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The Development of Insolvency Law as Part of the Transition from a Centrally Planned to a Market Economy***

With a Soviet-dominated Central Europe now largely a matter of historical curiosity, a number of countries and newly independent republics are addressing the host of economic, social, and legal issues involved in the painful transition from a centrally planned economy to a market economy. One of the strongest features of a market economy is the ability of a risk-taking enterprise to reap the benefits of any success it is able to achieve. As a necessary counterbalance to encouraging a private enterprise to succeed, a market economy must also provide mechanisms for dealing with enterprises that fail. As part of its new legal

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structure, therefore, a country in transition to a market economy will need a set of insolvency laws to provide a predictable mechanism for the liquidation or reorganization of failing enterprises.

> A second reason supports the implementation of modern insolvency laws. Just as the central government will no longer be able to siphon off a successful enterprise's profits, so too will the unsuccessful compensate it for its losses. With the loss of the central government as the largest investor, newly privatized enterprises will need to attract capital from other sources, including foreign investors. As one of the necessary prerequisites for attracting foreign investment, a market economy will need to demonstrate to the investor the existence of an established, predictable mechanism for seeking recovery of the invested capital in the event the enterprise fails. Modern insolvency laws provide this sense of predictability. The precise wording of the laws is less important—investors can adjust their return on investment requirements based on the level of perceived risk—as long as the laws provide for a predictable result and are applied consistently by the local courts.

This article discusses some of the more significant considerations relevant to the development of insolvency laws for countries in transition to a market economy.

I. Background

A. Overview

The following pages contain a discussion of a number of considerations that the authors feel would be crucial to any transition from a centrally planned, socialist economy to a free-market economy. While the authors prepared the discussion specifically for the newly independent Baltic Republics, they have revised it somewhat to make it more generally applicable to any similarly situated nation.

Any nation that commences a transition from a centrally planned economy to a market economy will encounter a host of difficulties. Insolvency laws—laws that govern the substantive and procedural rights of enterprises and their creditors in the event of financial difficulty—are as critical to the success of such a transition as are other laws that focus more directly on the financial institutions that will define the marketplace (for example, laws creating and regulating banking, securities, and commodities industries).

While the various insolvency systems around the world differ markedly from one another, virtually all of them share two primary objectives: to facilitate credit in commercial transactions by providing an orderly system for the liquidation of financially troubled enterprises; and to protect the rights of, and provide equal treatment to, similarly situated creditors and employees of insolvent enterprises.

Because all but the most basic market economies are, to some degree, dependent upon credit, virtually every market's operation will be disturbed when credit is not repaid in accordance with the terms of credit contracts. Insolvency laws lend a necessary element of predictability to market economies by establishing a framework for determining and enforcing the consequences that arise when a particular entity cannot repay its credit. It is not that creditors need assurances that their debts will be repaid even in an insolvency; rather, creditors need to be able to predict with some certainty the consequences of an insolvency, whether those consequences are favorable or unfavorable. With an understanding of those consequences, creditors will have a framework for assessing the credit terms (such as interest rate, maturity date, requirement of collateral, and so forth) that they should demand from a particular enterprise. Stated differently, rational insolvency laws create a degree of certainty that allows creditors to make more rational investment decisions than they otherwise could, thus resulting in a greater availability of credit in the market as a whole.

Promoting more efficient investment decisions, and ultimately, a more efficient market, is one of the primary purposes of an insolvency law. A second purpose is to ensure that similarly situated creditors of an insolvent enterprise trouble often exercise their contractual and legal rights by pursuing the assets of the enterprise as a source for repayment of their credit. Stronger or larger creditors will often be swifter, to the detriment of others. Certain creditors may succeed in preventing the enterprise's use of crucial assets, effectively preventing the enterprise from continuing operations. Such actions also work to the detriment of other creditors.

In the absence of an insolvency administration, creditors who proceed most swiftly enjoy the greatest likelihood of being repaid. While such a race for the enterprise's assets may benefit individual creditors, it will harm the creditor body as a whole (both by depriving them of access to the assets seized and by accelerating the economic dismemberment of the enterprise). Consequently, an insolvency law should not reward the swiftest creditors, but should stay creditor action and thereby afford the enterprise and all of its creditors the ability to resolve financial difficulties more equitably.

In addition to the two universal policies noted above, many insolvency systems (including the systems in the United States and England) also favor a third policy objective: to afford a "fresh start" to the financially troubled but honest debtor, particularly in cases of insolvent individuals. This goal is implicit in some insolvency systems and explicit in the more debtor-oriented systems. In countries where this third policy is adopted, two subsets of policy concerns arise: the terms and conditions of granting a discharge of an enterprise's obligations; and the procedures to be adopted to support legitimate attempts to reorganize—as opposed to liquidate—struggling businesses.

Any emerging market economy will weigh the risks and the rewards of emphasizing the policies in support of creditors' rights and those in support of an enterprise's ability to reorganize and receive a discharge. During the transition period, further complications emerge due to the need to balance the ideal objectives of an enacted insolvency system with the practical reality of fragile market economies that may not survive the consequences of a blind application of stated policies.

The transition to market economies will inevitably result in a high failure rate among newly privatized enterprises. A liberal approach to discharge might encourage private individuals and groups of individuals to take the economic risks that will be necessary to start new businesses in a very uncertain economic climate. A liberal approach to reorganization will give courts an additional measure of flexibility to support businesses that have a chance to survive in the new market environment. On the other hand, at least until the market economies are fully established and foreign investors have acquired greater familiarity and experience with the way in which businesses will succeed (and fail) under the new system, liberal approaches to discharge and reorganization may only serve to increase the nervousness of foreign investors. With increased anxieties these investors are less willing to take risks in the new and untested marketplaces.

Once the basic policy decisions are made, any insolvency system should be formulated so that the system as implemented serves the purposes for which it is intended. Insolvency laws are of little benefit if they work well from an academic and philosophical point of view, but do not work when they are applied to real situations. In order to ensure that an insolvency system will work in practice as well as in theory, the following principles should be carefully considered:

- the law should provide a fair and orderly process for addressing the financial affairs of insolvent enterprises;
- the law should provide for swift and inexpensive access to the process;
- the law should be impartial, efficient, and expeditious;
- the law should provide a convenient method for collecting and applying property to the claims against the insolvent enterprise; and
- the law should support commercial and economic processes and harmonize with the general law as much as possible.

Regardless of the policies a nation chooses, it should design an insolvency system to balance the policies and allow for a variety of solutions. Often, a business will be so threatened by financial difficulty that its creditors would prefer to have the business cease operations, liquidate its assets, and distribute the proceeds of the sales to the creditors (a liquidation). In other cases, however, all or part of the business may remain economically viable (albeit after restructuring the operations or adjusting the capital structure), and the creditors may wish to have the business continue operations, agreeing to be repaid on terms somewhat different from the terms of their original credit contract (a reorganization).

An insolvency system should provide for courts in which financially troubled enterprises (or their creditors) can seek relief in both liquidation and reorganization situations. These courts should take jurisdiction over and administer the assets of the enterprise until it is sold (in the case of a liquidation). It is preferable that the court's role be limited to that of supervision and dispute resolution, rather than active day-to-day involvement. Further, in a liquidation, the courts should have the ability to monitor the sale of the enterprise's assets in order to ensure the legitimacy and fairness of the sale procedures.

