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Draft legislative guide on insolvency law

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Contents

[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Add.3 and Add.4; Chapter III.A-D appear in documents A/CN.9/WG.V/WP.63/Add.5-8; Chapters IV-VII appear in subsequent addenda]

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Paragraph numbers in [...] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.

Recommendation numbers in [...] refer to relevant recommendations in A/CN.9/WG.V/WP.61 and A/CN.9/WG.V/WP.61/Add.1, the previous version of the recommendations. Additions to the recommendations are indicated in this document by underlined text.

Part Two (continued)

III. Treatment of assets on commencement of insolvency proceedings

E. Avoidance proceedings

1. Introduction

151. [124] Insolvency proceedings (both liquidation and reorganization) may commence at lengthy periods after a debtor first becomes aware that such an outcome cannot be avoided. In that intervening period, there may be significant opportunities for the debtor to attempt to hide assets from creditors, incur artificial liabilities, make donations to relatives and friends, or pay certain creditors to the exclusion of others or for creditors to initiate strategic action to place themselves in an advantageous position. The result of such activities, in terms of the eventual insolvency proceedings, is to disadvantage ordinary unsecured creditors who were not party to such actions and do not have the protection of security, and to undermine the key objective of equal treatment of similarly situated creditors.

152. [131] The use of the word “transaction” in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, a security, a guarantee, a loan or a release.

153. [125] Many insolvency laws include provisions which apply retrospectively and are designed to overturn those past transactions to which the insolvent debtor was a party or which involved the debtor’s property where they have certain effects. These include reducing the net worth of the debtor (for example, by gifting of its assets or transferring or selling assets for less than their fair commercial value); or upsetting the principle of equal

sharing between creditors of the same class (for example, by payment of a debt to an unsecured creditor or granting a security to a creditor who is otherwise unsecured when other unsecured creditors remain unpaid and unsecured). Many non-insolvency laws also address these types of transactions which are detrimental to creditors outside of insolvency, but they may also be relevant in insolvency. In some cases, the insolvency representative will be able to use those non-insolvency laws in addition to the provisions of the insolvency law.

154. [133] Transactions typically are made avoidable in insolvency for several reasons, including: to prevent fraud (for example, transactions designed to hide assets for the later benefit of the debtor or to benefit the officers, owners or directors of the debtor); to uphold the generally enforcement of creditors' rights; to ensure equitable treatment of all creditors by preventing favouritism where the debtor wishes to advantage certain creditors at the expense of the rest; to prevent a sudden loss of value from the business entity just before the supervision of the insolvency proceedings is imposed; and, in some countries, to create a framework for encouraging out-of-court settlement—creditors will know that last-minute transactions or seizures of assets can be set aside and therefore will be more likely to work with debtors to arrive at workable settlements without court intervention.

155. [125] The principal goals of avoidance powers are to preserve the integrity of the insolvency estate and ensure that creditors receive a fair allocation of an insolvent debtor's assets consistent with established priorities for payment. Notwithstanding this goal, it is important to bear in mind that many of the transactions that may be subject to avoidance powers are perfectly normal and acceptable when they occur outside an insolvency context, but become suspect when they occur in proximity to the commencement of insolvency proceedings. Avoidance powers are not intended to replace or otherwise affect other devices for the protection of interests of creditors that would be available under general civil or commercial law.

156. [126] Avoidance rules are much discussed, principally as to their effectiveness in practice and the somewhat arbitrary rules that are necessary to define, for example, relevant time periods and the nature of the transactions to be included. Nevertheless, avoidance provisions can be important to an insolvency law not only because the policy upon which they are based is sound, but also because they may result in recovery of assets or their value for the benefit of creditors generally, and because provisions of this nature help to create a code of fair commercial conduct and are part of appropriate standards for the governance of commercial entities.

157. [127] As is the case with a number of the core provisions of an insolvency law, the design of avoidance provisions requires a balance to be reached between competing social benefits such as, on the one hand, the need for strong powers to maximize the value of the estate for the benefit of all creditors and on the other hand, the possible undermining of contractual predictability and certainty. Even where an insolvency law adopts broad avoidance powers, the exercise of these powers can be subject to clear criteria which can assist in providing commercial certainty and predictability.

2. Avoidance criteria

158. [128] Approaches to establishing the criteria for avoidance actions vary considerably among insolvency laws in terms of specific criteria and how they are combined in each law. In terms of the applicable criteria, they can be grouped broadly as objective and subjective criteria.

159. [128] One approach emphasizes the reliance on generalized, objective criteria for determining whether transactions are avoidable. The question would be, for example, whether the transaction took place within a specified period prior to the application for commencement or the commencement of the insolvency proceedings (often referred to as the “suspect period”) or whether the transaction evidenced any of a number of general characteristics set forth in the law (e.g. provision of appropriate value for the assets transferred or the obligation incurred, whether the debt was mature or the obligation due or the relationship between the parties to the transaction). While generalized criteria may be simple to apply, they can also have arbitrary results if relied upon exclusively. So, for example, legitimate and useful transactions that fall within the specified period might be avoided, while fraudulent or preferential transactions that fall outside the period are protected.

