EFFECTIVE INSOLVENCY SYSTEMS

Issues Note on Insolvency Representatives (Principle D8)

(Draft discussion paper)

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This paper constitutes a work-in-progress, containing analysis and proposed guidelines to review issues related to the general regulation of insolvency representatives. This document is likely to undergo further refinement based on ongoing discussions.
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I. INTRODUCTION

1. Insolvency representatives\(^1\) are a key part of an effective insolvency system. In the vast majority of jurisdictions, the importance of the functions undertaken by the insolvency representatives cannot be overestimated: they relate to issues pertaining to the determination of estate and its administration and/or liquidation; their role is often intrinsic to the search, process, analysis and presentation of information to the stakeholders (private or public); and they normally provide important assistance to the court or the authorized body in procedural matters. In short, they cover almost every aspect of the insolvency process, and, as it was famously stated more than a century ago, *the question about the design of insolvency representatives is the question about the destiny of the insolvency process.*\(^2\) The World Bank Principles for Effective Insolvency and Creditors’ Rights Systems include two principles that refer – directly or indirectly – to the regulation of insolvency representatives: D7 relates to the *Role of Regulatory or Supervisory Bodies* and D8 sets the standards of *Competence and Integrity of Insolvency Representatives.* This Note details elements of both, although it predominantly elaborates on the latter,\(^3\) a Principle that embodies topics elastic enough to define the entire scope of the legal institution.

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\(^1\) Different jurisdictions use different terms for those appointed to administer insolvencies – trustee, liquidator, administrator, supervisor, receiver, receiver and manager, curator, official or judicial manager, commissioner, promoter, etc.; and some use the collective term insolvency practitioners. For the purposes here, the terms *insolvency representative* and *insolvency administrator* are used.

\(^2\) V. Ernst JAEGER, *Konkursordung Grosskommentar*, 1901.

\(^3\) *Competence and Integrity of Insolvency Representatives (World Bank Principle D8)*

The system should ensure the following:

- Criteria as to who may be an insolvency representative should be objective, clearly established, and publicly available;
- Insolvency representatives should be competent to undertake the work to which they are appointed and to exercise the powers given to them;
- Insolvency representatives should act with integrity, impartiality, and independence; and
- Insolvency representatives, where acting as managers, should be held to director and officer standards of accountability and should be subject to removal for incompetence, negligence, fraud, or other wrongful conduct.
2. In principle, the insolvency representative must have only one overriding aim, albeit a complex, multi-sided one: to translate to reality the policy choices made by the insolvency Law of the country. An effective system of insolvency representatives would seek to ensure the appointment of persons that are technically skilled and independent from both the debtor and its creditors, in the context of a system which was transparent to stakeholders and enabled insolvency representatives duly to be held accountable for decision, acts, and omissions.

3. There are many different ways to achieve this difficult aim. The following note includes a brief description of the possible models of insolvency administration. A model of insolvency administration comprises at least the following key features: 1) the “subjective” (i.e., personal) characteristics of the candidates (who can be appointed); 2) the system of selection and appointment of the candidates (who makes the selection); 3) the structure (number of insolvency representatives who could or must be appointed in a proceeding); and 4) the system of remuneration. In addition, the following will briefly address other relevant issues concerning the regulation of insolvency representatives, including the nature of the duties to which they may be subject (duty of care, duty of loyalty), the systems of control of their professional activity (both for each proceeding and their general activity) and, finally, the accountability and liability of insolvency representatives.

II. THE MODELS OF INSOLVENCY ADMINISTRATION

1. COMPETENCE

4. An insolvency representative should be expected to be competent to undertake the work for which s/he is appointed. Thus an insolvency representative should be expected to maintain appropriate levels of knowledge of, and experience in, the administration of insolvencies, and to engage on an ongoing basis in continuing professional development.

5. The types of insolvency administration that have existed in different times and countries could be classified in accordance with two general models: a public model and a private/professional model.4 The former is far less common than the latter. However, they both have advantages and disadvantages.

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4 History shows that, theoretically, there are also two other possible models: a system of insolvency administration composed of creditor(s) and a system of free appointment. However, the practical application of these two models has shown that the original design ends up as a general private/professional model. The model of insolvency administrations composed of creditors has been
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(a) The “public model.” According to a pure “public model,” insolvency representatives are specialized public servants who are integrated in the country’s public administration. A properly designed model of “public” insolvency administration has *prima facie* the following advantages: a) a body of technically skilled public professionals can be created by the State, by means of a publicly organized and conducted examination (although this feature is not exclusive to the public model); b) in the majority of cases, there would be no (or limited) cost for the insolvency estate (again, there are some cases of state employment but with private funding, either by individual creditors or by the insolvency estate); c) insolvency representatives could benefit from all the information available to public authorities (information gathered through the years by the tax authority, reports on the solvency of debtors held by the central bank, etc.) and avail themselves of public resources (i.e. the infrastructure of State attorneys, etc.); and, finally, d) the fact that insolvency representatives are civil servants, who get paid from the public budget (or with strict controls as to remuneration from private sources) and are banned from conducting other professional activity places them in a position where conflicts of interest are more difficult to occur and may be more easily controlled.

The disadvantages of a “public” insolvency administration are also many. The scarce use of public models in international jurisdictions may be an indication that the costs outweigh the benefits. To the extent that public models imply the use of public funds in private affairs, this constitutes state aid (to the debtor, to its creditors, or to both) and amounts to the *pro tanto* externalization of the costs of distress resolution, and hence of credit, to the public purse; the model will share the inefficiencies of a country’s public sector and the total outcome may be more costly than in a private system with a reasonably functional market; the

the most common model in history, from the medieval city-states of Italy until some XIX-century continental European and Latin American legislations. Only in rare occasions did creditors actually perform the duties of insolvency representatives in the proceedings, for they had their own duties. They appointed legal experts or accountants to represent them and execute the task (therefore making a professional model out of an initial creditors only system). The “open appointment” system would be one in which the court or creditors could appoint anyone they thought fit. In those countries where the judge had the choice, a need was felt to have a list from which the court could elect; and in order to join the list, some criteria had to be included, criteria that almost invariably included subjective qualification. On the other hand, if the choice was up to the creditors, they tended to appoint experts in the matter. Both situations, therefore, ended up as private/professionals systems.

The body of public insolvency representatives would be typically integrated in the Ministry of Economy/Finance or be part of the judiciary; alternatives include affiliation with local or regional departments.

The public model may also be used to patch for the flaws of a private model. Typically, public receivers have been appointed to wind up those companies that did not have enough to even cover for the procedural costs associated with insolvency.
model will also share other defects of a country’s public system, such as – possibly – lack of integrity, excessive bureaucracy, insufficient incentives to engage in continuing professional development, lack of responsiveness to stakeholder needs and absence of effective accountability to them; and, finally, there is a risk that public insolvency representatives, who might be part of the hierarchical system of a given public administration, will take decisions based on political opportunism or on considerations unrelated to the optimal treatment of the insolvent estate (for example, avoiding redundancies even if they would seem reasonably necessary to save the business).

(b) The “private model.” The private model of insolvency administration can take different shapes. The purely professional model is one consisting of insolvency representatives that are grouped into self-regulatory bodies, that set the requirements for joining them and that organize access to their service according to technical standards, thereby exercising a monopoly on entry in the profession. Another variant would grant access to the insolvency profession to members of pre-existing bodies of lawyers and/or accountants, often by establishing further eligibility requirements. These two models may themselves have further variations. The bodies of insolvency representatives may be private or have a semi-public side, and it is also possible that the State assumes the organization or the supervision of a national exam to qualify professionals to act as insolvency representatives.

In the private/professional model, insolvency representatives may come from a range of backgrounds, provided that they are able to demonstrate their competence – either generally or in relation to particular types of insolvencies. Thus, an insolvency representative may be a lawyer or accountant; hold a degree, such as in economics or business administration; have a specialization, such as property or business management; have passed insolvency examinations; and/or have experience relevant to insolvency. Competence would generally be assessed or confirmed by evidence of educational and/or professional qualifications, examinations and/or experience, which may be supplemented by some form of test or interview, and the testimony of credible individuals, organizations or institutions.