In the case of a reorganization the courts should be available for redress during the period after the commencement of a proceeding, but before the successful reorganization of the business. The reorganization process should consist of a negotiation among the representatives of the business and the creditors of the business. These parties should determine how the various credit contracts will be modified. The parties will base negotiations upon their perception of the value of the business, and accordingly, how much debt the business can repay. The negotiations will be most effective if they take place without a great deal of court supervision, but against the backdrop of measures that court could impose upon the enterprise and its creditors if the parties cannot agree. If the parties cannot agree on a reorganization, the law could provide for an ability to force a reorganization if certain criteria are met (minimum recoveries for creditors), or the law could provide that the enterprise's assets should be liquidated.

B. Reorganizations and Liquidations

When faced with a financially troubled business, the parties will need to analyze whether the business is likely to be profitable and should accordingly be liquidated or restored to profitability via a restructuring. In individual cases, such a determination will serve the best interests, in the aggregate, of all interested parties.

On a larger scale, the insolvency law should reflect the social policies that a nation wishes to promote. For example, if a nation wishes to preserve as much job security for employees as possible, its law should be designed to foster reorganizations (either through a continuation of the enterprise or through a sale of the enterprise's business as a going concern), thereby preserving the operations of the enterprises that provide employment. If, on the other hand, a nation wishes to encourage foreign investment as much as possible by promoting creditors' rights, its law should foster liquidations, permitting creditors relatively quick access to the assets of the financially troubled business in order to satisfy their debts. As a very broad generalization, the insolvency laws of a majority of countries are geared primarily toward the liquidation of most insolvent businesses. In a few countries (most notably the United States and France) the laws provide more practical mechanisms for the reorganization of businesses and the preservation of employment.

One economic theory worth noting is that it is inefficient and unnecessary to seek to reorganize failing enterprises in order to preserve employment. The theory suggests that the assets themselves, rather than the particular business that utilizes the assets, produce economic value and employment. If an insolvent enterprise owns productive assets, the enterprise should be liquidated, and the productive assets redeployed (via an asset sale or spin-off) to a newly formed or more efficient enterprise that is better able to utilize the assets. In such cases, the owners of the business (as well as some creditors) may lose their interests in (and claims against) the enterprise's assets, but the sale will have preserved the ongoing operations of the former enterprise. The new enterprise will continue to employ workers and will not necessarily have to incur the usual expenses associated with starting a new business.

Such a redeployment will result in increased employment at the new enterprise. And on a macroeconomic scale, the appropriate employment level for the market as a whole will be returned to its proper balance. The difficulty with this theory, particularly during a transition period, is that it can massively disrupt local economies. From a national employment level it may be considered an appropriate adjustment to lose 1,000 employees at the local site of a failed enterprise, while gaining 1,000 employees at the distant site of the new enterprise that is able to operate the productive movable assets on a sounder economic basis. From the viewpoint of the local economy that lost the 1,000 jobs, however, the adjustment could be catastrophic. If that local economy was entirely dependent on the failed employer, the government would face the massive task of retraining and, quite possibly, relocating virtually the entire population. In the face of such hardships the macroeconomic theory may have to give way to the reality of the human element involved in any enterprise, thus suggesting a need for greater flexibility in dealing with failing enterprises in such situations.

C. The Transition Period

The transition from a centrally planned, socialist economy to a market economy will be painful and will require intermediate steps. Not only will it take time to develop the laws and systems that will govern the markets, but a nation making such a transition will also need to examine the legacy of the socialist system and choose which aspects of it are worthy of preservation and which require reforming in light of the transition. Such philosophical reflection will affect practical decision-making on several issues: which enterprises should remain state-run and which should be privatized; to what extent should the government regulate the privatized enterprises; and what should be done with financially troubled monopolies.

The resolution of such issues will undoubtedly change over time as the markets expand to include larger sectors of the economy. The most significant changes, however, are likely to occur during the early months and years of the new market system. This "transition period" may be quite difficult, especially if a nation decides to revise social policies significantly.

As any formerly socialist nation implements insolvency laws, it will have to decide the extent to which the law should apply equally to all enterprises and the extent to which, of necessity, exceptions will be made. Initially, certain essential industries will remain monopolized by a single enterprise. As noted above, other enterprises, although not monopolies, may provide the principal source of employment for economically depressed regions. It may be considered too disruptive to permit such businesses to liquidate overnight and leave massive local unemployment in their wake. Until the market systems have progressed sufficiently to allow for the introduction of multiple competing enterprises, a nation may not be able to afford to allow the monopolies and employment-intensive enterprises to be liquidated, at least in the short run. Accordingly, there may be little choice but to provide direct financial assistance to certain enterprises during this period. Creditor remedies, in general, against such enterprises will presumably expand over time as the enterprises' ability to withstand such remedies grows. Some industries, however, may be too important to the smooth operation of the market economy to permit their liquidation. Accordingly, a nation may wish to exclude certain industries from the application of the insolvency laws (or provide special treatment for such industries within the laws) even after the transition period. See the discussion in part II.B.1. below.

D. Recognition of Foreign Insolvency Proceedings

Any nation that embarks on this transition will become a more significant part of the "global marketplace." It will encounter the tensions among commercial nations. Among those tensions will be the need for the resolution of insolvencies of enterprises with assets in more than one country. Often, such enterprises find themselves in formal insolvency proceedings in several countries (often commenced by local creditors seeking preferred treatment with respect to local assets). In such a situation two of the policies underlying insolvency systems are hindered: (1) it will be more expensive and less efficient for insolvent enterprises to be involved in multiple proceedings rather than in a single proceeding (thereby making it more difficult for the enterprise to resolve its financial troubles and reducing the property available for distribution to creditors); and (2) there will be heightened concerns that creditors in one country will not be treated equally with similarly situated creditors in another.

In order to resolve these problems an increasing number of commercial nations are adopting provisions that (1) afford foreign creditors equal status with domestic creditors (reducing somewhat the likelihood that such a creditor will initiate insolvency proceedings against an insolvent enterprise in the creditor's country), and (2) govern the recognition of foreign proceedings. The latter provisions may create various forms of relief that can be selected based upon the circumstances of the case. For example, the provisions could allow a local court to stay all creditor action against an entity that is in insolvency proceedings in other nations. Further, the provisions could allow the local court to order that any property of such an entity (or the proceeds of such property) be turned over to the jurisdiction of the court overseeing the enterprise's foreign insolvency proceeding. In this context the EEC, the Council of Europe, INSOL International, and the International Bar Association have each commenced efforts to address these issues (albeit in widely divergent ways). A nation may want to consider participating in such efforts in order to provide greater comfort and certainty to foreign investors (thereby promoting increased foreign investment).

It must be conceded, however, that well-intentioned unilateral "cross-border insolvency" provisions have not functioned as smoothly as many would have hoped. Too often, a subconscious (or even conscious) desire to protect local creditors causes a court, faced with these issues, to provide preferred treatment to local laws and local creditors. Multilateral treaties have proven to be more effective, but relatively few such treaties are in effect due to the difficulties of attempting to resolve the policy concerns of disparate insolvency systems. Nevertheless, international cooperation in insolvency matters will become increasingly essential to the smooth operation of the "global marketplace."

