

THE FRAMEWORK OF INSOLVENCY LAW

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Abstract:

There are a number of ways to classify the legal systems or legal families of the world, but in general legal families across the globe will in many jurisdictions either have an English law, or what can broadly be termed a Civil law, orientated foundation. When analyzing the insolvency laws of various jurisdictions such foundation will also show up in the variety of insolvency laws. But certain aspect of insolvency law will be affected by local legal culture, basic rights and the way in which a system deals with related matters such as the security rights provided for, or the approach to labor issues for instance.

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In the English Law, the Cork Report¹ drawn up in January 1977 is an important document, which contains the context of the acceptance of the final form of the Insolvency Act in 1986. Although the Insolvency Act from the English law seems to be an example of a unified legislative document, it actually duplicates all the provisions for natural persons and legal entities.

It is worth noticing that the Insolvency Act from 2000 and the Companies Act from 2002 amended certain relevant aspects of the Insolvency Act from 1986. The UNCITRAL Model Law on Cross-Border Insolvency was also adopted in 2006. Section 426 of the Insolvency Act contains a procedure by means of which recognition is more easily granted to the foreign estate representatives coming from countries designated by the legal text. Adding the UNCITRAL Model Law obviously extended the cross-border insolvency procedures of this jurisdiction to other countries that were not designated within the purposes of the previously mentioned section 426.

In the insolvency law applicable in the USA the difference between the State Law and the Federal Law must be noticed. The US Bankruptcy Code of 1978 as amended is a federal law and, as such, it applied on the whole territory of the USA.

The system established by the insolvency legislation in USA is characterized as being a pro-debtor system due to its approach towards the rehabilitation of the debtor with the possibility to offer a "fresh start" (referred to as discharge of debts), the Code was amended following the work of the Review Commission of the 1990's.

The 1978 Insolvency Code was amended in 1990 and reformed in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). The amendment of the Code introduced "means testing" as a basis to determine which individual debtors may file for relief. The new chapter, number 15, of the Code contains the adoption of the UNCITRAL Model Law on Cross-Border Insolvency. The insolvency code represents a perfect unification of all the relevant applicable provisions.

¹ In the early 1970's a consultative committee of the Ministry of Trade and Industry on issues of insolvency was constituted under the direction of Kenneth Cork. The conclusions of the work underlined the necessity of an ample revision of the insolvency act. In January 1977, the Insolvency Act review committee lead also by Kenneth Cork published the Report for the fundamental reform of the insolvency act. The recommendations in this report were taken over for the adoption of the Insolvency Act in 1986.

Among the civil law systems we may remind the Dutch, the German and the French one, all having a certain tradition in the matter of insolvency. The Netherlands with an insolvency law applicable since 1879 is currently undergoing a process of reform of the insolvency law because the orientation of the legal provisions towards a pro-creditor system is intended to be replaced by the pro-debtor orientation, following the concept implemented in USA. Germany reformed its bankruptcy laws in the 1990's and Insolvenzordnung ("InsO") that came into force on January 1, 1990 is the current code on insolvency. InsO is another example of unified legislation in the field of insolvency. In France, the Insolvency Law of 1985 is still in force although it has suffered a series of modifications up to now.

The African countries still follow, generally, the laws of their colonizing powers. Thus, countries like Nigeria, Kenya, Botswana and Zambia, as well as countries from the eastern part of Africa, like Tanzania, have a tradition of the English law. On the other side, countries like Angola or Mozambique have a tradition of the civil law based on the Portuguese law. The French-speaking countries of West Africa are strongly influenced by the French law. Some countries, like South Africa and Namibia have mixed legal systems because both the Dutch law and the English law influenced their respective legal systems.