160. [129] Another approach emphasizes case-specific, subjective criteria such as whether there is evidence of intention to hide assets from creditors, whether the debtor had ceased making payments when the transaction took place or became unable to make payments as a result of the transaction, whether the transaction was unfair in relation to certain creditors and whether the counterparty knew that the debtor had ceased making payments. This individualized approach may require consideration in some detail of the intent of the parties to the transaction and of other factors such as the debtor’s financial circumstances and what constitutes the normal course of business between the debtor and particular creditors.

161. Very few insolvency laws rely solely on subjective criteria as the basis of avoidance provisions; they are generally combined with time periods within which the transactions must have occurred. [129] In some countries a heavy reliance upon subjective criteria has led to considerable litigation and extensive cost to the insolvency estate. In order to avoid these costs, some laws have adopted a strictly objective approach of a short suspect period, such as three to four months. In some cases, this short suspect period has been combined with an arbitrary rule that all transactions occurring within that period would be suspect unless there was a roughly contemporaneous exchange of value between the parties to the transaction. A number of insolvency laws combine these different approaches to address different types of transactions. For example, preferential transactions and undervalued transactions may be defined by reference to objective criteria, while transactions aimed at defeating or hindering creditors will be defined by reference to the more subjective elements involving questions of intent. One insolvency law that adopts a combination of objective and subjective elements provides, for example, that transactions such as gifts, security for existing debts and extraordinary payments (those that have not been made with the usual means of payment or before the due time) can be avoided where they are made within three months prior to commencement. Other transactions can be set aside if the debtor has ceased making payments, the transaction is unfair or improper in relation to a group of creditors and the counterparty knew that the debtor had ceased making payments at the time the transactions occurred.

3. Types of transactions subject to avoidance

162. [132] Although variously defined, there are three broadly common types of avoidable transactions that are found in most legal systems and are used in this guide as the basis of the discussion. They are: transactions intended to defeat, hinder or delay creditors from collecting their claims (often referred to as fraudulent transactions), transactions at an undervalue, and transactions with certain creditors which could be

regarded as preferential. Some transactions may have the characteristics of more than one of these different classes, depending upon the individual circumstances of each transaction. For example, transactions which appear to be preferential may be more in the character of transactions intended to defeat, hinder or delay creditors when the purpose of the transaction is to put assets beyond the reach of a creditor or potential creditor or to otherwise prejudice the interests of that creditor and the transaction occurs when the debtor is in a position of financial difficulty and will be unable to pay its debts as they become due or where they leave the debtor with insufficient assets to conduct its business. Similarly, transactions at an undervalue may also be preferential when they involve creditors, but not when they involve third parties, and where there is a clear intent to hinder, defeat or delay creditors, they will fall in to the first category of transactions. For these reasons, it is desirable that an insolvency laws specify the particular characteristics that are essential for avoidance of transactions, rather than relying on broader labels, such as “fraudulent” or “preferential”.

(a) Transactions intended to defeat, hinder or delay creditors

163. [134] These types of transactions involve the debtor transferring assets beyond the reach of creditors to any third party with the intent of favouring certain creditors, and generally require that the third party knows of that intent, or in some cases should have known of that intent. These transactions cannot generally be automatically avoided by reference to an objective test of a fixed period of time in which the transactions occurred because of the need to prove the intent of the debtor. That intent is rarely proven by direct evidence, but rather by identifying common circumstances that are present during these types of transfers. Although these circumstances differ between jurisdictions, there are a number of common indicators, including:

- (i) the relationship between the parties to the transaction or obligation, where a transfer was made or an obligation incurred directly to a related person or via a third party to a related person;
- (ii) the lack or inadequacy of the value received for the transfer or the obligation incurred;
- (iii) the financial condition of the debtor both before and after the transfer was made or the obligation incurred, particularly where the debtor was already unable to pay its claims or became unable to pay shortly after the transfer was made or the obligation incurred;
- (iv) the existence of a pattern or series of transactions transferring some or substantially all the debtor’s assets occurring after the onset of financial difficulties or the threat of action by creditors;
- (v) the general chronology of the events and transactions under inquiry, where for example, the transfer occurred shortly after a substantial debt was incurred;
- (vi) the transfer or obligation is concealed by the debtor, especially when it was not made in the usual course of business, or fictitious parties were involved; or
- (vii) the debtor absconds.

164. Some laws also specify circumstances in which there may be a presumption of intent or specify those transactions where intent or bad faith is deemed to exist, for example, transactions involving related persons occurring within a specified period prior to the commencement of proceedings (discussed further below). Under other laws it may be sufficient for a transaction to be avoided if the debtor could, and therefore should, have

realised that the effect, if not the intent, of a transaction would have been to disadvantage creditors and that the beneficiary could and therefore should have realised that the debtor's action could produce that effect. Some laws also provide that certain transfers, such as conveyances of land, will be exempt from avoidance under this category of transactions if the transfer was bona fide for good value and the beneficiary had no notice or was unaware of any intent to defraud.

165. [134] As a practical matter, in order to prove intent, if the debtor cannot explain the commercial purpose of a particular transaction which extracted value from the estate, it may be possible to show that the transaction is one which fits into this category. In designing an insolvency law, as noted above, it may be desirable to bear in mind that transactions of this type that are potentially avoidable under insolvency law are often perfectly valid under non-insolvency law.