A related issue is the extent to which foreign insolvent individuals and enterprises should be restricted from investing in projects in the nation undertaking this transition. The reason for restricting such investment is understandable—reduction of the risk that foreign investors will become insolvent in their local ventures. A nation may find it better, however, especially after the transition is well underway, to allow the market to determine which investments are acceptable and which are too risky. Texaco, for example, which is one of the largest oil companies in the world, emerged from insolvency proceedings in the United States within the last several years. Yet many start-up or financially distressed oil ventures would likely be delighted to receive a substantial investment from Texaco in their projects.

E. Related Laws

Although not a part of an enterprise insolvency law, the following provisions of law are integral to the operation of an insolvency system. Accordingly, an understanding of these provisions, and the policies they serve, is necessary to the formulation of an insolvency law.

1. *Secured Transactions*

From a practical standpoint the development of a law providing for and governing secured credit is as immediately critical as the development of insolvency laws. In a market system creditors often will not provide goods or services on credit, or make loans, unless the repayment of such obligations is assured by something more than the enterprise's promise. If the enterprise cannot or will not pay the obligation when it becomes due, such a creditor would want to pursue another source for repayment. Most often that source will be assets owned by the enterprise. Thus, in addition to promising to pay its credit obligations, an enterprise will grant the creditor the right to take possession of and sell the enterprise's assets. In the event the enterprise cannot or will not pay its obligation to the creditor according to the terms of the credit contract, the creditor will apply the proceeds of the sale to the enterprise's obligation.

The foregoing is more than theoretical: in a number of countries where obtaining collateral is not customary or practical, businesses have relatively little ability to obtain meaningful credit. Instead, goods and services are primarily provided on a cash, barter, or "retention of title" basis. The introduction of meaningful secured credit, on the other hand, provides greater opportunities for business operation and expansion. While, inevitably, this leads to more business failures, it also leads to more business successes by enabling entrepreneurial enterprises to take greater risks and reap greater rewards.

Some do not agree, however, that secured credit is necessary to the smooth operation of a market economy. They argue that the availability of secured credit has the effect of preferring stronger creditors (who can insist on a security interest) over others. Such a preference is unnecessary to the operation of a market because creditors require certainty more than anything else. If all creditors can be certain that they will be treated equally, they will have sufficient incentive to extend credit, assuming the borrower's business is sound. This theory must be balanced with the reality, however, that western lenders are accustomed to a system of secured credit and may be reluctant to invest in a totally unsecured environment.

Any enacted law governing secured credit should address at least four concepts, unless there is a preference to leave security issues entirely to the private contracts between the parties involved. First, the law must describe how an enterprise grants the security interest and when it is enforceable by the secured creditor against the enterprise. This can take the form of a simple contract between the enterprise and the creditor describing the obligation secured, the assets pledged as security, and the creditor's rights upon the enterprise's default in payment of the obligation. Alternatively, the law could be silent as to requirements, leaving the means for the grant and enforcement of the security interest to the discretion of the contracting parties.

Second, the law must describe the relative rights among secured creditors themselves (if more than one creditor is secured by the same asset), as well as among unsecured creditors and secured creditors. Generally, a creditor who receives a pledge of an enterprise's assets first in time normally has a first priority claim to those assets. In many jurisdictions, in order to ensure that other potential secured creditors are aware of prior security interests that an enterprise has granted in its assets, the law provides for a public, central filing system for both immovable (real property) and movable (personal property) assets, containing notice of all security interests granted by all enterprises within the jurisdiction. Such a filing system allows a potential creditor to determine what priority it will have with respect to those assets. Secured creditors are required to file a record of their security interest on penalty of losing their priority. A secured creditor who has properly filed such a record has the right to the proceeds of the assets securing its obligation before any later filing secured creditors or any unsecured creditors can be paid out of those proceeds.

Central filing for both movables and immovables is not the rule in all jurisdictions, however. A number of European countries still follow the older systems of "pledge" and "retention of title" when dealing with movables. Such systems have worked for hundreds of years and will presumably remain the principal security devices for movables in a number of countries (particularly civil law jurisdictions) for the foreseeable future. The benefit of such systems is that they provide greater efficiency and certainty to secured creditors when they need to enforce their rights. The disadvantages are that they greatly restrict the ability of an enterprise to grant liens on assets to multiple creditors (even though there may be substantial value in the assets above the amount owed to the primary creditor). Also, they do not provide clear notice to other creditors that particular assets may not be available for satisfaction of their claims. A creditor in the United States, for example, will often search the central records to determine whether an enterprise's principal assets are subject to security interests. If nothing appears in the records, the creditor can be reasonably assured that the enterprise's assets will be available for the satisfaction of claims in general. Thus, the creditor will be more likely to provide credit on an unsecured basis.

Third, the law must describe the secured creditor's rights upon the enterprise's default in payment of the secured obligation. The law should provide that the secured creditor has the ability to take possession of the assets securing its obligation and to sell those assets, applying the proceeds of the sale to the obligation. Alternatively, the law could be silent as to requirements, leaving the rights of the secured creditor upon default to the discretion of the contracting parties.

Finally, if there is a strong desire to attract foreign investment, the law should make most assets freely alienable. That is, foreigners should be permitted to acquire, own, and dispose of domestic assets that are not politically sensitive and do not concern the national security.

Secured credit, along with permitted foreign equity investment, will be absolutely crucial to the transition to a market economy. The ability to obtain substantial unsecured credit depends upon a business's credibility and reputation. Foreign (and even domestic) credit sources will be understandably wary when lending to enterprises facing free market competition for the first time. The creditors will be unable to assess the enterprise's ability to repay the credit with any certainty. On the other hand, those same creditors will have some idea of the value of the assets used in the operation of its business. Accordingly, the creditors can extend secured credit in instances when unsecured credit would be imprudent.

2. *Contractual and Fiscal Responsibility*

Another significant part of the transition to a market system will be the implementation of laws governing the contractual relationships between and among enterprises. In a market economy, enterprise managers are not held responsible to artificial, centrally prepared plans. Instead, each private enterprise is free to choose (based on an analysis of the profitability of each contract) which contracts to enter into and which to refuse. Each enterprise is then bound by the provisions of the contracts it signs.

Enterprises must be held legally and economically accountable to each other for the breach of their contracts. Contracting parties should be able to pursue their causes of action against each other in lawsuits brought in the civil courts.

3. *Negotiated Work-Outs*

Just as the state's role in defining the obligations of enterprises will be reduced, so too will its role as the arbiter of contractual disputes. In a market economy enterprises negotiate with each other on how to resolve their credit troubles instead of looking to the central planning committee for alternate goods or funds in the event of a default. Upon an enterprise's default under the provisions of its credit contracts, its creditors will analyze the relative merits of exercising their collection remedies (including placing the enterprise into insolvency proceedings) and negotiate modifications to their credit contracts. Accordingly, an insolvency system for a market economy should implicitly acknowledge and respect the ability of the parties to engage in out-of-court workout discussions.

4. *Personal Insolvencies*

Personal insolvencies raise policy concerns quite different from those raised by enterprise insolvencies. For example, laws governing personal insolvencies need not strive to attract foreign investment. On the other hand, such laws might be more concerned with providing the debtor with a "fresh start," thereby preventing an insolvent person from becoming destitute. Also, personal insolvency laws must address domestic matters—child support and alimony obligations for example.