The Insolvency Laws in India have their roots in the English law and reflect the older model that provided different legislations for companies and, respectively, for personal insolvency. The 1956 Companies Act, as amended, contains provisions that deal with the winding-up of companies. The 2008 Companies Bill was subject to debates in the Parliament in August 2009 and was sent to the Permanent Committee of the Parliament in order to invite comments from the public and trade bodies. It is to be noted that the 2008 Companies Bill contains new provisions on winding-up as well as provisions that amount to a consolidation of the corporate rescue provisions. There are two other laws that deal with personal insolvency: The Presidency Towns Insolvency Act 1909 that applies in the provinces of Mumbai (Bombay), Chennai (Madras) and Kolkata (Calcutta); and the 1920 Provincial Insolvency Act which applies to the rest of India.

Recent developments in Russia commenced with the Bankruptcy Law of 1992 and which finally determined the adoption of the bankruptcy law in 2002. The law is marked by stringent qualifications for the insolvency administrators and their ethical conduct, yet creditors enjoy a rather high degree of control. Russia has not adopted the UNCITRAL Model Law.

At a global level, there are several ways to classify legal systems, but generally the legal families across the globe have a foundation which is oriented either towards the English law, either towards the civil law. When analyzing the insolvency laws of different jurisdictions, these foundations will stand out among the different laws on insolvency. Certain aspects pertaining to the insolvency law are influenced by the local legal culture, as well as the manner in which a system deals with the related matters as the security rights or labor. Approaches towards the socio-economic issues will also be reflected in aspects of the country-specific laws.²

Within this global context, the selection of a single legal system for the matter of insolvency becomes difficult, establishing a point of departure in order to create a universal functional framework of the insolvency law. Since it is so difficult to work with one single system in order to explain many of the basic concepts in insolvency law, the *UNCITRAL Legislative Guide on Insolvency Law 2004* will provide, to a large extent, the basis needed to deal with different aspects or elements of an efficient and developed insolvency legal system.

² Sealy, L., Milman, B., *Annotated Guide to the Insolvency Legislation*, Sweet&Maxwell, 2011, p. 119

In the 1st Part of the *Legislative Guide* that deals with the design of an insolvency law, the key objectives and the structure of an effective and efficient insolvency law are explained as follows:

"When a debtor is unable to pay its debts and other liabilities as they become due, most legal systems provide a legal mechanism to address the collective satisfaction of the outstanding claims from assets (whether tangible or intangible) of the debtor. A range of interests needs to be accommodated by that legal mechanism: those of the parties affected by the proceedings including the debtor, the owners and management of the debtor, the creditors who may be secured to varying degrees (including tax agencies and other government creditors), employees, guarantors of debt and suppliers of goods and services as well as the legal, commercial and social institutions and practices that are relevant to the design of the insolvency law and required for its operation. Generally, the mechanism must strike a balance not only between the different interests of these stakeholders, but also between these interests and the relevant social, political and other policy considerations that have an impact on the economic and legal goals of insolvency proceedings. To the extent that it is excluded from the scope of such legal mechanisms, a debtor and its creditors will not be subject to the discipline of the mechanism, nor will they enjoy the protections provided by the mechanism.

Most legal systems contain different types of proceedings (which are referred to in this *Legislative Guide* by the generic term "insolvency proceedings") that can be initiated to resolve a debtor's financial difficulties. Although addressing this resolution as a common goal, these proceedings take a number of different forms for which uniform terminology is not always used and may include both "formal" elements and "informal" elements. Formal insolvency proceedings are those initiated under the insolvency law and governed by that law. They generally include both liquidation and reorganization proceedings. Informal insolvency proceedings are not disciplined by the insolvency law and involve voluntary negotiations between the debtor and some or all of its creditors. These types of negotiations have been developed by the banking and commercial sectors and, usually, they provide for some form of restructuring of the insolvent debtor. Although not regulated by an insolvency law, these voluntary negotiations nevertheless depend for their effectiveness upon the existence of an insolvency law which can provide indirect incentives or persuasive force to achieve reorganization."