(b) Undervalued transactions

166. [135] Many insolvency laws provide that transactions are generally avoidable where the value received by the debtor as the result of the disposal of an asset or the incurring of an obligation to a third party was either nominal, such as a gift, or much lower than the true value or market price of the asset disposed of or the obligation incurred, and where the transaction occurred within a specified period of time before a particular date (the suspect period). Some laws also require a finding that the debtor had ceased making payments at the time the transaction occurred, or became unable to make payments as a result of the transaction. These transactions include transactions with both creditors and third parties. Some insolvency laws provide that these types of transactions will not be avoided if certain conditions are satisfied, such as that the beneficiary acted in good faith, that the transaction was for the purpose of carrying on the debtor's business, that there were reasonable grounds for believing that the transaction would benefit the debtor's ordinary business, and where cessation of payments is a relevant requirement, that the debtor's assets exceeded its liabilities at the time of the transaction.

(c) Preferential transactions

167. [136] Preferential transactions may be subject to avoidance where (i) the transaction took place within a defined but usually rather short period of time before the application for commencement of the insolvency proceedings (the suspect period); (ii) the transaction involves a transfer to a creditor on account of a pre-existing debt; and (iii) as a result of the transaction, the creditor receives a larger percentage of its claim from the debtor's assets than other creditors of the same rank or class (in other words, a preference). Many insolvency laws also require that the debtor had ceased making payments or was close to being in a position where it was unable to pay its debts when the transaction took place. The rationale for including these types of transactions within the scope of avoidance provisions is that when they occur very close to the commencement of proceedings, a state of insolvency is likely to exist and they breach the key objective of equitable treatment of creditors.

168. [137] Examples of preferential transactions may include payment or set-off of debts not yet due; performance of acts which the debtor was under no obligation to perform; provision of security to secure existing debts; unusual methods of payment, other than in money, of debts that are due; payment of a debt of considerable size in comparison to the assets of the debtor; and payment of debts in response to extreme pressure from a creditor, such as litigation or attachment. A setoff, while not avoidable as such, may be considered

prejudicial when it occurs within a short period of time before the application for commencement of the insolvency proceedings and has the effect of altering the balance of the debt between the parties in such a way as to create a preference or where it involves transfer or assignment of claims between creditors to build up setoffs. It may also be subject to avoidance where the setoff occurs in irregular circumstances such as where there is no contract between the parties to the setoff.

169. [138] One defence to an allegation of a preferential transaction may be to show that although containing the elements of a preference the transaction was in fact consistent with normal commercial practice and, in particular, with the normal course of business between the parties to the transaction. For example, a payment made on receipt of goods that are regularly delivered and paid for may not be preferential even if made within proximity of the commencement of insolvency proceedings, whereas payment of a long overdue debt could be preferential. This approach encourages suppliers of goods and services to continue to do business with a debtor which may be having financial problems, but which is still potentially viable. Other defences available under insolvency laws include that the beneficiary extended credit to the debtor after the transaction and this credit has not been paid (the defence is limited to the amount of the new credit); the beneficiary can show that it did not know a preference would be created; the beneficiary did not know or could not have known that the debtor had generally ceased making payments; or where cessation of payments is a required element, that the debtor's assets exceeded its liabilities at the time of the transaction.

(d) Security interests

170. [139] While security interests valid under the laws permitting the grant of security to creditors should generally be regarded as valid under insolvency law, they may nevertheless be avoidable in insolvency proceedings on the same grounds that any other transaction might be challenged and avoided - as a fraudulent, preferential or undervalued transaction. For example, the grant of a security interest shortly before commencement of proceedings, although otherwise valid, may be found to have favoured unfairly a certain creditor at the expense of the rest. Where the security interest is granted to secure a prior debt or on the basis of past consideration (permitted in some legal systems, but not in others) it may also be invalid as favouring that particular creditor unfairly. Payments received by a secured creditor might be regarded as preferential (at least in part) if an undersecured creditor is paid in full within the suspect period. The same considerations would apply to a security interest that was not perfected under the relevant secured transactions law and, under some laws, to a security interest perfected within a short period before the commencement of proceedings.

(e) Related person transactions

171. [146] As noted above, one criterion relevant to avoidance of certain transactions is the relationship between the debtor and the counterparty. Where the types of transactions subject to avoidance involve related persons (these may also be referred to as connected persons or insiders), insolvency laws often provide stricter rules, particularly with regard to the length of suspect periods and treatment of any claim by the related person (see Part two, chapter VI.A). [130] A stricter regime may be justified on the basis that these parties are more likely to be favoured and tend to have the earliest knowledge of when the debtor is, in fact, in financial difficulty.

172. Related persons are generally defined by varying levels of connection to the debtor. Most jurisdictions regard those with some form of corporate or family relationship with the debtor as related persons. The legislative approach taken is generally, but not always, prescriptive. With regard to those with some form of business association with the debtor, a narrow approach would focus on the directors or management of the debtor, while a wider definition may extend not only to those who have effective control of the debtor, but may include all employees of the debtor and guarantors of the debts of any person with a business connection to the debtor. Similarly, a family relationship may be defined to include relatives by blood or marriage and even, in some laws, persons living in the same household as the debtor as well as trustees of any trust of which the debtor or a person connected with the debtor is a beneficiary. Relatives of those who have a business association with the debtor are also commonly regarded as related persons. An important element in many jurisdictions is to include as related persons those who had a defined relationship with the debtor in the past or may have a defined relationship in the future.