The law governing personal insolvencies can very well form a part of a single body of insolvency law (that also addresses enterprises), as it does in the United States. Many concepts will apply to both types of insolvency, and separate sections of the law can address the differences. Alternatively, the law could provide a wholly separate system for addressing individual insolvencies, a system that would be less formal, more expeditious, and inexpensive. While the primary focus of this report is the insolvency of enterprises, occasional comments will also be made concerning issues of particular importance for insolvent individuals.

II. Discussion of Specific Provisions of an Insolvency Law

A. General

1. *Purpose*

An insolvency law should set forth the purpose for which it has been drafted and implemented in order to provide a framework for the application and interpretation of its specific provisions. If the objective is to promote efficient operation of the market by enabling creditors to make more knowledgeable investment decisions and by regulating the exercise of creditors' remedies against financially distressed enterprises, so as to facilitate the greatest and most equitable distribution of property among all creditors and employees (leaving the enterprise in business when appropriate), the laws should so state. If a competing objective of providing a "fresh start" for honest debtors exists, this should also be clearly enunciated.

2. *Forms of Relief*

The law should set forth the various forms of relief available: recognition and approval of out-of-court restructurings, liquidation of assets for the benefit of creditors, reorganization of viable businesses (or the viable parts of a business), or state economic assistance when necessary.

3. *Courts*

The law should acknowledge the special judicial expertise required to hear and decide insolvency-related issues. In time the number of insolvencies may be enough to warrant either special courts or specially designated units of the general courts with particular expertise in insolvency matters. In the United States, special courts exclusively adjudicate insolvency matters, and even those courts are overloaded with the volume of matters before them. Further, special insolvency courts will develop expertise in the resolution of insolvency matters through their concentration on the issues involved. Given the significant changes that can be occasioned upon enterprises in insolvency proceedings, a nation may wish to consider whether superior courts should handle insolvency matters. On the other hand, given the likelihood that the number of insolvencies in the early stages of the transition will be substantial, it may be wise to ensure that the judges who are trained in insolvency matters are also trained in other fields. Over time the number of insolvencies will decline, and the judges could then be available to hear other matters.

B. Commencement

1. *Eligible Types of Enterprises*

The insolvency law should contain provisions that govern who is entitled to the protections of the law, who may commence a proceeding, and the mechanism by which a proceeding is commenced. The broader the spectrum of entities eligible for the protections afforded by an insolvency law, the more the law will promote reorganization of enterprises. As a result fewer enterprises will be subject to creditors' unhampered execution on their assets, leaving the enterprises unable to continue operations. On the other hand, certain enterprises (banks or insurance companies, for example) may be so crucial to the financial stability of a market system in general, that separate, more protective systems should be created to govern their financial difficulties. During the transition period, a nation may decide to prohibit the commencement of any type of insolvency proceedings (or restrict the form of relief available) against monopolies or other crucial enterprises until such time as the markets have matured and could withstand the loss of such enterprises.

In some countries (Czechoslovakia, for example), the insolvency laws are available only for merchant enterprises and individuals. If an individual is not engaged in a trade or business, he cannot petition for insolvency protection. This type of law stems from a long-standing belief in some areas that insolvent individuals should not receive a discharge from their debts, and therefore, there is little point in permitting such individuals to file for insolvency protection.

2. *Tests for Determining Eligibility for Insolvency Proceedings*

Beyond deciding which enterprises are eligible for the protections of the insolvency law, a nation may wish to consider setting forth standards that an eligible enterprise must satisfy before it may commence an insolvency proceeding. For example, in many countries, an entity must be insolvent under a defined test (the enterprise's liabilities exceed the fair value of its assets, or the enterprise is generally unable to pay its obligations when they are due), or an entity must have committed an "act of bankruptcy" (such as a preferential or fraudulent conveyance of its assets). Such requirements are designed to ensure that the insolvency law is invoked only when it is truly needed to protect not only the interests of the enterprise's managers and employees, but also those of the enterprise's creditors.

In the United States, on the other hand, the insolvency laws were amended in 1979 to eliminate any standards for most enterprises to satisfy in order to commence an insolvency proceeding. Some argue that enterprises accordingly commence insolvency proceedings not because they need court protection, but as a means to increase their ability to reduce the burdens of their credit contracts. Others argue that the stigma of insolvency proceedings prevents truly unnecessary cases. They also argue that it is more efficient to use a court's time to resolve an enterprise's financial troubles than to determine whether an enterprise is insolvent.

An insolvency law could also require that an entity commence a proceeding within a certain period after becoming unable to pay its obligations. In some countries with such requirements civil and even criminal penalties can be imposed against directors and other persons in control for failure to commence a proceeding in time. Such a requirement helps to guard against enterprises incurring debts that they will probably be unable to pay, but at the same time it can discourage entrepreneurial risk-taking.

3. *Involuntary Proceedings*

Insolvency systems are designed in large part to protect creditors. Accordingly, every insolvency system should afford creditors the opportunity to commence a proceeding against an eligible enterprise if that enterprise is unable to acknowledge the gravity of its situation or is unwilling to act.

There is a wide variety of approaches to the commencement of an involuntary proceeding and to court review of the petition commencing the proceeding. In some systems, such as those of France and Germany, a single creditor can commence a case. In other systems, such as that of the United States, a minimum number of creditors holding a minimum amount in claims must join together. Virtually all systems, using various procedures, afford the debtor an opportunity to contest the commencement of the proceeding.

4. *Government Intervention*

A particularly controversial issue is whether an agency of the government itself should have the power to commence insolvency proceedings against financially troubled enterprises. In the United States various federal and state government agencies have the unilateral power, and in some cases the statutory obligation, to commence insolvency or special receivership proceedings against certain enterprises that engage in businesses particularly dependent on the public trust. Such entities include, for example, banks, savings and loan institutions, insurance companies, securities dealers, stockbrokers, utilities, and municipalities. A few of these entities are eligible for relief under special provisions of the general insolvency laws, but more commonly completely separate and exclusive receivership statutes and administrative procedures apply to insolvency proceedings of the type described. Such procedures are beyond the scope of this article since they are more appropriately addressed in the context of establishment of, for example, banking and insurance regulatory systems.

5. *Conversion or Dismissal of the Proceeding*

Because almost every insolvency is unique, insolvency laws should be sufficiently flexible to accommodate the particular needs of the particular case. An insolvency law should probably provide the courts with the flexibility to convert a case from a reorganization to a liquidation, or vice versa, and the flexibility to dismiss a case if the interests of creditors and the enterprise are better served out-of-court.

Some insolvency systems provide a measure of flexibility by allowing an enterprise to attempt a reorganization before the enterprise, its creditors, or a court decide that reorganization is not feasible. For example, French law allows an enterprise, after filing, to continue operating its business, under the supervision of a trustee and the control of the court. The enterprise operates its business through an observation period pending the drafting and approval of a recovery plan, until the court decides that recovery is not feasible and orders a liquidation.

U.S. law characteristically allows an enterprise or its trustee to convert a liquidation case into a reorganization case. U.S. law also allows a court to dismiss a case altogether for cause—whether the case is a liquidation case or a reorganization—if dismissal is required to prevent abuses or to protect creditors' interests. The law in the United States even authorizes a court to abstain from exercising jurisdiction or to suspend a proceeding if dismissal or suspension would better serve the interests of the enterprise and its creditors. The same is true if a foreign insolvency proceeding can provide a better forum for administering the assets of the enterprise and processing the claims of the creditors.

