/WG.VI/WP.2/Add.10, a report on the treatment of security interests in insolvency proceedings prepared for consideration in the context of the legislative guide on secured interests. The Working Group agreed on the need to ensure a consistent approach by both Working Groups with respect to the treatment of secured interests in insolvency proceedings. It was suggested in that regard that document A/CN.9/WG.VI/WP.2/Add.10 provided a useful summary of the areas in which secured interests intersected with insolvency law and might provide material that could be included in the insolvency Guide to clarify the treatment of secured creditors at each step of insolvency proceedings.

127. Support was expressed for the suggestion that core principles which might govern the intersection of the work on insolvency and secured interests could include that the pre-insolvency priority of security rights should be maintained vis-à-vis other creditors; that secured creditors have the right to the economic value of the secured asset to the extent of their security; that enforcement of the secured right should be subject to the stay; that the secured asset could be used by the debtor; and that the debt secured should be able to be modified in reorganization proceedings.

2. Progress of the work on preparation of a legislative guide on insolvency law

128. The Working Group considered the progress of its work on the development of the legislative guide and the likely timing of completion of that work. General satisfaction was expressed with respect to the progress of the work to date.

129. There was some support for the view that the work might be capable of finalisation by the Commission in 2003, and that the Working Group would be in a better position to make a recommendation on that question at the completion of its 27th session in December 2002.