(f) Void or voidable transactions

173. [147] Where a transaction falls into any of the categories of transactions subject to avoidance, insolvency laws either render it automatically void or make it voidable, depending upon the test that is adopted in respect of each category of transaction. For example, those laws which refer only to transactions occurring within a certain fixed period of time and include no subjective criteria, sometimes specify that relevant transactions will be void. However, even where that approach is adopted the insolvency representative may have to commence proceedings to recover the assets or their equivalent value from the counterparty.

174. [148] In those laws where the transaction is voidable, the insolvency representative will be required to decide whether the avoidance of the transaction will be beneficial to the estate, taking into account the elements of each category of avoidable transaction as well as possible delays in recovering either the assets involved or the value of the assets and the possible costs of litigation. That discretion would generally be subject to the insolvency representative's obligation to maximize the value of the estate, and it may be responsible for its failure to do so.

4. Transactions exempt from avoidance actions

175. Some insolvency laws provide that certain transactions will be exempt from avoidance provisions. These may include transactions that occur either between the application for commencement and commencement or after commencement provided they fall within the ordinary scope of the debtor's business, that are made in good faith by, or with the consent of, the insolvency representative or the court, and are undertaken to further the conduct of the proceedings. Other transactions that it may be desirable to exclude from the scope of avoidance are those transactions that occur in the course of implementing a reorganization plan, where the implementation fails and the proceedings are subsequently converted to liquidation. Finally, certain transactions essential to the functioning of financial markets, (such as close-out netting of securities and derivative contracts) may be exempted from avoidance actions (see Part two, chapter III.F).

5. Establishing the suspect period

176. [140] Most insolvency laws explicitly specify the duration of the suspect period with reference to the particular types of transactions to be avoided and indicate the date from

which the period is calculated retroactively. For example, so many days or months before a particular event such as the making of the application for commencement of proceedings, the commencement of insolvency proceedings or the court's decision as to the date when the debtor ceased paying its debts in the normal way ("cessation of payments"). A related issue is whether suspect periods stipulated in the insolvency law can be extended by the court in appropriate situations, such as where transactions, which occurred outside the specified suspect periods in questionable circumstances, had the effect of diminishing the estate. While a discretionary approach may allow a certain degree of flexibility with respect to the transactions to be caught by the avoidance provisions, it may also lead to delay in the proceedings and does not give a predictable or transparent indication to creditors as to the transactions that are likely to be avoided. If transactions can be unwound where they took place at some unspecified time prior to the commencement of insolvency proceedings and subject to the discretion of the court, there is likely to be less safety in commercial and financial transactions. For these reasons, it is desirable that a discretionary approach be limited to fraudulent transactions, where issues of commercial certainty are of less concern.

177. [141] Some insolvency laws provide one suspect period for all types of avoidable transactions, while others have different periods depending upon whether the basis of avoidance is fraudulent transfer or preference and upon additional factors such as whether the injury to creditors was intentional and whether the transferee was a related person, as discussed above. Because some transactions involve intentionally wrongful conduct, many insolvency laws do not limit the time period within which these types of transactions must have occurred in order for them to be avoided. Other insolvency laws establish a very long limit (examples range from one to ten years) where the suspect period is generally calculated from the date of commencement of proceedings.

178. [142] Where preferential and undervalued transactions involve creditors who are not related persons, the suspect period may be relatively brief, perhaps no more than several months (examples range from three to six months). However, where related persons are involved, many countries apply stricter rules. These rules may include longer suspect periods (for example two years as opposed to three to six months where the transactions does not involve a related person), shifted burdens of proof (see 6(d) below) and dispensing with requirements that the debtor have ceased making payments at the time of the transaction, or was rendered unable to make payments as a result of the transaction.

6. Commencement of avoidance proceedings

(a) Parties who may commence

179. Avoidance of a particular transaction generally requires an application to the court to declare the transaction void. A number of insolvency laws provide that proceedings for the avoidance of specified transactions should be taken by the insolvency representative, although there are some laws that also provide the power to creditors and, in some cases, the creditors committee. The decision to commence such a proceeding, as noted in paragraph (174), will require a number of different considerations to be weighed, depending upon whether avoidance is sought for the benefit of the insolvency estate or, in the case of a creditor, for the benefit of that creditor.¹ Relevant considerations will

¹ Some laws provide that a creditor has the right to contest individual transactions of the debtor, and that they may personally benefit where the proceeding is successful. Some laws also specify that only creditors whose debt precedes the challenged transaction may initiate such proceedings.

generally relate to cost and likely benefit; in the case of actions to restore assets to the insolvency estate, they will include whether avoidance of the transaction will be beneficial to the estate, the likely cost to the estate, the likelihood of recovering value for the estate, possible delays in recovery and the difficulties associated with proving the elements necessary to avoid a particular transaction.