A model of professional insolvency representatives should also address the question concerning the eligibility of legal entities to act as insolvency representatives. From the point of view of the resources available to perform the tasks, professional legal entities may reach a bigger size and benefit from internal specialization, creating synergic effects. Further, they would tend to favor the transfer of experience and know-how and might arguably be more stable (not being susceptible to possible events such as illness or death). However, legal persons make control of conflicts of interest and the monitoring of a representative’s performance more difficult. There is also usually a loss of the personal relationship of trust and confidence between
the court and the representative that is the hallmark of some systems; and, in countries with an underdeveloped system of liability, it may bring along abuses of the corporate veil.\(^7\)

2. THE APPOINTMENT OF INSOLVENCY REPRESENTATIVES

6. The decision on who has the final word on the insolvency representative’s appointment is an important part of the model. The choice can be made by: a) the court (or a public agency in charge of insolvency matters); b) the parties (especially creditors); or c) there can be a mixed model, according to which the court initially appoints an insolvency representative but later creditors may replace him/her by another individual of their choice, or where a stakeholder (creditor or the debtor’s managers or shareholders) make the appointment but other stakeholders have the right to ask the court to appoint a substitute.

(a) A purely court-based decision making process can be quick and efficient.\(^8\) If properly designed, it may ensure that an independent, sufficiently qualified person is appointed from the start of the proceedings. The appointee’s position does not depend on the debtor or its creditors. These features explain why court-based appointments can be regarded as an effective instrument to achieve an “aseptic” (unbiased), technically-qualified model of insolvency administration. This system, however, when based on the discretionary decision of the judge, may create a situation in which appointments tend to be concentrated in a few individuals, and is not always adequate in countries with high levels of judicial lack of integrity.

In some countries there is a model of automatic appointment by the court: the insolvency representative is appointed according to a list that has been compiled after a draw. While apt to avoid judicial bias, the automatic designation is a blind system that can provide for a sufficient level of technical skills for the appointee

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\(^7\) The possibility of appointing legal entities can be a temporary solution for those jurisdictions where there are not enough professionals technically qualified and a new Law has been enacted. In those jurisdictions, audit firms will be present in the market and may be a solution until the system is able to generate a sufficient number of skilled practitioners.

\(^8\) This is a conceptual analysis, and it is based on the assumption that the court acts independently and with fairness.

The assertions are valid also when the model includes a public agency in charge of the appointment of insolvency representatives. Some further considerations would apply when the court (or the public agency), upon opening the insolvency proceedings, requests a self-regulatory organization to exercise its discretion to appoint a practitioner; however, for the sake of simplicity, the same assertions could be said to apply (in as much as the SRO is adequately monitored by the public authority).
when there are strict requirements for joining the list of candidates from the outset.

(b) A system of selection based on the initial decision of the petitioning private parties may also be an effective way to ensure that the role of insolvency representative falls on a technically qualified person from the start of the procedure. However, these models can hamper the achievement of independence.

- The choice of an insolvency representative by the petitioning debtor is the riskiest model, due to the following key reasons: the debtor is an interested party; its interests are generally subordinate to and in conflict with those of other participants (especially [secured] creditors); some of the transactions entered into by the debtor may have to be avoided; the insolvency representative may be required to conduct an independent analysis and assessment of the causes of insolvency and the objective possibilities of reorganization, with no interference from the debtor and its directors; and, finally, the debtor’s behavior may have to be scrutinized in order to find possible liability or causes for disqualification. The possibility of conducting all those tasks independently may be undermined by a situation in which the debtor is in charge of “selecting” who does it.

- The situation is to some extent different in a purely creditor-based system of appointment. The reasons are several: the interest of creditors is – at least in most insolvency systems – the primary interest, their behavior is normally not to be scrutinized and they are – in most cases – not party to the transactions that may need to be avoided. However, some situations of conflict persist. Not all creditors are in the same situation, and their entitlements are by definition in conflict with one another (the more a creditor is paid, the less the rest will get, in cases where the debtor’s estate is insufficient to satisfy all claims). If secured creditors appoint an insolvency representative, their interest will not necessarily be aligned with those of unsecured creditors. Secured creditors are in many occasions sophisticated creditors, present in a number of insolvency proceedings, and the incentives for insolvency representatives to conduct each proceeding in such a way as to maximize their reappointment potential is not

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9 As it was famously stated, the only thing creditors of the common debtor have in common is… the debtor (GALGANO, “Note sull’organizzazione collegiale dei creditori concorsuali,” Riv. Dir. Civ., 2 (1959) pg. 262 et seq.). The quoted paragraph was an intentional – and very graphic – overstatement, since it is evident that creditors included in the same class by insolvency law frequently share important interests. However, it is no less evident that the creditors in one class may find themselves in conflict with the common interests of creditors in another class.
always compatible with independence. The problem may be ameliorated when the insolvency representative is selected by creditors who are in fact the residual claimants to the debtor’s estate and thus have a direct interest in the maximization of its value.\textsuperscript{10}

- Some systems provide for the court to make an initial appointment of a provisional receiver who is eventually displaced by a creditor-nominated insolvency representative. This can stave off some of the afore-mentioned dangers. The creditors nominate at a time when the most relevant information has already been gathered by an independent court appointed representative, and the nomination is usually made not by a single creditor but by the creditors’ assembly or committee. This “third kind” (\textit{tertium genus}) bears its own drawbacks, one being the creation of transition costs (a new person needs to step in and invest time and resources in adjusting to the new role, possible lack of coordination, information asymmetries and other transaction costs etc.). The legislator will also have to decide if secured creditors (and if so, which secured creditors) can take part in the nomination.

\textbf{3. The Number of Insolvency Representatives Responsible for a Proceeding}

7. In a few jurisdictions, the model of insolvency administration includes an organ (a panel) with more than one member. The idea is to achieve technical excellence by appointing an expert in each field necessary to properly carry out the task inherent to insolvency proceedings: at a minimum, a legal expert and an accountant/auditor (or a business management professional). In order to avoid the problems of a two-person decision making body (blocking of decisions, problems of representation, etc.), some systems include a third member that is usually an ordinary creditor who controls the two technical members of the insolvency administration (although it may also be a third technical member). This model is uncommon and tends to be less efficient and more costly than single-member insolvency administration.\textsuperscript{11} Except for extreme cases (very experienced professional, very small insolvent business) no insolvency practitioner is able to personally execute every task required by the insolvency proceedings. If a lawyer is appointed, he/she will need

\textsuperscript{10} Secured creditors with security over the business, cash flows or other objects will also benefit from the insolvency estate’s value maximization, but they share the other conflicting points of the rest of the secured creditors.

\textsuperscript{11} The model is sometimes restricted to special cases, namely very large cases or the insolvency of debtors operating certain type of business (financial, insurance, etc.), and it usually includes a system of appointment by a public authority.
the help of an auditor/accountant/business trained expert. If the latter are appointed, a legal expert will be required. Single-member panels engage third party experts, but they do so freely in the market, and it will be in their best interest to find the most suitable person. In the three-member structure, the members are elected a priori, there can be an unnecessary duplication of resources, and the possibility is lost to benefit from previous synergic professional relationships. Moreover, if, as happens in many jurisdictions, the remuneration is to a certain degree determined by statute and it constitutes a monopolistic price for the service, the model becomes too costly. Multi-member panels may however be useful in the context of litigious systems where insolvency representative appointments are frequently challenged but where court processes are unduly slow. Here, borrowing from a model common in the appointment of arbitrators, competing stakeholder groups – secured vs. unsecured creditors, or even shareholders vs. creditors – may be entitled to nominate an insolvency representative each, and the two nominees themselves choose a third person to complete the panel. No challenge is allowed to the identity of the nominees, so long as they are professionals in good standing with the relevant regulator. The cumbersomeness and other costs of this model need to be carefully balanced against the costs of litigation and delay in a single insolvency representative model. The model may also be used (and it is in some jurisdictions) for special cases, namely very large insolvency proceedings or the insolvency of debtors operating certain type of business (financial, insurance, etc.), and it usually includes a system of appointment by a public authority.

4. Objectivity, Impartiality, Independence and Suitability

8. This note has earlier provided a brief description of the abstract requirements required of an insolvency representative according to the different models addressed above. However, a person may meet the general requirements and not be suitable for a specific appointment. Those who are (or may be seen to be) in a conflict of interest and those who have been sanctioned for certain types of misconduct should be ineligible and, if selected, should be removed.

9. Insolvency representatives should be expected to be objective and impartial, acting independently of those involved in or affected by the insolvency. It is therefore appropriate to have provisions dealing with issues of objectivity, impartiality and independence – or what may generally be referred to as conflicts of interest and duty – arising from a prior or a continuing business or personal relationship or other involvement with any of the parties.

10. The insolvency representative is required to act in accordance with the law and to deal with all parties – creditors, the debtor and others having dealings with or otherwise involved in or affected by the insolvency – fairly and openly. As noted
above, s/he is not acting for his/her own account but on behalf of all those parties. It is therefore important that objectivity, impartiality and independence be not compromised nor be at risk of being, or appearing to be, compromised.

11. Objectivity is the condition that has regard to all considerations relevant to the task in hand, but to no other. It is dealing with matters uncolored by personal feelings or opinions and without regard to personal relationships, advantage or disadvantage, gain (beyond proper remuneration for administration of the insolvency) or loss, preferences or prejudices and favor or disfavor.