C. Management and Committees

1. *Management*

a. Administrators

In most insolvency systems a court-appointed or creditor-designated administrator (also variously called a trustee, liquidator, or receiver) automatically assumes control of the enterprise upon the commencement of an insolvency proceeding. The administrator is often a specially trained, specially licensed expert who deals exclusively in insolvency matters and is expected to provide an independent and knowledgeable assessment of the prospects for the insolvent enterprise. The administrator can be an accountant, lawyer, economist, or experienced businessperson. The administrator's profession is less important than is his or her ability to undertake an independent evaluation of the most appropriate course of action for an insolvent enterprise. Administrators should have the ability (and will likely exercise the ability fairly often) to retain the existing managers of the enterprise, but they should also be empowered to replace those managers if and when appropriate.

The administrator will be the senior manager of the insolvent enterprise, ultimately responsible for all decisions of the enterprise during the course of the insolvency proceeding (subject to court supervision to ensure that the administrator properly performs his or her duties). In liquidation cases the administrator will oversee the sale of the enterprise's assets and the collection and distribution of the proceeds among the creditors. In reorganization cases the administrator will oversee the formulation of the reorganization plan, the attendant negotiations with creditors, and the implementation of the plan. In all cases the administrator (or his or her appointed representative) will represent the enterprise before the court.

In the British Commonwealth countries (and some other jurisdictions as well) the administrator can be the appointee of a private creditor who holds a special type of lien covering substantially all of the enterprise's movable assets. In that event the administrator (called a receiver) will normally liquidate the secured creditor's collateral for the creditor's benefit and turn over any excess proceeds either to the enterprise or to a second administrator for distribution to the enterprise's unsecured creditors. Many countries have begun to impose duties of "good faith" and "commercial reasonableness" upon privately appointed administrators in order to ensure that they observe accepted standards of commercial conduct in the fulfillment of their obligations. These duties are designed to benefit other creditors of the enterprise. They can require, for example, that the administrator attempt to obtain the highest price for assets sold, thereby increasing the likelihood that funds will be available for distribution to other creditors after the secured creditor has been repaid.

A matter having nothing to do with the law, but everything to do with the practical success of insolvency proceedings, is the availability of qualified individuals to serve as administrators. Initially, few people in an emerging market economy may be qualified or experienced enough to serve as administrators. A short-term solution is for the government to constitute an administrative agency whose employees will serve as administrators. Nevertheless, there is often a substantial concern (legitimate or not) in market economies that government employees will be more interested in furthering political objectives than in seeking practical business solutions. A further concern (again, which may well not be legitimate in all circumstances) is that relatively underpaid government employees are less likely to devote the necessary time and attention to administrator appointments than are privately compensated (and, thus, economically motivated) insolvency specialists. An exception may occur in situations in which the government provides financial assistance to the insolvent enterprise. In that event there is less legitimacy to the argument that the government should not participate in the management of the enterprise.

Another possibility in the short term is to utilize the services of qualified foreign administrators on the condition that they involve, and provide substantial training and experience to, local administrator candidates. In the long term, however, a group of experienced domestic insolvency practitioners eminently qualified to take on administrator appointments will inevitably emerge. (One of the tenets of capitalism is that a demand for a service or product results in the development of an industry willing to supply that service or product for the right price.) Ultimately, this group will divide itself into smaller groups with specialized expertise in particular industries and types of industries.

b. Debtor in Possession

Many countries provide for circumstances in which the laws permit existing management of an insolvent enterprise to remain in control of the business without the interposition of a supervising administrator. In practice, however, such an arrangement seldom occurs.

In the United States, on the other hand, it is the rule rather than the exception in reorganization proceedings that existing management remains in control as the "debtor in possession." (In straight liquidations an administrator is automatically appointed, however.) This practice has a number of reasons, many of them having to do with historical and cultural precedents unique to the United States. Most other countries, with their own differing business climates and harsher societal attitudes toward insolvent enterprises, have remained reluctant to adopt the debtor in possession approach in a meaningful way.

2. *Committees*

Often, it is impractical and too costly for individual unsecured creditors and employees to participate actively in an insolvency proceeding in order to improve their prospects for recovering on their claims. Meaningful participation often requires the retention of a lawyer familiar with the insolvency laws. Individual creditors and employees often conclude that their time and money can be better spent in pursuing more productive possibilities outside of the insolvency court. To address the concern that small creditors are unfairly excluded from the insolvency system due to the time and expense involved, most insolvency laws permit the formation of creditor committees or the appointment of creditor representatives to represent the interests of the unsecured creditor body as a whole. It may also be appropriate, particularly in the context of labor-intensive enterprises, to form employee committees or appoint employee representatives to ensure that the rights of the enterprise's employees are appropriately safeguarded. Finally, a nation may wish to consider providing for the creation of a "committee of inspection" that would represent the interests of all creditors and employees in the administration of an insolvency proceeding rather than creating several committees for each case. The policy considerations supporting the creation of creditor and employee committees are more significant in reorganization proceedings than in straight liquidations. In the latter case the proceeding often involves little more than the quick sale of the enterprise's assets, presenting fewer issues affecting employees' and creditors' recoveries.

D. Stay of Creditor Actions

1. *Imposition*

Upon the commencement of an insolvency proceeding, the law should provide for a stay of further creditor action against the insolvent enterprise. The stay provides creditors with the assurance that, from the date of the stay forward, similar creditors will receive similar treatment without having "to race to the courthouse" to enforce their rights. The stay is also designed to afford a business an opportunity to examine its financial troubles without having to defend against creditor action.

Such a stay may be effective automatically or may take effect upon the entry of a court order, which order itself may be required or discretionary. An automatic stay allows an enterprise to focus more quickly on its financial troubles because the enterprise does not have to litigate whether a stay need be imposed generally or defend against particular actions. Generally speaking, an automatic stay is preferable from an administrative point of view as well because it avoids the issue of whether particular creditors have received actual notice of the imposition of a stay (often a problem area with discretionary stays issued pursuant to specific court orders).

2. *Scope*

A stay may extend to as much or as little creditor action as a nation deems appropriate. In some countries virtually all creditors, including secured creditors, are bound by the stay. In other countries unsecured creditors are stayed, but secured creditors may continue to pursue their collateral as though the insolvency filing had not occurred. The latter can effectively undermine many reorganization attempts, unless the secured creditors consider continued operation of the business to be in their best interests, as the secured creditors often have liens against assets that are crucial to the enterprise's continued operations. If, however, secured creditors are also stayed, the law should make clear that the secured creditor does not lose its security interest, but is only prevented from enforcing it during the pendency of the insolvency proceeding.

3. *Duration*

If the stay applies to secured creditor actions, it should remain in place for a reasonable period of time, sufficient to allow the parties in interest (or the court, if necessary) to assess the financial troubles of the business. In the case of a liquidation the stay should prevent unsecured creditors from taking any action, without the approval of the court, against any of the enterprise's property during the pendency of the case. In the case of a reorganization the stay should remain in place until a plan of reorganization has been approved and its provisions made effective.