180. [149] In those laws where the insolvency representative has the power to commence avoidance proceedings and, based on the balance of the considerations noted above, (that is for reasons other than negligence or bad faith, or for no justifiable reason²), decides not to commence proceedings to avoid certain transactions, insolvency laws adopt different approaches to the conduct and funding of those proceedings. The manner in which they may be funded may be of particular importance where there are insufficient assets in the insolvency estate to do so. As to the conduct of those proceedings, some laws permit a creditor or the creditor committee to require the insolvency representative to initiate an avoidance proceeding where it appears to be beneficial to the estate to do so or also permit a creditor itself or the creditor committee to commence proceedings to avoid these transactions, where other creditors agree. Where this latter action is permitted, some laws provide that the assets or value recovered by the creditor are to be treated as part of the estate; in other cases whatever is recovered can be applied in the first instance to satisfy the claim of the creditor which takes the action.

(b) Funding of avoidance proceedings

181. [150] As to the manner in which they may be funded, some countries make public funds available to the insolvency representative to commence avoidance proceedings. In other countries, those proceedings are to be funded from the insolvency estate. This latter approach may be appropriate where sufficient funds exist but in some circumstances could operate to prevent the recovery of assets that have been removed from the estate with the specific intention of leaving the estate with few assets from which to fund their recovery through an avoidance proceeding. Some insolvency laws allow the insolvency representative to assign the ability to commence proceedings for value to a third party or to approach a lender to advance funds with which to commence the avoidance proceeding. In support of the use of the latter mechanisms, there are clearly significant differences between countries in the availability of public resources for such funding and where there is no ability to fund avoidance proceedings from the insolvency estate, these alternative approaches may offer, in appropriate situations, an effective means of restoring value to the estate.

(c) Time limits for commencement

182. Some insolvency laws establish specific time limits within which avoidance proceedings should be commenced, while others are silent on this issue. Those laws that do specify time limits provide, for example, that the proceeding should be commenced within a specified period after the date of the application for commencement (such as three or twelve months) or no later than a fixed period (for example, six months) after the insolvency representative is able to assess and pursue claims. If an insolvency law is to establish specific time limits, rather than relying on those applicable under general law, an approach that combines different limits, such as a fixed period after commencement and a

Other laws limit the right to pursue avoidance actions to the insolvency representative when insolvency proceedings have been commenced.

² See chapter IV.B on the rights and obligations of the insolvency representative.

period after the insolvency representative has discovered a certain transaction, would be desirable. Such an approach would provide flexibility sufficient to address those transactions that are concealed from the insolvency representative and discovered only after the expiration of the fixed period after commencement.

(d) Evidentiary issues

183. [151] Insolvency laws adopt different approaches to establishing the elements of an avoidance action. In some laws, the onus is on the debtor to prove that the transaction did not fall into any category of avoidable transactions.

184. [151] Some insolvency laws provide that the insolvency representative or other person permitted to challenge the transaction, such as a creditor, is required to prove the existence of each element of an avoidance action. Where these elements include intent, some laws allow the burden of proof to be shifted to the counterparty where, for example, it is difficult for the insolvency representative to establish that the debtor's actual intent was to defraud creditors except through external indications, objective manifestations, or other circumstantial evidence of such intent. The law may provide a presumption that the transaction was done to harm creditors, and it is up to the counterparty to prove otherwise.

185. Another approach is to provide that the requisite intent or bad faith is deemed or presumed to exist where certain types of transactions are undertaken, for example, within a specified period before the application for commencement or within a number of years before commencement. The types of transactions may include, for example, transactions with related persons, payment of non-matured debts, and payment of gratuitous or onerous transactions. A slight variation is an approach providing that a transaction will be deemed to be voidable where it occurred within a short specified period and had the effect of conferring a preference.

186. Where knowledge of cessation of payments is a required element of avoidance, some insolvency laws provide a presumption that the creditor knew of the poor financial condition of the debtor if the debtor entered into certain transactions with that creditor, such as for repayment of a non-mature debt or repayment in an unusual manner, or where the transaction occurred within a short period before an application for commencement or before commencement.

187. A further approach is to provide that where a certain type of transaction occurred within a specified period and had the effect of conferring a preference, a rebuttable presumption as to intention to prefer will arise. Unless the creditor can rebut the presumption, the transaction is avoided and the insolvency representative can recover the assets involved in the transaction or obtain judgement for the value of the asset involved.

7. Liability of counterparties to avoided transactions

188. [143] Where a transaction is avoided, there is a question of the effect of avoidance on the counterparty. In most insolvency laws the result of avoidance of a transaction is generally that the transaction will be reversed and the counterparty required to return the assets obtained or make a cash payment for the value of the transaction to the insolvency estate. Some insolvency laws provide that the insolvency representative can be awarded judgement for the value of the property involved. Some insolvency laws also stipulate that the counterparty who has returned assets or value to the estate may make a claim as an unsecured creditor in the insolvency to the extent of the assets returned. Where the

counterparty fails to disgorge assets or return value to the insolvency estate, most of remedies available are under non-insolvency law, but some insolvency laws provide that a claim by the counterparty (for amounts owed in addition to those involved in the voidable transaction) cannot be admitted in the insolvency.