12. The provisions may specify, by reference to examples, the relationships or involvements which may give rise to an actual or potential conflict and which may, in fact or appearance, influence the insolvency representative’s professional judgment, such as where s/he or his/her firm or company or an employee of his or her firm or company has previously acted as the debtor’s accountant and/or auditor; or has acted for the debtor in legal proceedings; or has been employed by or acted for or advised the debtor in some other capacity; or has had personal contacts. The provisions may not only reflect the possible conflict existing in previous relations with the debtor, but also with other interested parties (namely, the creditors). Depending on the nature of the previous connection, a continuing relationship may be rendered necessary (or not). For example, one single instance of a legal relationship with the debtor may be enough to place the insolvency practitioner in a conflict of interest and duty where it related to avoidable transactions or to actions that may trigger liability within the insolvency proceedings.

13. The provisions may specify those relationships which preclude appointment because of close current or recent business or personal connection. But where not specifically precluded, the insolvency representative should nevertheless be required to have considered the risk of conflict, and to record the basis of his/her conclusion that his/her objectivity would not be impaired. In his/her judgment and conclusion, the insolvency representative needs to keep in mind that an appearance of possible conflict may undermine confidence in his/her objectivity as perceived by others or by the general public, and thereby undermine the integrity of the insolvency system.

14. Where an issue of potential conflict might still arise, it might be addressed in several ways, depending on the nature of the potential conflict:
(a) If the conflict is permanent, the normal solution should be not to appoint the person or, if the situation arose after appointment, the person should be removed. Arguably, an alternative solution could be the disclosure to all parties of prior or continuing relationships which might give rise to the risk or appearance of conflict, followed by a unanimous approval of the appointment in the knowledge of such relationships.

(b) If the conflict refers only to a specific situation, it can be tackled by the appointment of one or more joint insolvency representatives to deal with those aspects of the insolvency where there might be seen to be the risk or appearance of conflict. This may be the best solution in the case of conflicting duties: when one and the same insolvency representative is appointed in two or more procedures and the correct exercise of the duty as insolvent representative in one of them would prejudice the interests defended in the other proceedings. This is particularly the case in the insolvency of enterprise groups.

Similarly, the fact that the insolvency representative is remunerated by one or more creditors might of itself be enough to give rise to a risk of conflict or preference to those creditors. Where it is perceived to be a possible threat to an insolvency representative’s impartiality and independence, then the regulatory or supervisory body might be expected to pay particular attention to the case.

15. An insolvency representative should be expected to be suitable, or as it would be put in some jurisdictions – fit and proper.

16. Given the position of the insolvency representative and the powers and trust placed in him/her, there should be some consideration of his/her conduct which may bear on his/her suitability. Matters of conduct relevant to consideration of suitability include:

   (a) Conviction for any offence particularly involving fraud, dishonesty or violence;

   (b) Contravention of any legislation, and particular insolvency, tax or related legislation;

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12 By a permanent (actual or potential) conflict, we mean the situation in which the conflict derives from general circumstances affecting the insolvency representative: a family tie, a previous position as a director of the insolvent company, etc. In other words, those situations that potentially affect every act of the person appointed in a particular case (as opposed to the situations where the conflict lies in a particular act).
(c) Infringement of any deceitful or oppressive practices, or otherwise unfair or improper practices, illegal or otherwise;

(d) Failure to comply with rules or guidance on conduct, standards and ethics of any relevant professional body to which s/he has belonged;

(e) Bankruptcy or entering into an arrangement with his/her creditors or being a director of, or involved in, the management of a company subject to insolvency proceedings;

(f) Failure to satisfy a judgment debt entered against him/her;

(g) Removal as the insolvency representative in another insolvency, on the ground of misconduct, or removal from public office.

17. None of the examples given above may necessarily or automatically exclude an insolvency representative from being appointed. It may depend on when the conduct took place and the seriousness of it.

18. Any matters of conduct relevant to consideration of one’s suitability to be an insolvency representative would usually be subject to disclosure requirements to appropriate authorities. Failure to disclose, or providing false or misleading information, would itself bring the suitability of the insolvency professional into question.

5. ACCEPTANCE OF APPOINTMENTS

19. A person appointed as insolvency representative should not accept the appointment if s/he is in any of the situations of actual or potential conflict described above. Acceptance should also be denied in case s/he is not suitable according to the relevant above-mentioned circumstances.

20. An insolvency representative should neither accept an appointment nor perform work for which s/he does not have relevant expertise, skills and experience or agree to give specialist advice and assistance if s/he does not have the staff and other resources to enable him/her to properly carry out his/her functions and duties. 21. Once a person is nominated, express acceptance of the engagement should follow. It may be done privately or even be regarded as implicit if the debtor or the creditors select the insolvency representative and include his/her name in the petition. But it should be included as a procedural requirement in those systems where the court appoints the insolvency representative. Formal acceptance may be relevant to establish the moment from which the debtor is to be deemed
dispossessed or subject to the supervision and authoritative powers of the insolvency representative. It is possible that in some systems the refusal of an appointment requires justified cause.13

6. TERMINATION OF ENGAGEMENT

22. Insolvency representatives should have a justified cause to resign, such as illness or an objective reason that renders him/her unable to perform their duties or renders him/her only able to fulfill them at an unreasonable personal or professional cost. Resignation may be harmful for the interest of the proceedings. It may paralyze the procedure and the representative’s substitution is bound to cause undue costs to the estate (loss of acquired knowledge, investment of time and resources of the newly appointed practitioner and other transitional costs, dissemination of confidential information, etc.). Non-justified resignation may be sanctioned through a fine or a suspension of the license to act as practitioner for a specified period of time.

23. An insolvency representative should not remain in office if there is a justified reason for removal and, at the same time, their powers and duties and the multifaceted functions involved make it inadequate for the parties to have the power to remove him/her from office at will (revocatio ad nutum). Insolvency legislation must reach a balance between tenure and free removal. For the sake of internal legal consistency, a justified cause for removal should be any breach of the requirements to become elected or entering into any situations that grossly impair objectivity (general conflicts) or that undermine suitability (sanctions for misconduct). A justified cause for removal may also be a relevant failure to properly comply with the duties envisaged by the country’s insolvency legislation or acting with negligence. In some legal systems, it is possible to include as a cause for removal the loss of confidence in the practitioner’s abilities or other subjective reasons. In this case, the decision to remove the insolvency representative (regardless of who is competent to appoint the professional) should at least be controlled by the court, so as to avoid interested parties (namely, large creditors) influencing the practitioner’s exercise of his/her duties. The possibility of court removal may be deployed as an important instrument to exert independent control over the insolvency

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13 This may particularly be the case in those models where the court selects and appoints the insolvency representative and the remuneration is pre-established by Law on rigid terms. Often the judge will use a list voluntarily joined by the practitioner, and the rejection of a particular appointment may be due to the fact that the insolvency proceeding to which the practitioner is appointed does not involve adequate remuneration. This may cause harm to the parties of the insolvency proceeding: the rejection of one practitioner would imply the need to appoint another one that could also deny acceptance (and so on), creating a situation of “race to the bottom,” with harmful delays and a final possibly inadequate candidate.
representative. It may be designed as a *sua sponte* control system, whereby the
court can act *ex officio* as an hierarchically superior body in the insolvency
proceedings; or it can be envisaged as a system of party control over the insolvency
administration, whereby the debtor or the creditors may apply to the court for
removal of the insolvency representative (or there can be a combined model of both
possibilities). In this regard, self-regulatory organizations may also play a role,
either triggering the process for court removal or arguing in favor of their member.

24. When an insolvency representative vacates office (in case of removal or when the
procedure ends, as the case might be), the Law should provide a process by which
the leaving practitioner must account for his actions while in office. The
representative removed in this manner should be able to explain the main lines of
his/her performance and render account of his/her administration of the insolvency
estate. This process can be designed as a mere instrument to provide information for
the participants in the insolvency proceedings (without further value) or as a way to
allow the representative to discharge his liability *vis-a-vis* the debtor and its
creditors.

### III. INSO LVENCY REPRESENTATIVES’ FEES

#### 1. INTRODUCTION

25. A central issue in every insolvency case is the insolvency representative’s fees,
including expenses and costs of those employed by him/her. An insolvency
representative should be entitled to be fairly remunerated for his/her work and to be
reimbursed for reasonable expenses and costs properly incurred in the performances
of his/her functions and duties.