4. *Relief*

If the stay is to apply to secured creditors in reorganization cases, the law should permit the secured creditors to seek relief from any stay that is imposed. Such relief, whether to pursue an action against the enterprise or against its property, could hinder the enterprise's ability to focus on its financial troubles.

Accordingly, the law should require the secured creditor to demonstrate that the detriment to the creditor occasioned by the stay materially exceeds the detriment to the business (and its estate) in litigating with the creditor, or that the property against which the creditor wishes to proceed is unnecessary to the continued operations and attempted reorganization of the business.

E. Estate

1. *Property that the Enterprise Holds*

Upon the commencement of an insolvency proceeding an estate should be created that consists of the property of the enterprise. The estate should include all interests of the enterprise in any property (except exempt property, described below), wherever it may be located, as of the date the case is begun. The estate should be defined broadly to include as much property as possible so as to maximize the distributions to creditors and employees.

In many countries the law permits a creditor to provide business with the possession and use of property while retaining title to the property in the name of the creditor. In those countries property subject to such "retention of title" agreements is considered not to be property of the enterprise in the first instance, and therefore not subject to the stay. In the United States, however, the implementation of a central filing system resulted in the elimination of retention of title arrangements. The concern was that to uninformed creditors assets subject to a retention of title agreement would appear to belong to the business and therefore be available to satisfy the creditor's debt. Now, the important focus in the United States is whether the creditor has properly recorded an interest in the property in question, not whether title to the property nominally remained with the creditor. (This is not meant to preclude true lease transactions, however, where the property is expected to have a material economic value at the end of the lease term and the business is contractually required either to return the property to the creditor or to pay to the creditor the remaining fair market value of the property.)

2. *Exemptions*

Whatever the extent of the insolvency estate, a nation may wish to exempt certain property from this estate. Certain property may be necessary (especially in cases of insolvent persons) for a fresh start. Without such exemptions, insolvent persons would be left destitute and unable to begin again, something an insolvency law should not permit. Examples of the types of property a nation may wish to exempt for individuals include household furnishings, clothing, books, animals, crops, or musical instruments. Perhaps certain property used in a trade (books, tools, etc.) should also be exempt, as should other property (such as religious or ancestral items) that may have special significance.

There is less need to exempt property from the estate of an insolvent enterprise. Still, if during the transition period crucial enterprises are subjected to insolvency proceedings, certain assets such as land, buildings, and equipment could be exempted as a means of ensuring that the enterprise is not liquidated.

3. *The Estate's Causes of Action*

In some instances creditors would be well served if the law permitted the administrator (or debtor in possession) to pursue causes of action against other entities. For example, in the days leading up to the commencement of the insolvency proceedings the enterprise may have paid some creditors and not others, often because the preferred creditors were more diligent or aggressive in pursuing recovery on their claims or had a special relationship to the enterprise (an affiliated enterprise, for example). In hindsight, the enterprise and its remaining creditors would have been better served if the enterprise had commenced insolvency proceedings earlier, rather than preferring some creditors over others. Had the enterprise done so, the payments would have been available to help finance the reorganization of the enterprise. In a liquidation scenario the payments would have been available to be shared equally among all the unsecured creditors.

On the assumption that the enterprise made the payments at a time when it was approaching insolvency, an insolvency law should allow the enterprise's estate, once in insolvency proceedings, to recover any such payments that preferred some creditors over other creditors. The law should only permit such a recovery for relatively recent preferential transfers, made within several months or so (no further back in time than the presumption of insolvency can reasonably be extended) before the commencement of the insolvency proceeding. The recovery period can be established by statute, for example, six months for ordinary payments and one year for payments made to creditors with special relationships to the enterprise. Alternatively, the court can, in hindsight, pick the date within the prior one or two years on which it became apparent that the enterprise was, in fact, insolvent.

In the days leading up to the commencement of the insolvency proceedings, the enterprise may have also transferred property to another entity in a fraudulent effort to conceal its assets from its creditors. An insolvency law should allow the enterprise's estate to recover such transfers for the benefit of creditors. In determining whether any transfer was fraudulent, a court can examine the enterprise's actual intent. If the value of the property the enterprise received in exchange for the transfer was disproportionately small when compared to the value of the property the enterprise transferred, the court could infer an intent to defraud. If the value of the enterprise's assets remaining after the transfer is disproportionately small when compared to the amount of the enterprise's debts, again the court could infer an intent to defraud.

Finally, an insolvency law might empower the enterprise's estate to avoid the granting of security interests in the enterprise's property that were not properly recorded at the commencement of the insolvency proceeding. Similarly, it could avoid the creditor's security interest in pledge or retention of title transactions when the transaction was not properly documented.

F. Claims

1. *Proof*

Every insolvency system is designed—at least in theory—to protect creditors, and every insolvency system is designed—again, at least in theory—to provide an efficient and economic means for the administration of the affairs of an insolvent enterprise. Accordingly, every insolvency system has procedures for creditors to prove their claims against the enterprise, so they can share in the recoveries from its assets.

Two methods are available for handling creditors' claims: (1) require the enterprise to disclose the amount and the nature of its obligations to its creditors; (2) require the creditors to register their own independent proofs of claim. Different countries have adopted different combinations of these two methods, and may even have different procedures for different kinds of insolvency proceedings (liquidations or reorganizations).

Most systems allow filing or registration of claims by mail in order to expedite the administration of the enterprise's affairs and reduce the inconvenience to creditors who do not have easy access to the court. Further, most systems provide standardized proof of claim forms that are simple enough so that individuals can fill them out without professional advice. The standardized form requires the inclusion of certain basic information (subject to fraud penalties if the creditor knowingly includes false information) so that the administrator can make an intelligent assessment of the validity of the claim merely by reviewing the completed form.

All types of creditors should probably be permitted to file proof of their claims, whether for a fixed amount of debt or for claims that have yet to be determined or fixed in amount (such as claims for breach of contract or tort). The law should provide a means for estimating those claims that are not yet determined or fixed in amount, so that the claim is treated as if it were for a certain amount for purposes of distribution under a liquidation or plan of reorganization.

The time for filing proofs of claim varies greatly from system to system. Some systems do not set any final deadlines. In Australian insolvency cases the administrator gives notice of his or her intention to pay a dividend to creditors. Creditors that fail to file a proof of claim after receipt of that notice are barred from participation in that dividend. They can still participate in future dividends, however, by later filing proofs of claim.

The time for filing claims should be short enough to allow for reasonably speedy administration of the case, but long enough for creditors to receive actual notice of the case, fill out their forms, and deliver their forms to the court by mail or by person. Local authorities should set the time in light of practical considerations such as the quality of mail service, the availability of copying machines to produce copies of debt records or supporting documentation, and delays that might be required to translate documentation if local law requires that legal documents be written in the local language.

2. *Secured Claims*

Secured lending is a key component of the credit system of any market economy, and the extent to which secured lenders are affected by insolvencies and insolvency laws can affect the availability and price of secured credit. The rights of U.S. enterprises to stay foreclosures by secured creditors or to rewrite obligations to secured creditors in reorganization plans is a key difference between the U.S. system and the systems of most other English-speaking countries. Many practitioners in English-speaking countries are loath to encourage the spread of these concepts outside of the United States.