8. Post-application and post-commencement contracts

189. As noted above (Part two, chapter III.B.6), some insolvency laws address contracts entered into and transactions implemented between application and commencement of proceedings and after commencement in terms of avoidance provisions when those transactions or contracts are not authorized by the insolvency law or approved, as required, by the court, the insolvency representative or creditors. Some insolvency laws specify the types of these transactions that may be avoided, such as performance of obligations arising before commencement, payment of pre-application debts, creation of security over assets of the estate and disposal of any right or asset forming part of the estate. Other laws provide for avoidance of any unauthorized transaction entered into by the debtor at these times unless the counterparty can provide that the transaction did not impair creditor's rights.

Recommendations

Purpose of legislative provisions

The purpose of avoidance provisions is to:

- (a) ~~preserve~~[reconstitute] [reconstruct] the integrity of the estate and ~~ensure~~ the [fair][equitable] treatment of creditors;
- (b) ~~provide certainty for third parties by establishing clear rules for the circumstances in which transactions [occurring] prior to the commencement of insolvency proceedings [or unauthorized transactions occurring after [application for] commencement]~~ involving the debtor or the debtor's property may be considered injurious and therefore subject to avoidance;
- (c) enable the ~~insolvency representative to~~ commencement of proceedings to avoid those transactions;
- (d) facilitate the recovery of money or assets from persons involved in transactions that have been avoided.

Content of legislative provisions

(69) [(56)] The insolvency law should include provisions which apply retroactively and are designed to overturn past transactions³ [or unauthorized transactions occurring after [application for] commencement] to which the debtor was a party [or which involved the debtor's property] and which have the effect of either reducing the net worth of the debtor or upsetting the principle of [fair] [equitable] treatment of creditors.

³ [131] The use of the word "transaction" in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, a security, a guarantee, a loan or a release.

Transactions subject to avoidance

(70) [(57)] The insolvency law should provide that the following types of transactions are subject to avoidance ~~the insolvency representative may commence proceedings in court to set aside as void the following types of transactions:~~

- (a) transactions intended to defeat, delay or hinder the ability of creditors to collect claims by, for example, the transfer of assets to any third party where the purpose of the transaction was to put assets beyond the reach of a creditor or potential creditor or to otherwise prejudice the interests of that creditor and where the third party knew of the debtor's intent; ~~(fraudulent transactions)~~
- (b) transactions where a transfer of an interest in property or the undertaking of an obligation by the debtor was made in exchange for a nominal or less than equivalent value (undervalued transactions) which occurred at a time when the debtor [was insolvent] [had ceased making payments] or as a result of which the debtor became [insolvent] [unable to make payments]; and
- (c) transactions involving creditors where a creditor obtains more than its pro rata share of the debtor's assets (preferential transactions) which occurred at a time when the debtor had ceased making payments [was insolvent].

Security interests

(71) The insolvency law should provide that although security interests valid under laws permitting the grant of security to creditors are generally valid under insolvency law, they will be subject to avoidance on the same grounds as other transactions.

Related person transactions

(72) [(61)] In relation to transactions of the type referred to in recommendation (70) involving related persons, the insolvency law should provide that ~~insolvency representative may commence proceedings in court to set aside as void undervalued and preferential transactions~~

- (a) those transaction are subject to avoidance;
- (b) the suspect period for those transactions may be longer than for transactions with unrelated persons; and
- (c) there may be presumptions or shifts in the burden of proof that favour the insolvency estate.

(73) The insolvency law should specifically define the categories of persons considered to be sufficiently related to the debtor for the purposes of recommendation (72).

~~(62) — The insolvency law should clearly establish the suspect period for the types of transactions referred to in recommendation (61), which would generally be longer than the time periods applicable to both undervalued and preferential transactions that do not involve related persons.~~

Transactions exempt from avoidance actions

(74) The insolvency law should specify the transactions that will be exempt from avoidance. These transactions may include transactions entered into in the ordinary course of business prior to commencement of insolvency proceedings, transactions entered into the course of reorganization proceedings which are subsequently converted to liquidation and certain financial market transactions.

Establishing the suspect period

(75) [(58)] The insolvency law should establish that transactions with the characteristics described in recommendation (70) may be avoided if they occurred within a specified period (the suspect period) [prior to] [calculated retroactively from] the [application for] commencement of the insolvency proceeding. The insolvency law may specify different suspect periods for different types of transactions, but in general the suspect periods for transactions referred to in recommendation (70)(a) and those involving related persons (recommendation (72)) should be longer than for other types of transactions and those not involving related persons.

Commencement of avoidance proceedings

(76) The insolvency law should specify that the insolvency representative [and ..] may commence avoidance proceedings.⁴

Time limits for commencement of avoidance proceedings

(77) [(59)] Following commencement of the insolvency proceedings the period within which an avoidance proceeding may be commenced in respect of a transaction of which the insolvency representative is aware, may be limited by the insolvency law or by applicable procedural law.

Funding of avoidance proceedings

(78) [(64)] The insolvency law may provide alternative approaches to address the funding of avoidance proceedings where the insolvency representative does not pursue the avoidance of particular transactions either on the basis of an assessment that the transactions are not likely to be avoided or that pursuing such transactions will impose [unjustifiable] [excessive] costs upon the insolvency estate. These approaches may include permitting individual creditors or the creditor committee to pursue avoidance and (a) allowing the creditor(s) to retain an amount of any sum recovered towards satisfaction of their claim, (b) paying the costs of the avoidance proceeding from the insolvency estate in the event that the proceeding is successful; or (c) modifying the priority of the claim of the creditor(s) pursuing avoidance.