26. To design an effective system for remuneration of insolvency representatives is as
difficult as it is important. A model that pays too much would unnecessarily
undermine the insolvency estate (or, if funded directly by creditors, it could create
the dangerous “appearance” that the practitioner was being paid to protect the
partial interests of those paying). A system that pays too little would keep
technically skilled and qualified practitioners away from the task. A balance
between the need to limit the expenses generated by the insolvency procedure and
the need to attract good professionals should be achieved. Certainty is another
important objective that must be sought by the system of fees. It is important for the
market to be able to know in advance what the cost of insolvency proceedings will
be; and the remuneration of insolvency representatives is an important part of the
costs. When a debtor is to make the strategic decision of filing for insolvency or when creditors are faced with the question to lend or to petition for the insolvency of an already existing debtor, the cost of the procedure is a relevant factor to consider. 27. The central issues in designing a system for the regulation of insolvency representatives’ fees are: a) to opt for a model that is market based or rather for one with pre-determined fees (by statute or by the court applying scales); b) to establish the criteria in case there is a pre-determination of the fees; c) to determine who has the final decision on the fees and who may resort to the final decision maker in case of disagreement.

2. THE PROBLEMATIC CASES

28. Before all those questions are addressed, the Law should provide an answer to the situations in which the payment of fees is under threat (i.e., when there is a risk that the insolvency estate may not be enough to cover the costs of the procedure). This issue is normally addressed by, firstly, granting priority over the claims of the creditors. In some jurisdictions, there is absolute priority. In others, the insolvency practitioners’ claim yields to the claims of some secured creditors (at least to a certain extent). 14 And in other legal systems, a distinction is drawn between the claims to fees arising after the insufficiency of the estate is ascertained and those claims that arose before (where the former enjoy absolute priority and the rest rank at the same level as other post-insolvency procedural expenses). 15

29. This leads to the second question: what happens when there is not enough to pay the insolvency representatives’ fees? 16 There are five possible answers:

a) debtor-related person/entities pay;

b) creditors assume the cost;

c) the insolvency practitioner loses – totally or partially – his/her right to the fees;

14 Where secured creditors rank ahead of the insolvency representative’s remuneration, the Law sometimes provides for the payment of a percentage of the liquidated asset (that is subject to the guarantee) to the liquidator.

15 This rule seeks to create an incentive for the insolvency representative to continue rendering his/her services correctly. Not establishing absolute priority would make the professional work knowing he may not be paid.

16 The question does not refer to a lack of liquidity, but of a real insolvency of the estate to cover for the expenses incurred after the commencement of the proceedings (the situation which has famously been labelled as “insolvency of the insolvency”).

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16
d) public authorities fund the insolvency representative; or

e) there is a fund set up to pay in these situations.

30. The first two solutions are arguably problematic: shareholders/directors should not personally bear a cost unless there is a general private-law institution whose requirements are met (piercing the corporate veil, negligent misconduct that triggers liability, etc.); and creditors will have already lost their investment and it would make no sense to compound the damage they suffer. The third answer is the factual scenario that occurs in many jurisdictions (all those jurisdictions where there is no specific regulation of the matter). It is not a desirable solution, unless moderated by other types of compensation (for example, in some jurisdictions, insolvency representatives who complete their job and remain unpaid have a better chance of being appointed to other cases with appropriate remuneration in a future moment). In some countries, the public authorities assume the cost, either by using their own staff or paying a professional. The argument to support this model is twofold: on the one hand, the State may intervene without disrupting a market economy when, in extreme cases, there is a market failure; and, on the other hand, insolvency representatives are – in some cases – court-appointed officers, performing within the framework of a public procedure and they play a role that to some extent can be considered to be of public interest. Finally, the most recent and wide-spread solution is the existence of a contingency fund, normally set up by insolvency practitioners to cover these cases.

3. THE DETERMINATION OF FEES

31. Who determines fees (and their variations) differs among jurisdictions, and within the same jurisdiction may differ amongst various insolvency procedures. Legislation must establish what the role of the regulatory or supervisory body or the court is in relation to the insolvency representative’s fees. It must also decide the broader – and more complex – question of the nature of the system itself, namely, whether fees are freely agreed by the parties (remuneration determined based on market mechanisms) or established by a third party (a court or an Agency, normally pre-established by regulation). A market model would normally consist of an agreement between the debtor and/or the creditors’ committee or one (or more) main creditor(s) and the professional, frequently coupled with the subsequent consent of the creditor’s meeting (and, sometimes, with the control of the court or an external body). The idea underlying the model is that insolvency is a market

17 If the jurisdiction has a market-based system of fees, the insolvency professional may distribute the cost of unpaid work amongst his other clients by raising the price of his/her services, but this will not be the case in the systems where fees are predetermined by legislation.
event and, as such, it must be governed by market rules, based on the idea that competition will generate a body of sufficiently qualified professionals that will render their services at the lowest price. Experience shows, however, that this reasoning is not always correct. The type of service to be rendered and the factual situation of the parties involved make the market of insolvency professionals an especially complex one, not easy to compare with other markets involving professional services. In many cases, it will not be possible to know beforehand the nature and extent of the work that needs to be performed. Sometimes, there will not be enough assets to pay the price, and the objective and independent behavior that must be observed by the professional is not easy to reconcile with fee payments made by certain creditors, that might be in conflict with other creditors. International experience shows that a purely market-based fee system works better the more developed the economy and the larger the insolvency in question. The alternatives to the market-based private system for determining fees aim at tackling precisely the particular challenges posed by the insolvency of debtors in the market. Fees are regulated to place the professional in a more independent situation vis-à-vis the parties; criteria are legally set to limit the amounts payable and to create incentives for more efficient performance; and rules are provided to solve a situation where there are insufficient assets to pay for the services rendered. Experience shows, however, that a good system of pre-determined fees is very difficult to design and many times the outcome is no better than a market-based model, and with monopolistic prices. The debate remains open.

The criteria to determine fees

32. Different jurisdictions have approached the issue of determining an insolvency representative’s fees in broadly two different ways, or a combination or variations of them – scale or commission based on the estate (value of assets and/or liabilities or on percentages of assets realized and/or funds distributed), and/or time spent. Within one or both bases, there may be provision for an additional or alternative success fee or fixed fee in relation to amounts recovered generally or in relation to specific assets or the business as a whole.

33. Scale or commission fees may be set and operated in different ways:

(a) The scale or commission may be set by legislation or code for insolvencies generally, or they may be set in individual insolvencies, based on the scales
applicable to certain related professionals (auditors, lawyers) or freely determined by the court/creditors. Where they are set in individual insolvencies, there may nevertheless be a standard which insolvency representatives look to the creditors or the court to agree.

(b) Fees may be based on a constant percentage of the assets realized and/or funds distributed; or on a sliding (usually reducing)\(^\text{18}\) percentage of the assets realized and/or funds distributed.

(c) There may also be a descending scale based on the total value of the assets of the insolvency estate; or a combined scale based on assets and liabilities. This solution is based on the assumption that the higher the value of the assets and the higher the number of creditors, the more complicated the job.

(d) There may be a minimum threshold amount which recognizes the cost of complying in any event with statutory requirements applicable in all cases, and with or without an overriding maximum.

(e) All the previous possibilities may be complemented with the consideration of other circumstances that imply a higher (or a lower) degree of difficulty, and that can be used to increase (or decrease) the amounts resulting from the scales. Possible examples of factors that may be taken into consideration are:

1) the number of employees;
2) the number of creditors;
3) the location of productive centers in different countries;
4) the assumption of the actual administration of the business (as opposed to a debtor in possession situation), etc.

(f) In some countries, it is foreseen that the successful recovery of assets for the insolvency estate in court increases the insolvency representative’s remuneration. Normally, the representative who successfully reverses a detrimental transaction or achieves the annulment of a preference may claim a percentage of the value entering the insolvency estate.

\(^{18}\) It must be noted that the reducing scale may create perverse incentives, since it rewards the insolvency representative most for realizing the most liquid assets, which would tend to be dealt with first, and rewards him/her least for the most difficult-to-realize ones, whose disposal would naturally take longer. This might therefore not incentivize sufficiently the insolvency representative to seek the value-maximizing disposal of the least liquid assets.
34. Scale- or commission-based fees bring some degree of certainty for creditors and the insolvency representative. However, the following matters should be considered in this regard:

(a) Where the assets are readily realized, a fixed or standard percentage may unduly benefit the insolvency representative for the time and skill used in realizing them. In this context, it would be reasonable to consider setting the standard at an average market level – for example, ensuring that the insolvency representative receives for realizing land the same commission a real estate agent charges in a given country – with the possibility for the insolvency representative to apply to the creditors’ committee or the court for an increased level in cases of particular difficulty or complexity.

(b) There is an incentive to pursue recovery of assets and maximize realizations, although this may also be achieved by other means (see above).