The threshold question regarding allowance of secured creditors' claims is whether they need prove their claims at all. If an insolvency system otherwise leaves secured creditors free to liquidate their collateral without restraint by the enterprise or the insolvency court, there is little reason to require every secured creditor to prove its claim unless (1) the enterprise or other creditors dispute the validity of the debt or the rights to the security, or (2) the secured creditor intends to share in the proceeds of the enterprise's unpledged assets as a partially secured creditor or an unsecured creditor.

As to the first issue, if the administrator or another party objects to the secured creditor's claim or assertion of a security interest (because it was improperly documented, for example), the court can hold a hearing to resolve the objection. Pending resolution of such a hearing, the court, as a practical matter, will need to be empowered to stay the secured creditor temporarily from exercising its rights against the collateral. Accordingly, any such objection should be resolved quickly.

As to the second issue, if secured creditors are not required to file proofs of claim if they are fully secured (the value of their collateral is at least equal to the amount of their claim) or willing to defer from sharing in the proceeds of the sale or use of unsecured assets, an insolvency law will still have to provide procedures for dealing with the undersecured creditors (the value of their collateral is less than the amount of their claim) and the secured creditors that are willing to surrender their security in exchange for being allowed to participate in the insolvency proceeding. Secured creditors that are partially secured or that have surrendered their collateral can be required to file claims for the balance of their debt remaining after accounting for the net amount that they received, if any, from the sale of their collateral. Administrators may or may not be granted the right to redeem collateral for the values estimated by their secured creditors if the secured creditors file proofs of claim.

3. *Privileged Claims*

Although every insolvency system is designed to protect creditors' interests by treating creditors equally, every system provides that some creditors are "more equal" than others. Therefore, certain kinds of claims are paid in full before distribution of the balance of the assets available to nonprivileged unsecured creditors.

The amounts of claims that are entitled to privilege, and the relative priorities of privileged claims among themselves, vary from system to system. Nevertheless, almost every system affords a measure of priority to the costs of the insolvency proceeding itself. Indeed, some systems actually dismiss the proceeding unless the assets are sufficient to pay the costs of the proceeding. Employee claims and domestic (as opposed to foreign) tax claims also usually receive priority. In Czechoslovakia, for example, a first privilege (after expenses of the insolvency administration itself) is reserved for the rights of employees accrued within three years prior to the insolvency proceeding; a second privilege is reserved for taxes, customs dues, national insurance contributions, and the like, accrued within those three years. A few other systems also grant priority to tax claims from other countries, and to other favored groups such as consumers that left deposits with the enterprise, or local farmers and fishermen. Belgium, on the other hand, allows no privileges for any unsecured claims of any nature incurred prior to the commencement of the proceeding.

Commercial law in some countries may also provide hidden privileges to employees or tax claimants. Often, secured creditors holding liens on all of the assets of an enterprise—the "blanket lien" or the "standard mortgage debenture"—pay outstanding employee wage claims from the proceeds of their collateral before applying the proceeds to their debts. By the same token, lenders in the United States with mortgages on office buildings or hotels effectively take their collateral subject to real estate taxes, which are generally a lien on the real estate in question with priority over any private mortgages (even if the real estate taxes accrued after the creditor's mortgage was recorded).

Consideration may be given to placing a ceiling on the amount of employee and tax claims entitled to privileged treatment. If the number of employees is substantial, or if the tax arrearages are significant, often nothing is left over for unsecured creditors unless the employee and tax claims are statutorily limited.

The privileged claims can be equal among themselves, or, as in the current Czech law, the distribution can be hierarchical. That is, the claims in one privileged class are entitled to be paid in full before the claims in the next lower privileged class become entitled to any distribution. If the funds are insufficient to pay a privileged class in full, the claims in that privileged class share the available funds on a pro rata basis. The claims entitled to privilege and the structure of the privileges will depend on the policy decisions of the lawmakers. While it is politically tempting to provide unlimited privilege to employee and tax claims, it must be kept in mind that such a system will factor into the credit analyses of potential creditors when they assess the likelihood of recovery on their claims in the event of an insolvency. Accordingly, it might make sense to limit the claims that will be afforded a priority or not to afford a priority to the claims at all.

4. *Allowance*

Any insolvency system must have a method for reviewing claims that are made against the estate to assure that all creditors receive their fair share of the assets either in a liquidation or a reorganization. The allowance process raises several issues: the legal effect of a proof of claim; who has the right to object to a claim; the time limit for objecting to a claim; who determines the validity of a claim; and the ground rules for a hearing on the validity of a claim.

There are many possible resolutions to these issues. Some systems provide that a properly completed proof of claim is prima facie proof of the validity of the claim; others leave the question open. Some systems allow the enterprise, or any creditor or party in interest to object to a claim; others provide for the administrator to review claims and reject claims considered improper. Furthermore, some systems do not set a time limit for objecting to claims, while other systems contemplate or require objections within certain time frames.

In some systems the assertion of an objection will automatically result in a court hearing to resolve the objection. In administrator-oriented jurisdictions the administrator is often empowered to reject the claim, and the creditor must specifically request a court hearing if the creditor wants to overturn the administrator's decision.

The general ground rules for a hearing on the validity of a claim will depend in large part on the general procedural law of the country in question. For example, legal procedures in all of the English-speaking countries are governed by common law notions of due process. Due process requires fair notice of a legal action that could affect one's rights and an opportunity for a fair hearing on that proposed action, with rights of appeal under certain circumstances. The subject of due process goes far beyond the limited questions of disputes about claims in insolvency proceedings because due process is central to an effective legal system in any free market economy. Any insolvency law will function more smoothly if it incorporates due process protections into the insolvency court system.

G. Discharge

The discharge of its debts is one of the principal goals of an enterprise or merchant entering a reorganization proceeding. Most insolvency systems afford some measure of discharge. However, the kinds of debts dischargeable and the procedure for obtaining a discharge vary widely from country to country.

To take these issues in reverse order, some countries provide for an automatic discharge of all debts—except those specifically excluded by law—unless creditors take affirmative steps to restrict or deny a discharge. Other systems require the enterprise to apply for a discharge after the commencement of the case. Australian law covers both bases. It automatically discharges a bankrupt individual three years after the filing, while affording the individual an opportunity to apply for an earlier discharge following the meeting of creditors. The bankrupt's discharge may be significantly delayed, however, if the individual is found to have been dishonest.

The grounds for objecting to a discharge are more consistent from place to place. Most countries will bar a discharge if the enterprise has not kept adequate books and records to explain its losses; has concealed or destroyed its books and records; was engaged in reckless speculation; was engaged in fraud; or has recently been the subject of another insolvency proceeding. Some countries also grant a discharge only if the enterprise's assets are worth at least some percentage of the amount of its liabilities, unless the enterprise can prove that its financial problems arose from circumstances beyond its control.

U.S. law provides an alternative to outright denial of a discharge by allowing creditors either to object to a discharge in general or to the dischargeability of a particular claim. An enterprise could thus be guilty of fraud in the United States and receive a discharge of all claims other than the claim arising from the fraud.

Many countries draw distinctions between the discharges available to different kinds of enterprises and discharges available under different kinds of insolvency proceedings. For example, U.S. law denies discharges in liquidations unless the debtor is an individual. However, it allows an enterprise to discharge debt under a plan of reorganization if that enterprise will continue operations after confirmation of the reorganization plan.