⁴ Issues relevant to avoidance may also arise in proceedings commenced by a person other than the insolvency representative, where the insolvency representative raises avoidance by way of defence against enforcement.

Evidentiary issues

(79) [(60)] The insolvency law should specify the elements to be proved in order to avoid a particular transaction and possible defences to avoidance.

(80) [(63)] The insolvency law may provide that special evidentiary presumptions apply to the avoidance of certain transactions occurring within specified periods involving certain clearly specified persons [such as related persons] or classes of person.

Liability of counterparties to avoided transactions

(81) The insolvency law should provide that a counterparty to a transaction that has been avoided is bound to return to the estate all material benefits derived from the avoided transaction. Where the counterparty refuses to return those benefits, the insolvency law may provide that the counterparty cannot make a claim in the insolvency proceedings.

Review of decisions concerning avoidance

~~(65) — The insolvency law should permit interested parties to seek judicial review of decisions taken by the insolvency representative with respect to avoidance. Grounds for review may include: [...].~~

F. Setoff, netting and financial contracts**1. General right of setoff**

190. [116] An important issue that arises in the design of an insolvency law is the treatment of a creditor who, at the time of the application for commencement of proceedings, also happens to be a debtor of the estate. If the fundamental principle of equality of treatment of similarly situated creditors is applied, the outcome would be relatively straightforward: the insolvency representative will be able to receive the full amount owed by the creditor and the creditor's claim will be satisfied upon the liquidation of the estate or in the reorganization. However, an alternative approach permits the creditor, in these circumstances, to exercise setoff rights against the estate after the commencement of proceedings, with the effect that, depending on the size of the estate's claim on the creditor, the creditor's claim is satisfied in full. The main effect is thus that a creditor with a setoff is in substance "secured" because the debtor's cross-claim can be paid or discharged by setting it off against the creditor's claim. Setoff is not significant until insolvency, because if a counterparty could always pay, there would be no need for setoff.

191. Since claims are a major form of property in modern economies and since creditors are often also debtors to the same counterparty, the law of setoff is important in business and in financial markets (see below). Setoff is prevalent in business transactions because wherever there is a series of contracts between the same parties, there is a potential for setoff. This extends also to mutual trading transactions.

192. [119] The international position with regard to setoff in insolvency reveals considerable diversity. In some countries, setoff is restricted between solvent parties, but is

compulsory on insolvency, in other countries the opposite position exists and it is permitted between solvent debtors, but prohibited on insolvency.

193. [117] There are several reasons why it may be appropriate to include the right of setoff in an insolvency law. The first is that of fairness: notwithstanding the importance of equality of treatment among creditors, it can be considered unfair for a debtor to refuse to make a payment to a creditor but, at the same time, to insist upon payment from that creditor. In addition, since many counterparties are banks, the right of setoff is particularly beneficial to the banking system and, because of the important credit creation role of banks, it is therefore considered to be of general benefit to the economy. By virtue of their core functions (lending and deposit taking) banks that have lent to an insolvent debtor often find that they have financial obligations to the debtor in the form of deposits. A post-commencement right of setoff will allow the banks to offset their unpaid claims with the debtor's deposits even though these reciprocal claims are not yet due and payable. Setoff allows the creditor to escape the difficulties created by the insolvency of the debtor and thus helps to avoid the cascade effect of bankruptcy, as well as reducing exposures and transaction costs and thus the cost of credit. Setoff also avoids circularity of payments and associated costs.

194. [118] Although there are a number of advantages to allowing setoff, these may need to be balanced against some of the arguments against a right of setoff. Insolvency setoff is a violation of the *pari passu* principle because a creditor with a setoff gets paid in full without there being general awareness, unlike publicized security interests, of the existence of reciprocal claims. Setoff can deplete a debtor's assets and inhibit reorganization particularly where the debtor loses access to its bank accounts or cash in its bank accounts.

195. [120] The right of setoff interacts with other provisions of insolvency in a number of important respects. For example, the right of a creditor to claim the benefit of a setoff may be subject to the avoidance provisions (see Part two, chapter III.E.3(c)). Where an insolvency law generally allows termination clauses to be overridden thus allowing the insolvency representative to continue unperformed contracts, a creditor will only be able to exercise setoff rights regarding mutual monetary claims where the right to override the termination clause includes an exception which expressly allows a creditor to terminate the contract and setoff those claims. This is particularly important in the context of short-term financial transactions.

2. Netting and setoff in the context of financial transactions

196. In addition to its importance in business generally, setoff is also important in financial markets. Some common cases of setoff include setoff by banks of loans against deposits; setoff between institutions in financial markets such as the inter-bank deposit market; and netting of foreign exchange, swaps, futures, securities and repurchase contracts; and setoff in centralized payment systems. The amounts involved are often very large and the reduction in exposures achieved by setoff, with a resulting reduction in credit costs, and cascade risks threatening the integrity of the financial system, are correspondingly large.