(c) Where there are difficulties or uncertainties in realizing certain assets, the insolvency representative may be reluctant to pursue them or to attempt to maximize their value if it seems possible that his or her time and skill will not be adequately compensated. However, insolvency representative’s reluctance in this respect may be counterbalanced by the prospect of removal from the role of insolvency representative or professional liability if his/her inaction damages the interests to be protected through the insolvency proceedings.

35. There is a further risk, if the scale is set at too low a level, and is not regularly reviewed and revised,\(^{19}\) that some competent and able professionals will not be prepared to become insolvency representatives or will not be prepared to accept appointment in particular insolvencies.

36. Fixed amounts are certain (to the extent that assets are realized to meet them), but they may also be arbitrary or require some prior assessment of the work involved in a context where in many, particularly larger, insolvencies there may be many uncertainties. They also provide no incentives to the insolvency representative. And again, if fixed amounts are set at too low a level, competent and able professionals may not be willing to undertake the work.

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\(^{19}\) The scale should be set by secondary legislation which can be revised without going through the entire legislative process.
37. Fees based on time spent would take into account:

   a) the complexity of the case;
   b) responsibility of an exceptional kind or degree;
   c) the effectiveness with which the duties of the insolvency representative are carried out; and
   d) the value and nature of the assets dealt with.

38. Fees based on time spent seem to also represent a reasonable basis for recompensing an insolvency representative. The lack of pre-determination allows for a more case-adjusted valuation of the work done. However, it must be noted that the criteria mentioned for calculation of the per hour-based remuneration are not an exclusive feature of this system. They may – and should – also be taken into account in a scale/commission system of fees, for most examples of that type of regulation show that remuneration is never only based on a simple scale, but the final amount paid is determined by a number of facts that reflect the special needs of the case (i.e., its complexity, the value and nature of the assets, etc.). In addition, this system shares two problematic trends of rate-per-hour systems: firstly, unless a cap is initially set or the system is balanced through other evaluation instruments, there is an incentive to inefficiency (the more hours, the higher the fees); secondly, there is a risk that practitioners shall charge a rate per hour based on their general activity as auditors/lawyers, which are established according to a market with totally different circumstances. Arguably, a fairly reasonable approach to this fee system is the following:

   (a) a remuneration should reward value returned to creditors, not only costs incurred by the insolvency representative (which is what’s mainly measured by time);
   (b) any claim for remuneration must be justified (nature of the tasks undertaken, grounds to execute the task and the outcome of the task);
   (c) tasks should only be undertaken (and executed in the manner proposed by the insolvency representative) if a reasonably prudent person, faced with the same circumstances regarding her own affairs, would spend her own money in doing what has been done (deploying commercial judgement); and
   (d) records must be kept of what has been done.
39. No approach is without some drawbacks and limitations, and some criticism. That criticism might however be met, at least in part, by openness and transparency of what is charged as fees (and expenses and costs) and the basis on which those fees are charged; and that there is some mechanism by which those who are dissatisfied with the amount (including the insolvency representative) can seek some form of review.

40. It is convenient to incorporate rules to coordinate the remuneration of an insolvency representative appointed to two or more insolvency proceedings of enterprises belonging to the same group. If the fees are determined on an individual case basis, this factor should be taken into account when calculating the remuneration in each procedure. In the insolvency of enterprise groups, part of the work to be done by a common insolvency practitioner (and his/her team) is shared by all the procedures. In some cases, then, to award fees that are a plain numeric addition of the fees accrued in each individual procedure would be over-compensating the practitioner.

Who determines fees

41. The question of who and how fees are determined can be addressed in very different manners. A comparative look at different jurisdictions across the globe show that, summing up, fees may be determined:

(a) Generally:

- by statute;
- by code promulgated by the government or by the regulatory or supervisory body or other public authority or by a professional association;

(b) On an individual case basis:

- by the regulatory or supervisory body;
- by a professional body;
- by the court;
- by the creditors or their committee
c) A combination of a Statute/Code and an individual case basis: this will happen whenever the Statute/Code only provides guidelines or it leaves questions to be determined in each insolvency proceeding (such as, for example, when the person(s) in charge of determining the fees are given a range of possible fees according to their understanding of the difficulty of the case). In this – common – case, the determination shall normally be done:

- by the court; or
- by the creditors or their committee.

42. A number of jurisdictions provide that even where fees are fully determined by Statute or Code, the insolvency representative may apply to the court or the regulatory or supervisory body or other public authority to increase what s/he is to be paid on the basis that the statutory or code amount is insufficient to properly remunerate him/her for the time and skill expended in the insolvency.

43. In some jurisdictions, the regulatory or supervisory body may have the power to review an insolvency representative’s fees or to require them to be reviewed; or the right to apply to the court or to address the court where it is of the view that the fees are excessive; or the insolvency representative may be required to submit his fees to the regulatory body for observations or recommendations prior to applying to the court.

44. Where the fees, or the basis on which they are calculated, are fixed by the regulatory or supervisory body or by the court or by the creditors or their committee, there are generally provisions enabling a dissatisfied creditor or other interested party, or the insolvency representative, to apply to the court (or, recently, to an independent external body) for the basis or amount to be reviewed where they consider them excessive (or for the insolvency representative, inadequate). 45.

One other issue that should also be considered by legislation is the moment when the right to remuneration accrues to the insolvency representative. In those systems where the right to the remuneration only exists once the task is completed (or in those where there are different procedural stages whose completion is necessary for the fees to be due), it is convenient to provide for the possibility of advance payment. The contrary does not only jeopardize the priority of the insolvency representative’s claim but puts an unjustified burden on the practitioner (who would have to bear the costs of executing the task himself) and might undermine his/her motivation.
4. Costs of the Insolvency Representative

46. Expenses and costs may also pose difficulties:

(a) To what extent are scale or time/rate fees of the insolvency representative intended to cover the cost of staff working for him/her as well as his or her administrative expenses such as photocopying, mailing, storage of records, etc?

(b) When, on what basis and for what purposes can s/he engage, and recover the cost of advice from, for example, solicitors, accountants, valuers, debt collection and other agents?

(c) In what circumstances should s/he be required to obtain the prior approval of the creditors or their committee or the court to incur expenses and costs?

47. Some or all of these matters may be covered by legislation or statutory code, including where prior approval of the creditors or their committee or the court is required. But in a number of jurisdictions, the approach has been to deal with much of the detail in professional standards and guidelines which enable amendments to be more readily made to reflect practice and to respond to abuse.

48. What is clearly important is that the insolvency representative should set out clearly what s/he is seeking to be paid by way of fees and what s/he is seeking to recover in relation to expenses and costs — and the purposes and benefits of those fees, expenses and costs to the administration of the insolvency — in seeking approval from the creditors or their committee, from the regulatory or supervisory body or from the court.

IV. The Exercise of the Insolvency Representative’s Powers and Duties

49. The insolvency representative will be expected to skillfully exercise a range of powers and comply with a number of duties aimed at solving the problem posed by the insolvency of a debtor according to the values embodied in the Law. Insolvency laws necessarily include policy choices that express how the legislator believes the loss caused by the economic crisis of a person or a business must be allocated.
Whatever those choices may be, the most effective system of insolvency administration will always be one that ensures -to the extent possible- that the values underlying the choices are carried out and “brought to reality” in an independent, “aseptic” (unbiased), technical and efficient manner.

1. The Multi-faceted Duty of Loyalty

50. The insolvency representative – in every insolvency legal system – will have to perform his task pursuing the aim defined by his/her insolvency Law, which will be independent of the particular interests of the debtor, of each creditor individually considered or of other stakeholders. The officer owes a general duty of loyalty to not have regard to personal interest in the outcome and to have no particular interest other than the private interest of those that the law has chosen as the recipients of what’s left in the estate. The interest of some is elevated by the Insolvency Law to the category of “public policy”.

51. Insolvency practitioners must refrain from:

(a) Actively trying to be appointed through an improper approach or pressure; or from making payments for an insolvency appointment, or offering the possibility of some future benefit or gain.

(b) Placing themselves in a position in which their duties may conflict with their interests: as a rule, they should not employ a relative or connected business or person in, for example, the sale of a debtor’s assets, or hire them to render other services for the debtor. A fortiori, they should refrain from acquiring (themselves or a member of one’s firm or company or a relative or connected business or person) assets from the insolvency estate.

(c) Taking for themselves or for the benefit of third parties business opportunities somehow related to the insolvent’s professional activity or using the insolvent’s information or position for personal gain or for the gain of a third party. This is particularly relevant in those cases where the insolvency practitioner is authorized to exercise other professional activities (such as economic or legal
consultancy) and/or when s/he is professionally related with a firm that offers financial or legal advisory/auditing services.