Different countries have different policies on nondischargeability of specific kinds of debts. A nation might decide to except from discharge: any claims against the enterprise for fraud (if the fraud is proven) in order to discourage fraud; claims for alimony or child support in order to ensure that the divorced can support themselves and their children; claims for fines in order to enforce the criminal laws; and claims for taxes in order to prevent enterprises or persons from escaping their obligations as citizens. Further, in order to ensure an enterprise's compliance with the provisions of the insolvency law, the law can provide that an enterprise will be denied a discharge generally if it violates the law.

H. LIQUIDATION

Liquidation proceedings are little more than the collection and sale of the enterprise's assets and the distribution of the proceeds to creditors according to the priorities established by the insolvency law. In the event that the insolvent is a person, and the policy is to permit a "fresh start," the person will receive a discharge from the debts on which he or she was liable before the commencement of the proceeding. Whether an enterprise receives a discharge in a liquidation proceeding is irrelevant because the enterprise will have been dissolved and, in any event, will have no remaining assets to apply in satisfaction of creditors' claims.

As noted above opinion may legitimately differ on whether it is more appropriate to appoint an administrator or to leave existing management in control in a reorganization case. Little dispute exists, however, that the appointment of a administrator is appropriate in straight liquidation proceedings. Most persons and enterprise managers will not be experts at collecting and selling assets pursuant to the insolvency law and distributing proceeds according to relevant priorities. Accordingly, the creditors or the court should be able to select capable administrators to oversee the liquidation.

The administrator can be made responsible for preparing lists of creditors, a schedule of assets and liabilities, and a schedule of income and expenditures that the enterprise would otherwise have to file. The administrator should then be required to examine potential causes of action against other entities, decide which ones are worth pursuing, and prosecute them. Further, if it makes sense, the administrator should have the power to operate the enterprise's business for a limited period of time until the assets can be sold. The administrator should coordinate the sales of the various assets and collect the proceeds. Finally, the administrator should distribute the proceeds to the various creditors according to the priorities set forth in the law.

After the distribution the person or enterprise should be discharged from its debts (if permitted by the law) and the case should be closed. The administrator should file a final report describing the assets sold, the amounts for which they were sold, and how the proceeds were distributed. In cases where the enterprise has essentially no assets, a nation may wish to consider whether the law should require the government to fund an impartial investigation of the enterprise.

I. Reorganization

A reorganization proceeding can be divided into two parts: (1) operation of an enterprise's business after the commencement of the proceeding, and (2) the development and implementation of a plan (also called a scheme or a proposal) to restructure the enterprise's operations and debts. An insolvency law should address both parts in order to ensure that the enterprise is operated in a way that minimizes financial losses during the case, and that the plan of reorganization has the approval of as many creditors as possible. The law should also require the reorganization plan to provide those creditors who do not approve of the plan with a distribution no smaller than the law specifies.

1. *Operation of the Business*

a. Use of Property

Ordinarily, a reorganizing enterprise should, under the supervision of a administrator (or the debtor in possession if considered appropriate), be authorized to continue to operate in the ordinary course of its business without a great deal of court or creditor supervision. The enterprise should be able to continue to deliver its products or services, collect payment, and pay its ordinary bills. To require court or creditor review of each business decision would be cumbersome.

It would also reduce the efficiency of the business to the detriment of the estate and its creditors.

Creditor and court review should be limited to actions proposed by the administrator that are not in the ''ordinary course'' of the enterprise's business, for example, a sale of some assets. Creditors should have the opportunity to review any proposed extraordinary action and voice to the court their views about the wisdom of such actions. This type of creditor review would apply only to court-appointed administrators, since privately appointed administrators by their nature act at the behest of secured creditors to liquidate the creditor's collateral. Further, if the administrator's proposed action concerns property of the estate, and a creditor has an interest (a security interest for example) in that property, that creditor should receive some assurance that its interest in the property will be protected. If, for example, the administrator proposes to sell property in which a creditor has a security interest, the creditor could receive an interest in the proceeds of the property as a replacement.

b. Credit

Because credit is crucial to most enterprise's operations, and especially those of a financially troubled enterprise, a reorganizing enterprise ought to be able to obtain credit. So long as such credit is unsecured and incurred in the ordinary course of the enterprise's business, the enterprise ought to be able to obtain such credit without the approval of creditors or the court. In order to encourage others to continue to do business with the insolvent enterprise, claims on account of such credit should be afforded a priority in the enterprise's eventual plan of reorganization.

If, however, the enterprise requires more credit, and the administrator can find a willing lender, the law should provide the administrator with the ability to obtain more credit. Available lenders will probably insist on a security interest in some or all of the business's assets. Some lenders will further require that their security interest be senior to any other security interests in the property. Accordingly, the law should provide the administrator with the ability to grant such security interests, so long as other creditors who have an interest in the property to be pledged receive some protection of their interest. For example, if an administrator grants a security interest to a new lender that is senior to another security interest, the administrator might pay an appropriate sum of money to the holder of the older security interest. Such a payment would prevent the aggregate distribution to that creditor from being diminished.

c. Contracts

The general contracts (for example, contracts for sales, purchases, and services, or leases) to which a reorganizing enterprise is a party may, in addition to its credit contracts, be a source of difficulty for the enterprise. An insolvency law should thus permit an enterprise to examine its contracts and decide whether those contracts will be honored or repudiated by the enterprise. An administrator should have the ability to decide that certain of its contracts are no longer beneficial to the business and simply repudiate the enterprise's obligations under those contracts. The other parties to such repudiated contracts should be able to claim damages against the estate on account of the repudiation.

If, on the other hand, the administrator decides that a given contract is important to retain, the administrator should have the opportunity to assume such contract and the obligations that go with it. The insolvency law can set a deadline by which the administrator must decide whether it will repudiate or assume contracts. It may be appropriate to allow the administrator to make such decisions through the date a plan of reorganization is confirmed. At that time, the administrator will know better which contracts the enterprise requires and can perform.

2. *Plan of Reorganization*

Soon after the commencement of a reorganization proceeding, the administrator should begin to prepare a plan of reorganization. The plan should classify the claims against the estate; specify the treatment to be afforded the various classes (how the enterprise will pay the various claims); identify which contracts are repudiated and which assumed; and establish the means for implementation of the proposed restructuring.

The law should address who may file a plan of reorganization. Certainly the administrator ought to be empowered to do so, but creditors (and even employees) might also be so empowered. The ability to file a plan and solicit votes is a powerful negotiating tool. Accordingly, perhaps the administrator could be afforded a period during which no other party may submit a plan for consideration. Creditors might be able to file plans if the administrator proves incapable of proposing an acceptable plan.

Once a plan has been prepared, all parties in interest ought to have the opportunity to vote on the plan. The law should describe how votes are to be registered and the percentage of the claims that must approve the plan before it will be considered approved.

III. Conclusion

This discussion of an insolvency law, its purposes, implementation, and provisions is a mere overview of major issues that emerging market economies are likely to encounter as they implement their transitions. This article is designed primarily to highlight the more significant issues relevant to an insolvency system and is not intended to serve as a recommendation to implement any particular policy or system. Before specific recommendations can be made, a nation will have to make an informed judgment as to the major policy objectives that it wants to accomplish through its insolvency laws. Then, with the policy considerations firmly established, a nation can undertake to draft the specific provisions of an insolvency law designed to promote the selected policies.