The very notion of "insolvency" is not used uniformly at a global level in that some legal systems use "bankruptcy". Although these terms essentially carry the same meaning in many systems, there is an explanation that insolvency sometimes means the state of financial affairs of a debtor while bankruptcy refers to the formal state of being put into formal bankruptcy. The notion of insolvency takes two definitions referring to the situation where the liabilities of a debtor exceed his or her assets, i.e. balance sheet insolvency, or where the debtor cannot repay the debt as it falls due by reason of a cash flow problem, i.e. commercial insolvency.

The specialty literature³ lists the following essential features of insolvency law that are said to be universal principles:

- actions by individual creditors against the debtor are frozen - thus individual pursuit is stayed (also referred to as the automatic stay signifying a moratorium against individual debt enforcement). This is the only truly universal feature according to this author.
- the assets are pooled which become available to pay creditors - replacing the piecemeal seizure of assets by individual creditors. This feature is eroded as a universal principle in that different jurisdictions provide different exceptions of exclusion of certain property from the estate.

³ Wood, P.R., *Principles of International Insolvency*, 2007, Sweet&Maxwell, p. 3-4

- creditors are paid *pari passu* i.e. *pro rata* out of the assets according to their claims. The author terms this a piece of ideology "which is nowhere honoured", since priority creditors and secured creditors form exceptions to this rule, while in practical terms very few pro rated unsecured creditors will receive any payment whatsoever from an insolvent estate.

Some authors⁴ consider that common and universal principles in the insolvency law cannot be set without separating the objectives of insolvency for individuals from the ones for legal entities (corporations): As far as individuals are concerned, it is deemed that they must be protected from creditors by taking into consideration the personal circumstances of the debtor, they must have the possibility to continue their activity in order to reduce the indebtedness degree. As far as legal entities are concerned, when it is possible the business or viable parts of it must be preserved without necessarily keeping the debtor company and when this is no longer possible it must be eliminated from the market.

In this vision it is considered that the general common and universal principle of insolvency consists in ensuring the *pari passu* distribution.

Undoubtedly there is a series of common elements in approaching the insolvency of a natural person (individual) or of a legal entity, yet there are also pertinent differences. For instance, the notion of exempt property or excluded assets is only applied in relation to individuals. This means that some systems make provision for the insolvent individual to keep some of the assets required to maintain him or herself and his or her dependants.

Although there are many elements that need to be taken into consideration when analyzing or reforming an insolvency system, a broad and very generalized approach must keep track of whether that particular system is pro-creditor oriented (jurisdictions following a more conservative approach towards the granting of discharge of debt to debtors and the granting of a "fresh start") or pro-debtor oriented (jurisdiction which adopt the idea of discharge of debt of the debtors and their "rehabilitation").

When analyzing the insolvency laws of a certain jurisdiction it is extremely important to identify the main sources of that particular system. In modern times these rules will usually be found in legislation or codes. As it was already demonstrated some systems, as the one applicable in USA, have one single insolvency code. In other systems, as it is the case with South Africa and Australia, there are several laws that apply and these must be examined in conjunction with each other in order to fully understand the system. It is known the fact that besides the legislation on insolvency, many legal principles that are part of the general law will also have an effect in insolvency.

All the systems provide for a method by means of which the formal insolvency proceeding may initiate. The opening of the proceeding is performed by means of a decision of the court, even if some legal systems have insolvency - specialized courts (as the USA) while in other systems the general courts decide upon such cases. The insolvency proceeding may also be opened by means of an informal process, in other works the process may be opened by means of an administrative process outside the jurisdiction of the courts.

After the opening of the insolvency procedure a number of consequences or effects will follow. Some deal with the legal position or the status of the insolvent debtor and its assets (estate assets) or transactions performed before the opening of the proceedings, while others deal more with the management of the estate itself.

A general feature of the setting into motion of an insolvency proceeding is that the individual actions of creditors are stayed. The reason for this is that insolvency

⁴ Sealy, L., Hooley, W. Text Cases and Materials in Insolvency Law, Oxford University Press, 2008, p. 902

represents a collective procedure, which must, as a principle, be mandatory for all creditors. If it were allowed to the individual creditor to continue with the mechanism of recovery of his or her debt, the collective procedure will be pointless.