(d) Insolvency representatives must be subject to a duty of confidentiality that should last beyond their period in office, after their removal or after the conclusion of the proceedings. They have access to very relevant information (about the debtor, but also about creditors and possibly other third parties, and both of a personal and professional nature) for the exclusive use of the execution of their powers and duties as insolvency representatives. They should not be allowed to ever use such information unless they are authorized by each person involved or it becomes public by other means.

52. The issues listed above should be initially prohibited, but some of the prohibitions may be lifted either by the court or by the creditors’ committee (or both together) on a case by case basis after careful consideration of all relevant circumstances.

In many cases, insolvency representatives will act within the framework of a formal procedure, carried out in public courts, and they will be performing – at least to a certain extent – a “public” task. The “public” aspect of the insolvency representative’s duties places them in a situation whereby they are expected to be honest and act with integrity and probity. Integrity and probity imply not merely honesty and bare compliance with the law, but also:

(a) fair dealing;

(b) not to seek unfair advantage;

(c) recognizing the need for transparency and accountability;

(d) not improperly withholding facts and information.

20 Although the situation is to a certain extent similar to that of company directors and business opportunities, the following must be remembered: 1) the insolvency representatives owe fiduciary duties to a number of parties that are in a conflicting situation among themselves, and their duties also frequently have a “public” aspect (for example, the investigation in the public interest of possible directorial misconduct) that company director’s do not share; 2) many of the grounds that are used in company Law doctrine to excuse the use by directors of the company’s opportunities should not apply in the case of an insolvency representative, for they would allow for the prohibition to be easily circumvented (i.e., the argument that the company could/would not have availed itself of the opportunity).
54. Insolvency is a complex area of the law. Many creditors and debtors and others involved in, or affected by, insolvency will be unfamiliar with all its implications and ramifications for them, individually and collectively, and with the functions, duties and powers of the insolvency representative. Such creditors, debtors and other stakeholders will not wish to, or will not be able to afford their own legal or other professional representation. While many jurisdictions provide for the appointment of a committee of creditors to oversee the work of the insolvency representative, few creditors have the knowledge or understanding to undertake that role; and, perhaps except where there are substantial sums involved, few can commit the time. In any event, creditors’ committees cannot always involve themselves in the details of the insolvency administration. There exist similar limitations where the supervision and control of the insolvency representative is assigned to the court or to an external body. That of course does place on the insolvency representative an increased responsibility – to do the right thing for the creditors, the debtor and others involved or affected, and to act with integrity and probity.

2. THE DUTY OF CARE

55. An insolvency representative should carry out his/her functions and duties and exercise his/her powers with skill, care and consideration in accordance with the professional and technical standards expected of a professional person. In most countries, insolvency representatives will be lawyers, auditors or accountants with experience or qualified knowledge in insolvency Law or, in those systems where there is a model of pure professionals, representatives will be especially trained insolvency practitioners who devote their professional time exclusively to insolvency practice. In all of those cases (the majority, id quod plerumque accidit), it is arguable that they should be expected to apply the knowledge and expertise of an average insolvency professional, not of an expert in the business field of the insolvent (that is, not of a company director with experience in the business developed by the insolvent).

56. Insolvency representatives must be meticulous and scrupulous when exercising their duties. They are expected to put in as much time and effort as the case requires, and diligence will demand that, before adopting a decision, all the information is duly gathered, processed and analyzed by them.

57. An insolvency representative does not act for himself but for creditors, debtors and others involved in or affected by the insolvency. S/he should therefore be expeditious in his/her dealings with them as well as with the court, the regulatory or
supervisory body and any other authority – for example the government tax department – and exercise the skills expected of him/her.

58. Normally, regulations will contain provisions setting timescales for, for example, submitting applications to the court, holding meetings of creditors, issuing reports, filing returns and making distributions; as well as requirements about the conduct of administrations. Insolvency representatives are expected to meet those dates, and failure may be a justified cause for removal and even liability.

59. The range of powers and duties assigned to insolvency representatives include tasks very different in content and nature. For the sake of simplification, a line can be drawn between those tasks related to the administration of the estate (i.e., the business) and the rest (procedural tasks – drawing a list of creditors, communications, etc. –, investigations, avoidance of transactions, etc.). Insolvency representatives are not expected to perform their duties on their own:

(a) for the administration of the assets, they occupy the position of supervisors (debtor in possession) or a directorial position, and in both cases they will be expected to comply with their duty together with the human resources of the insolvent business (staff and directors of the company, the old ones or newly hired ones);

(b) for the rest of the duties, they may resort to third parties to undertake part of the tasks and they may also make use of their own staff.

60. An effective insolvency Law would clearly establish which tasks must be undertaken by the insolvency practitioner himself (or his/her own staff, at his/her own expense) and which tasks can be externalized (and funded by the insolvency estate). An unclear definition of these matters may result in an unnecessary extra cost for the insolvency estate (to the detriment of the interests of creditors, the debtor and other relevant stakeholders). In any case, the following should be borne in mind:

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21 Standards may also include timescales for such matters as: responses to letters; or the provision of full and straightforward explanations to enquiries, particularly, where the enquirer may not have an understanding of insolvency and the procedures involved. Standards should emphasize that the insolvency representative should conduct himself or herself at all times with courtesy and consideration.
(a) There may be procedures for directing, overseeing and assuring the quality and
timeliness of the insolvency representative’s staff or that of his/her firm or
separate legal entity. The insolvency representative should satisfy himself or
herself that they have the appropriate knowledge and experience and directions
to undertake the work delegated to them; and, in any case, the representative
should be made accountable for the actions of his/her staff \textit{vis-a-vis} the
participants of the insolvency procedure.

(b) Insolvency representatives should be allowed to engage specialist lawyers,
accountants, agents or other experts to advise and act for him/her when: (i) it is
objectively out of their expected area of knowledge (for example, to request the
services of a lawyer when the insolvency representative is an accountant or to
hire specialists for the appraising of land owned by the insolvent enterprise); (ii)
it is proportionate (given the cost and the importance of the issue); and (iii) it is
useful to those interests protected by the aim of each insolvency system (i.e., it
is not only in the interest of the insolvency practitioner him/herself, for
example, to reduce the possibility of being liable in case a decision is wrongly
taken). In any case, it is important to ensure the competence and the quality and
timeliness of the work of those involved.

61. In reaching a decision about the engagement of third parties, the insolvency
representative should satisfy himself or herself that they are competent and
appropriate to undertake the specific task on which s/he requires advice and
assistance, by reference to:

(a) qualifications and experience;

(b) membership of a professional or accredited body;

(c) insurance, bond or some other security for advice and any action taken on
behalf of the insolvency representative, and for any of the debtor’s assets and
funds which they may handle.

62. The Law should provide means to control an abusive engagement of third parties,
and the insolvency representative should be rendered liable for \textit{culpa in
contrahendo}, in case he/she has negligently engaged an inadequate person for the
task. In some countries, the standard is tighter, and the insolvency representative is
rendered responsible and accountable for work undertaken under his/her
instructions by third parties or by staff.
3. **Control over the Insolvency Representative’s Performance**

63. The professional activity of insolvency practitioners must be subject to control. There exist different systems of control and supervision, according to the model of insolvency administration chosen by a country.

64. A public model of insolvency administration (whereby the insolvency representative is a public officer) can only be subject to the control of the insolvency court or by superior instances within the public administration to which s/he belongs or by an administrative court. In any other model of insolvency administration, control may be exercised in two different levels: “internal control,” which is asserted by the participants to a specific insolvency proceeding, where the scope of such control is limited to the insolvency representative’s performance within that concrete procedure; and “external control,” which is undertaken by external entities, normally not a party to the procedures in which the representative has acted, and which exert their supervisory and sanctioning powers either with respect to the misbehavior in particular cases or, more commonly, to the insolvency practitioner’s professional activity in general.22

**Internal control**

65. The activity of insolvency representatives within the framework of each insolvency proceeding must be subject to control. They exercise powers over assets and rights of third parties and should therefore be made accountable for their performance. The main instrument to allow the control of insolvency representatives is information. A balanced Law should create a range of information sharing duties to allow the court, the debtor, creditors and other relevant stakeholders to monitor the representative’s performance. Examples of such duties could be the following:

(a) Provisions in the law requiring reports to the court and to the creditors: normally, insolvency representatives are obliged to write a general report where the assets and liabilities of the insolvent are determined, an analysis of the causes of the insolvency is included, the possibilities of reorganization are assessed and the work done by the practitioner up to that stage is described and

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22 This separation is merely included for taxonomic reasons. There can be further variations, such as combinations of both external and internal control: this would be the case, for example, when an external professional body were legally considered a party to all specific proceedings where their members are appointed, and conferred controlling powers alongside other more common powers (such as defending their members’ interests).
justified. In those systems where the procedure is divided into stages, it is also common that insolvency representatives are asked to draw up a report at the end of each stage, a part of which consists of an account of his/her performance. Finally, certain laws include a duty for the insolvency representative to write periodic reports about the course of the restructuring or of the liquidation.