197. Netting differs from setoff in that in one form it can consist of the setoff of non-monetary fungibles (e.g. securities or commodities deliverable on the same day – settlement netting) and because in its more important form it generally involves a cancellation by a counterparty of open contracts with an insolvent debtor, followed by setoff of losses and gains either way – close-out netting.

198. The international position with regard to setoff and netting is complex. The minority of countries which have not traditionally accepted insolvency setoff, [119] except for certain transactions and for current account setoffs, still mainly adhere to that position, although a few have widened their transaction setoff and some have introduced netting legislation which applies only to specified contracts. Among those states that traditionally permit insolvency setoff a small number impose a stay in reorganization proceedings, although permitting an exemption for financial contracts. Other insolvency laws do not address the question of setoff.

3. Exceptions or carve-outs for financial contracts

199. [121] Whether it is desirable that an insolvency law include provisions regarding certain types of short-term financial contracts, including derivative agreements (e.g. currency or interest rate swaps) will depend upon how issues relating to the treatment of contracts and setoff rights are addressed. The terms of the increasingly standardized master agreements which govern these individual transactions normally contain provisions that enable close-out netting. Such provisions, which aggregate all independent payment obligations, are normally effective only upon the insolvency of one of the parties if the insolvency law contains two features. First, it must allow for the termination (or “close-out”) of all outstanding transactions under the agreement on the insolvency of a party, and second, it must allow the non-insolvent party to set off its claims against the obligations of the insolvent party.

200. [122] Many insolvency laws do not contain both of these features. As noted above in the discussion of treatment of contracts, some countries allow an insolvency representative to elect to continue the contract in contravention of the termination provisions of the contract. With respect to setoff, a number of countries do not allow for the setoff of independent financial claims that are not mature at the time of commencement.

201. [123] Many countries that do not possess these general rules providing for both termination and setoff, have nevertheless carved out exceptions to the applicable insolvency rules for the specific purposes of allowing “close-out netting” for prescribed eligible financial contracts, including security interests, repurchase agreements and securitizations. The rationale for these exceptions is the increasing importance of these transactions in the global financial market, the need for safety in markets, the complexity of these financial arrangements and the fact that access to such transactions would be restricted if there was no certainty with respect to the availability of netting upon the insolvency of one party. Notwithstanding these important advantages, it should be recognized that such “carve-outs” complicate the law and result in preferential treatment for certain types of creditors.

202. In addition to the exception discussed above, further exceptions may be required for financial contracts from the application of the stay (mentioned in Part two, chapter III.B.3), the operation of avoidance provisions (mentioned in Part two, chapter III.D.6) and from the power of the insolvency representative to continue and reject contracts under which the debtor and its counterparty have not yet fully performed their respective obligations (mentioned in Part two, chapter III.E.4). *[Note: the Working Group may wish to consider the scope of such exceptions and whether additional recommendations should be added to this section cover these issues – see note re recommendations 86-88 below.]*

Recommendations

Purpose of legislative provisions

[Purpose clause to be drafted]

Content of legislative provisions

General right of setoff

[(82)][(67)] The insolvency law should protect a pre-commencement right of set-off existing under general law ~~should be protected during liquidation proceedings and generally should be exercisable by both creditors and the insolvency estate.~~

[(83)] The insolvency law should permit post-commencement set-off where the mutual claims arise under the same agreement. ~~In addition, countries may also wish to consider allowing for post-commencement set off in other circumstances, particularly with respect to mutual financial obligations which derive from financial contracts defined by law.]~~

Netting and financial contracts⁵

(84) [(66)] In the context of financial [contracts][master agreements] the insolvency law should provide that netting and close-out arrangements are legally protected and, to the greatest extent possible, should not be unwound in insolvency proceedings.]

Exception to unenforceability of automatic contract termination clauses⁶

(85) [68] Where the insolvency law does not permit post-commencement setoff for mutual financial obligations, or renders unenforceable as against the insolvency representative any contract provision that would provide a right to terminate a contract upon, or identify as an event of default, (a) the application for commencement, or commencement, of insolvency proceedings; (b) the appointment of an insolvency representative; (c) the fact that the debtor satisfies the criteria for commencement of insolvency proceedings; or (d) indications that the debtor is in a weakened financial position, it may be necessary for the insolvency law to provide an exception for financial

⁵ The Working Group may wish to consider whether the term “financial contracts” should be defined, and if so, an appropriate definition. One example might be the definition included in the UNCITRAL Convention on the Assignment of Receivables in International Trade, art. 5(k) which 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 and any combination of the transactions mentioned above.

At the twenty-sixth session of the Working Group (May 2002), the view was expressed that that definition was too broad and should be more narrowly focussed to cover only those transactions which formed part of a broader framework contract (A/CN.9/511, para. 71). No specific drafting was proposed.

⁶ See Part two, chapter III, D Treatment of contracts, recommendation (53).

[contracts][master agreements] so that close-out netting provisions contained in those [contracts][agreements] between the debtor and another party can be applied with certainty.

Possible additional recommendations concerning financial contracts

(86) [Exception to application of stay: chapter III.B.3]

(87) [Exception to application of avoidance provisions: chapter III.D.6]

(88) [Exception to powers of continuation and rejection of contracts: chapter III.E.4]