One of the important aspects to take into consideration when opening an insolvency proceeding is what assets may be considered estate assets. This aspect acquires a particular importance in the case of a natural person because many systems allow the exclusion of certain assets from the estate.

Although the existing rights and obligations of the parties are, in principle, recognized and observed by the insolvency law, the insolvency systems typically allow the estate representative to deal with contracts entered into by the debtor before the commencement of an insolvency proceeding in a number of ways, for instance to decide if he or she will abide by the contract or not, in which case the solvent party will have certain remedies against the estate. There may also be special legal rules that set out the position of the solvent party in a particular case and in relation to a specific type of contract, for example a lease. Due to local culture and conditions, the treatment of especially contracts of employment differs depending on the jurisdiction's political dispensation and its approach to socio-economic matters. In some systems contracts of employment may terminate or be suspended at the commencement of an insolvency proceeding and such contracts may even be transferred to a new owner / employer where the business is transferred as a going concern⁵.

The UNCITRAL Legislative Guide states that since insolvency law establishes a collective debt collecting device, it is essential to discourage individual creditors to continue with individual debt enforcement measures as from the commencement of an insolvency procedure. Policy considerations dictate that some transactions that transpired prior to commencement may and should, under certain circumstances, also become subject to investigation. If certain requirements are satisfied, such transactions may be set aside and benefits received by the beneficiary of a transaction will be called upon to return such benefits to the insolvent estate. Transactions that are typically made avoidable in insolvency are those to prevent fraud (e.g.: transactions designed to hide assets for the later benefit of the debtor); to uphold the general enforcement of creditors' rights; to ensure equitable treatment of all creditors by preventing favoritism when the debtor makes preferential dispositions preferring some creditors at the expense of others; to prevent a sudden loss of value from the business entity just before the supervision of the insolvency proceedings is imposed.

Avoidable dispositions may be classified as either fraudulent conveyances or preferences. A fraudulent conveyance entails a disposition of property by the insolvent, usually in the form of a donation or undervalue transaction, that therefore causes or increases the insolvent's insolvency, while a preference is marked by the settlement of a pre-existing debt to a creditor or by affording such a creditor real security, thereby improving his position in insolvency. The *Actio Pauliana* forms the basis of fraudulent conveyance law in civil laws systems, while the Act of Elizabeth of 1570 is the basis of this remedy in English law.

In cross-border insolvency there is a range of models of management of the assets of insolvent entities that are located in foreign jurisdictions. While some systems contain express provisions of management of the cross-border insolvency cases, other systems do not know such provisions but the courts may be notified to issue an order that may allow the representative of a foreign insolvent estate to manage assets in that particular jurisdiction.

The insolvency of company groups and the insolvency of financial institutions as banks and insurance companies also raise special difficulties.

⁵ Fletcher, I., *The law of Insolvency*, Sweet & Maxwell, 2009, p.318

The difficulty in analyzing the company group in case of insolvency of one of the companies of the group is if the other companies in the group may be held liable for the insolvency status, if the group may be treated as a single entity for insolvency purposes, or if the insolvent company should, in line with the notion of the separate entity principle, be liquidated separately⁶. There are different approaches to this problem and UNCITRAL⁷ recently published a working document regarding the guidelines in this regard.

The financial difficulties of the banks and other financial institutions (as the insurance companies) may give rise to a domino effect in that such institutions are usually linked by means of transactions and the insolvency of one can cause the collapse of a number of such institutions in a particular country - and even beyond its boundaries. This poses a significant risk for all the local economies and also the global economy. Due to this risk factor, many jurisdictions allow for special insolvency dispensations for such entities and they are therefore also usually strictly regulated.

Although most of the law systems follow a general common framework in regulating the insolvency procedure, this framework falls apart when confronted with national particularities and socio-economic policies. The reality that we are facing, the global economic crisis, which has led to financial imbalances and difficulties in business management, has also unprecedentedly emphasized the need for unitary legal provisions at a global level in insolvency.

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