(b) When the insolvent person is a company or a professional entrepreneur and the business activity is not discontinued after the start of the proceedings, the Law may contain a duty to comply with the drawing up, approval and public deposit of the accounts as well as with other general duties that govern the supply of information to the market. Information pertaining to the activity of insolvency representatives will to some extent be present in the accounts and reports, either because they administer the business or because they control the debtor in possession.

(c) The insolvency representative should, whether generally or specifically called upon to do so, maintain and be able to provide for scrutiny a contemporaneous record of his actions and decisions. It may be considered important to assure the maintenance and content of the financial and other records of his/her operations, and the handling of assets and funds. Actions and decisions that should be recorded might include:

- The basis for the insolvency representative’s decision to close the debtor’s business or to continue it and formulate a proposal for reorganization, restructuring or sale;

- The basis on which the debtor’s assets were valued, by whom and what the agent’s expertise was (particularly where the assets were of a specialized nature); and the basis for the insolvency representative’s decision as to whether the assets should be sold privately or by advertisement, and whether by tender/sealed bids or by auction;

- The basis for his decision to investigate, or not investigate, the debtor’s dealings and transactions;

- The basis for the insolvency representative’s decision to pursue, or not pursue, debts and other potential recoveries;
The basis for his/her decision to admit or reject creditors’ claims, and their priority;

Consideration of any issues of potential conflict, and conclusions.

The information included in the insolvency representative’s own records should be accessible to the court. It may also be at the disposal of the parties and other relevant stakeholders for consultation, within the limits set by confidentiality.

66. The reports, the accounting documents and the insolvency representative’s records are the most common pre-established sources of information for the controllers, whoever they might be in each system. Such documentation can be labeled as “static” instruments of control, for they only permit an *ex post facto* supervision. However, many laws complement these static instruments with other preventive mechanisms of control that come into play before acts are executed by the insolvency representatives:

(a) In some jurisdictions, the court (or a delegate of the court) must authorize certain types of decisions by the insolvency representative before they are brought to practice. In most cases, the decisions that need to be approved are those that can be conceptually described as “acts of extraordinary administration,” i.e., those transfers of assets or other kinds of legal acts (surrender of claims, loans, entering into new contracts of long duration or that require the use of a large amount of resources, mergers and acquisitions, company splits, etc.) that do not belong in the day to day business of the insolvent. It is important that the procedure established to obtain the authorization not be slow and burdensome and that be flexible enough to not make the insolvency estate lose favorable deals. The procedure might allow the judge to hear the parties in some cases, and in any case it should allow the court to request external technical advice. It must be borne in mind that when the need for court authorizations is too broad, the administration of the estate becomes cumbersome and inefficient, and what is initially regarded as an instrument of control may end up being a much higher risk than the danger it tries to avert.

(b) The Law may provide instead for a creditor-based system of dynamic control of insolvency representatives. The body of creditors best suited to exercise ongoing control of insolvency representatives is the creditors’ committee, a body that normally includes a limited number of creditors, representative of the different classes. It is also possible to include a mixed system, according to which the general task of control is undertaken by the committee, with the
larger creditors’ assembly intervening only in a number of very relevant decisions (from both a quantitative and a qualitative perspective).

(c) There can be a mixed system of control, with both creditors and the court intervening. This is normally the case when the creditors’ committee is given very wide powers (in the sense that the need for the insolvency representative to request authorization from them is extended to most acts of administration) and the court is assigned the last word only on the most relevant decisions.

67. In some circumstances, if not otherwise required by the legislation, it may be appropriate for the insolvency representative to voluntarily consult the creditors, either their committee or generally, and/or seek the approval of the court for a particular decision or action.

68. The Law usually also contains general provisions enabling the court and the creditors (through their committee or, less commonly, the assembly) to request any information or explanation they consider necessary in order for them to execute their general mandate of control and supervision.

69. Alongside the internal instruments of control and supervision, insolvency laws normally envisage a range of remedies to tackle improper behavior from the insolvency representative in a specific insolvency proceeding. The most common consequences of inadequate performance are: removal from office, liability (compensation) and sanctions. Removal may be determined by the court or by creditors. The other two consequences, namely liability and sanctions, should only be determined by the court (or, in the case of sanctions, by an external body).

- Except in those jurisdictions where the court or creditors are given carte blanche for the power to remove, the remedy will only be applied in case of serious misbehavior (the replacement of the insolvency representative always brings along costs and delays that are detrimental to the estate). When the competences for appointment and removal of the insolvency administration lie in the creditors’ bodies (but removal needs a justified cause), the court should intervene in the decision to remove a representative due to inadequate performance in order to avoid a perversion of the system.

- The insolvency representative should compensate the damage caused to the insolvency estate, to the debtor, to creditors and to third parties (vid. infra). This can be achieved by means of an internal or an external procedure leading to a
court resolution establishing liability, or, normally for lesser offences, by an order to undo the harm caused. The fact that an insolvency representative is ordered to amend or to compensate the damage does not necessarily imply that s/he must be removed from office. That should depend on the relevance of the damage caused.

• The insolvency representative may be subject to sanctions due to misbehavior. Sanctions can be imposed in parallel to removal or liability. It is frequent that removal from office brings along the temporary suspension of the possibility to act as insolvency practitioner. Other types of sanctions are, for example, the loss of the right to remuneration or the payment of sums of money (not corresponding to the damages caused) to the insolvency estate. Finally, insolvency representatives may also be disqualified from holding office in the future as a result of a disqualification order issued by the court or by an external body legally empowered to do so.

Control by external bodies

70. Self-regulatory organizations or public bodies in charge of insolvency matters may exert control over insolvency representatives during the latter’s performance within the frame of each insolvency proceeding as well as over their general professional activity (and having regard to no specific procedure). It is also possible to envisage an independent private body (sometimes referred to as an ombudsman), funded by the registered practitioners, which may, at the request of the parties, exert control over insolvency representatives.

71. The external control over the insolvency representative’s performance in a specific insolvency proceeding is less adequate in two cases: (a) if the external body is a self-regulatory organization, of which the practitioner is a member, the interest of the parties may not be sufficiently defended (or at least it may so appear); and (b) if the body is a public body, then there would be a duplication of public resources, since the court will almost invariably be involved in the procedure. Typically, these two types of bodies determine sanctions applicable to insolvency practitioners for misbehavior while in office when the Law does not assign the competence to the court. The objections do not stand when there is an independent private body that controls practitioners. There is a recent tendency towards this model of independent external body.

72. Self-regulatory organizations and public supervisory bodies may be the most appropriate controllers regarding the general activity of insolvency practitioners. They may supervise the general performance of the practitioner considering all the cases in which s/he has acted, control the compliance with standards of quality, dedication and independence, the adequacy of the infrastructure used (staff,
material, etc.), etc. This may be done by creating general duties of information (periodic reports, etc.) or by inspections carried out by special groups within the bodies for that matter.

73. A detailed review of these matters is to be found in comment to D7.

V. ACCOUNTABILITY AND LIABILITY OF INSOLVENCY REPRESENTATIVES

74. The insolvency legislation should specifically address the issue of the insolvency representative’s liability. A lack of specific regulation would imply that the insolvency representative be subject to the different regulations of liability embodied in the country’s general laws (contractual liability, tortious liability, administrative liability, etc.). Such an absence of specific regulation may make the system suffer from an inconvenient lack of certainty.

75. The system of personal liability of insolvency representatives is one of the most important – and difficult – issues when drafting an insolvency law, for it may influence the representative’s behavior. The law must seek a balance between a system that is too stringent and one that is excessively lenient. Strictness may make the representative prone to an extremely conservative, risk-adverse attitude that would hamper the maximization of the estate, whereas leniency – especially if coupled with a results-driven remuneration system – would pave the way for a risky administration that is incompatible with the transitory situation of a business undergoing insolvency proceedings. Having recourse to bonds or insurance softens the relevance of the system of liability, but only to a certain extent.

76. The following paragraphs will make a brief reference to the liability of administrative representatives as well as to the bond/insurance system.

1. THE DUTY TO COMPENSATE DAMAGES

77. The array of duties inherent to the legal position of insolvency representatives stems from different sources: insolvency law creates the vast majority of the duties, but the representative is also typically bound by duties originating in tax legislation, or, as an officer involved in the administration of a business (as administrator or supervisor or a debtor in possession), duties arise in general civil law (contractual duties, tort law, company law), etc. The breach of each of those different duties is capable of triggering different types of liability. It is therefore normally the case
that the regulation of the liability of insolvency representatives involves different laws. A good insolvency law should not only regulate the liability originated by the breach of insolvency-based duties, but it should also provide for a coherent framework that incorporates and coordinates the other sources of responsibility. The framework should unify legal aspects of regulation such as court competence, statutory limitations, etc.

78. Insolvency representatives, when – directly or indirectly – administering the insolvent business, act on behalf of the estate. The immediate effect of their actions takes place directly between the debtor’s business and the third party with whom a legal relation (contractual or not) is established. In this regard, the insolvency representative, by mandate of the law (independently of who has appointed him/her, as powers derive from the law, not from the appointment) occupies a position typical of those that act for others (similar to agents, trustees or even “organic representatives,” such as company directors), and is a third party to the contract/legal act. This explains why insolvency representatives should normally not be made liable to third parties for liabilities incurred by the debtor (even if administered by the representative) in the ordinary course of business. When the representative enters into a contract on behalf of the insolvent company (openly acting as insolvency administrator of the insolvent company), damages accruing from that relationship should only be compensated by the insolvency estate, not by the representative. This assertion is only valid as long as the representative does not voluntarily assume a position that can render him/her personally liable (such as when, for example, the representative has concealed information from the counterparty, or placed himself in front of the counterparty as guarantor of the obligation). Although something similar may be asserted regarding tortious liability incurred while administering the insolvent business, in the case of torts there is a higher ground to render the representative jointly liable with the estate. However, and in order to protect the market, some States expressly make the insolvency representative liable if, either directly managing the business or, to a lesser extent, supervising administration, s/he enters into new deals when he knew (or is deemed to have known) that compliance would no longer be possible.

79. There should be provisions by which creditors and other interested parties can be recompensed in the event of fraud, defalcation or other malpractice. But a proper system of liability must not only consider intentional damage: insolvency representatives should also be made accountable for breaching their duty to act with due care. The standard of care may depend on the model of insolvency administration as a whole. If the insolvency representative is a civil servant appointed by the public administration, the general system of liability for the acts of
public employees may be applicable.\footnote{In some countries there is a system of objective liability, whereby damage caused by a public employee acting in his/her official capacity triggers the public duty to compensate, even if there was no negligence involved.} If the insolvency representative is a private practitioner appointed by the court (or by a public body), the standard of care may also differ to where the appointment is done by creditors in a market-based model. In most countries, the insolvency representative is expected to act with a professional standard of care, and his acts are to be tested against the general standard of care expected of an average insolvency professional (i.e., the application of the *bonus pater familias* standard to the activity of a professional: an insolvency representative will be deemed to have acted negligently when an average insolvency representative acting with care and skill would not have done the act). Normally, liability is triggered by negligence (*culpa leve*), not by gross negligence (*culpa levissima*). However, in some systems the degree of expected diligence is raised to the standard expectable from a professional having the qualities equal to those of the concrete insolvency practitioner (*quam in suis*). The systems that feature the higher standard of care usually have a system of appointment by creditors and the possibility to remunerate the practitioner according to the subjective circumstances (market value considering experience, sectorial knowledge, special skills, etc.).

80. Whatever the model, it must be borne in mind that the insolvency representative is a temporary manager, that directly or indirectly manages a business (*rectius, a estate*) until the debtor and its creditors reach an agreement or the business is transferred or wound up. The assessment of the insolvency representative’s activity should not be done with regard to the decisions that can be expected of a company director, even if the representative is in possession of the business. An insolvency representative should be expected to maximize the value of the estate, but it should do so observing a cautious approach to decisions. During the duration of the insolvency proceedings, no investment should be done that involves a high degree of risk.

81. Finally, the liability of insolvency representatives should be judged taking into account all the circumstances accruing in the case, including the situation of the business, the quantity of reliable information available as well as other procedural relevant facts such as – and above all – if the act that caused the damage had been decided after the authorization of the court or of creditors.\footnote{Certainly, the fact that a harmful action performed by the insolvency practitioner had been previously authorized by the court or by creditors does not by itself exclude liability, but it should have relevance when assessing if there had been negligence.}
82. When regulating the insolvency representative’s liability, some States differentiate between liability for damage caused to the estate and liability for damage directly caused to one of the parties to the insolvency proceedings (or, more generally to other relevant stakeholders).

83. When the insolvency representative causes damage to the estate and all the other requirements necessary for liability are met, a claim for compensation of damages is automatically originated as an asset of the insolvency estate. In some countries, the standing to sue during the insolvency procedure is given to the insolvency practitioner that replaces the representative that caused the damage (or, if not removed, the judge appoints an interim insolvency representative for the purpose of the action), and only once the insolvency proceedings are terminated may other interested parties sue. In other countries, the action can be exercised by the debtor, the creditors or even other stakeholders during the insolvency procedure and thereafter.\(^{25}\) There are also systems that combine both solutions. In any case, the success of the action will imply the payment of the compensation to the insolvency estate, not to the plaintiff. It must be noted that legally assigning the parties (and stakeholders) the standing to sue for damages caused to the estate during the insolvency procedure may create certain risks: on the one hand, it confers on the parties an individualistic instrument to influence the insolvency representative’s behavior, which can – and many times is – used improperly to threaten the officer; on the other hand, it is, by itself, an inefficient system of responsibility, for those with the right to resort to it (the debtor, individual creditors, other stakeholders) will only benefit from its success to a limited extent (if they will at all), since the monies payable as compensation would swell the assets of the estate, and they would only receive their share according to their standing in the hierarchy of the insolvency procedure. This is why, if the parties are given the right to sue in damages during the insolvency procedure for loss caused to the estate, standing should at least also be given to the insolvency administration that replaces the sued representative (or to another representative specifically appointed for the suit) in order to avoid the virtual non-existence of a system of responsibility.\(^{26}\)

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\(^{25}\) Note that, technically, at least in some jurisdictions (civil Law), the debtor, creditors and other stakeholders would not have standing to sue during the insolvency procedure unless specifically conferred by law. The reason is that a damage to the estate originates a claim in the estate itself (not directly in the estate of anyone else), and the administration of the estate is in the hands of the insolvency representative (as fiduciary of creditors in a collective procedure).

\(^{26}\) Creditors may not find enough incentives to sue an insolvency representative who negligently caused damage to the estate if they are risking the costs of the suit and likely fall-out with the sued representative, particularly where the proceeds of the suit may only benefit them partially (if at all). This scenario leads to the conclusion that only those creditors high up in the ranking of priorities may be interested in pursuing a suit; but those creditors are often secured creditors or large, sophisticated creditors, and the standing to sue would be giving them another instrument to influence a representative that should act impartially for the benefit of all creditors.
84. When the insolvency representative causes damages directly to a party (for example to a creditor by not safeguarding a secured asset or unduly leaving her out of the creditors’ list), the person who suffered the harm should be given a direct action against the officer, and the suit’s success would directly compensate the plaintiff.

85. One aspect of the regulation of the insolvency representative’s system of liability is the determination of the court competent to decide the suit. In most countries, jurisdiction is given to the insolvency court that has conducted the entire procedure (irrespective of whether it appointed the insolvency representative or not). Arguably, this solution adds certainty to the system, fosters procedural simplification and leaves the decision in the hands of the court that presumably will be most informed about the sued officer’s performance. However, practice shows that this might not always be the best solution. In those systems where the appointment and control of the representative is exercised by the court, and where the representative is not only conceived of as an auxiliary to the court but also has the duty (and the right) to request court-approval before executing certain acts, the relationship between the court and the representative may be too close for a fair decision on liability. In those systems where the representative – either de iure or de facto – is deemed to be “the eyes and the ears” of the court in the procedure, an action against the officer for damages should better be seen before a different decision maker (let alone those cases where the act that caused the damage had previously been authorized by the insolvency court).

2. Insurance

86. The insolvency representative will have in his/her possession, under his/her control or at his/her direction assets and funds of the debtor on behalf of the creditors. It is therefore appropriate that there should be arrangements in place to ensure compensation to the creditors (and the debtor or shareholders where there are assets and funds sufficient to first satisfy the creditors) in the event of loss occasioned by fraud, defalcation or by willful or negligent damage on the part of the insolvency practitioner. Those arrangements may be in the form of for example:

(a) general professional indemnity insurance;

(b) specific insolvency indemnity insurance;
(c) general or specific bond or guarantee underwritten by an approved insurance company or financial institution;

(d) compensation fund, financed by annual levies or calls on all insolvency representatives;

(e) restitution provision.

87. Debtor assets and funds in the hands of insolvency representatives may be substantial; and in determining the arrangements for insurance, bonding or a compensation fund, the adequacy of the cover needs to be kept under review. It has to be recognized that there is a particular risk with a compensation fund where there is a small number of insolvency representatives of limited size.